STRENGTHENING THE PROFESSIONALISM OF THE INDEPENDENT AUDITOR

Report to the Public Oversight Board
of the SEC Practice Section, AICPA

from the

Advisory Panel on Auditor Independence

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To All Interested Parties

On January 11, 1994, the Chief Accountant of the Securities and Exchange Commission delivered a speech at a gathering of accountants in Washington, D.C., in which he criticized independent auditors for "supporting their clients' incredible accounting proposals." He also stated that accounting firms are becoming "cheerleaders on the issue of accounting for stock options issued to employees."

In March 1993, the Public Oversight Board published a report, *In the Public Interest: Issues Confronting the Accounting Profession,* in which it also expressed concern for the independence and objectivity of the auditing profession.

Because of the gravity of the Chief Accountant's remarks—independence and objectivity are the *raison d'être* of the auditor—and its own professed concerns, the Board decided to appoint an Advisory Panel on Auditor Independence to assess the dimensions of the problem and recommend steps to bolster the professionalism of the independent auditor and to assess the working relationships among the profession, the SEC, and the FASB.

The persons asked to undertake this task were:

> *Donald J. Kirk,* a founding member of the Financial Accounting Standards Board who served for 14 years, 9 as chairman; presently a professor at the Columbia University Graduate School of Business and a member of the boards of directors and audit committees of several large enterprises; and earlier a partner of a major accounting firm. Mr. Kirk served as chairman of the Advisory Panel.
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> *George D. Anderson,* founder and retired head of Anderson ZurMuehlen & Co., a distinguished accounting firm in Helena, Montana; former chairman of the American Institute of CPAs; and a recognized leader of the accounting profession.
>
> *Ralph S. Saul,* formerly director of the SEC's Division of Trading and Markets and associate director of the SEC's Special Study of the Securities Markets; president of the American Stock Exchange and chief executive officer of CIGNA Corp.; and presently a director and audit committee member of several companies.

The Advisory Panel spent six months interviewing 77 professionals, business executives, attorneys, academics, and others who they thought could contribute to their inquiry. They reviewed 22 written submissions that they received in response to their requests, as well as numerous other reports and studies.

The Panel's report, which accompanies this letter, has been reviewed carefully by the Public Oversight Board. The Board believes it is an outstanding description of the most critical problems confronting the accounting profession and of related corporate governance issues. The Board believes that the report's conclusions are sound and must be heeded to avoid a further deterioration of confidence in the accounting profession and in the integrity of the financial information on which our economic system relies.

The report urges the accounting profession to look to the board of directors—the shareholders' representative—as the audit client, not corporate management. It calls for a direct interface between the entire board and the auditor at least annually, and an expanded interface with the audit committee.

To increase the value of the audit, the Advisory Panel calls for a new level of candor from the auditor. Auditors would not only apprise the board of what is *acceptable* accounting, they would be expected to express their views, as accounting experts, on the *appropriateness* of the accounting principles used or proposed by the company, the clarity of its financial disclosures, and the degree of aggressiveness or conservatism of the accounting principles and underlying estimates reflected in the company's financial statements.

That expansion of the auditor's responsibilities is a far-reaching, perhaps revolutionary, proposal, one that is responsive to complaints about "lowest common denominator" accounting principles often applied with "rose colored glasses."

These and the other important conclusions of the Panel, including those aimed at improving the relationships among the accounting profession, the SEC, and accounting standard setters deserve the careful study of all concerned with the integrity of financial reporting, auditing, and corporate governance processes in this country.

The report is a clear call for completion of a process that has long been developing and that has been presaged in reports of the Cohen Commission (1978) and the Treadway Commission (1987), among others. In it lies the hope for more credible, relevant, and meaningful financial information.

Very truly yours,

A. A. Sommer, Jr.
Chairman

TABLE OF CONTENTS

STRENGTHENING THE PROFESSIONALISM OF THE INDEPENDENT AUDITOR

I. PREFACE

In February 1994, the Public Oversight Board (POB) of the SEC Practice Section (SECPS) of the American Institute of Certified Public Accountants (AICPA) appointed a three-member Advisory Panel on Auditor Independence. The POB charged the Advisory Panel to determine whether:

> **the SEC Practice Section, the accounting profession or the SEC should take steps to better assure the independence of auditors and the integrity and objectivity of their judgments on the appropriate application of generally accepted accounting principles to financial statements.**

The Panel's observations and suggestions on those matters are set forth in this report.

MEMBERS OF THE ADVISORY PANEL ON AUDITOR INDEPENDENCE

Donald J. Kirk

Donald J. Kirk, Chairman

George D Anderson

George D. Anderson

Ralph S Saul

Ralph S. Saul

II. INTRODUCTION

Background

In March 1993, the POB published a comprehensive Special Report, *In the Public Interest: Issues Confronting the Accounting Profession*. That report contained 25 recommendations of specific actions to enhance the usefulness and reliability of financial statements, strengthen the performance and professionalism of the public accounting profession, including the ability of auditors to detect fraud and illegalities, and improve self-regulation.

In Chapter V of the Special Report, the POB expressed concern that the profession's objectivity, independence, and public responsibility would be compromised if, in the pursuit of client service, audit firms became advocates of their clients' positions in financial reporting matters. That concern resulted in the POB making three recommendations (V-3, V-4, and V-5) aimed at strengthening independence and professionalism and six others (V-6 through V-11) intended to improve financial reporting and corporate governance. Those nine POB recommendations relate directly to the work of the Advisory Panel and are reproduced in Appendix A to this report.

In a speech on January 11, 1994, the Chief Accountant of the SEC, Walter P. Schuetze, questioned the independence of accounting firms in situations in which they condoned or advocated what he called "incredible" accounting practices or were unduly influenced by client views in formulating positions on FASB proposals. The Panel's appointment was prompted by issues raised in that speech. Mr. Schuetze had made similar charges in an August 1992 speech. (Our analysis of the January 1994 speech is in Appendix B to this report.) The timing of Mr. Schuetze's speech less than a year after the POB's Special Report suggests that, in the view of the Chief Accountant of the SEC, the public accounting profession needs further examination.

The Panel's Approach

In accepting their appointment, the Panel members understood that their charge encompassed, but was not limited to, (1) assessing the working relationship among the SEC, the FASB, the auditing profession, and the business community and (2) identifying and evaluating steps to bolster the objectivity, independence, and professionalism of auditing firms.

Further, although the charge asks the Panel to identify steps that might be taken by three specific groups—the SEC Practice Section of the AICPA, the public accounting firms, and the SEC—some of the Panel's suggestions are directed beyond those three groups to corporate boards of directors and audit committees, corporate management, and the FASB.

Many of the concerns that the Panel has heard during its examination of auditor independence focus more on the perceived lack of *objectivity* of some auditors in their acquiescence, approval, and even advocacy of what critics believe to be questionable or inappropriate accounting principles and practices of their clients.

Consequently, this Report addresses questions about the *integrity* and *objectivity* of auditors to a greater extent than *independence*, although the three concepts are interrelated. Integrity is the basis for public trust. It requires the auditor to be honest and candid and never to subordinate principle or professional judgment. Objectivity gives value to the auditor's services. It requires the auditor to be impartial, intellectually honest, and free from conflicts of interest. Independence requires an auditor's freedom from both the fact and appearance of conflicts of interest.

In preparing this Report the Panel members have read prior studies and reports on the role of the independent auditor, solicited written comments, and interviewed many knowledgeable people, all identified in Appendix C. The Panel is indebted and grateful to all who volunteered their help in the course of this study.

The Panel has been ably assisted by Jerry D. Sullivan and Marcia E. Brown, Executive Director and Administrative Manager, respectively, of the Public Oversight Board, and by Paul Pacter, Professor of Accounting at the University of Connecticut's Stamford MBA Program. However, the views expressed herein are solely those of the Panel members.

The Panel has avoided the temptation to make a list of detailed recommendations, in part because of the comprehensiveness of the POB Special Report of March 1993, and also because the POB is better served by a less structured report. For those reasons, **the Panel's report takes the form of suggestions based on the numerous interviews the Panel conducted and Panel members' personal experiences in the business community and in various aspects of the profession. While several of the Panel's suggestions are fairly specific, most are broad in scope and intended to challenge and stimulate the profession and other participants in the financial reporting process to consider the long-range future of the profession and ways to bolster the independent audit.** While the Panel's observations and suggestions have been discussed in general terms with knowledgeable persons, this Report has not been exposed for comment prior to its submission to the POB. The Panel anticipates that the POB will give the suggestions in its report careful consideration before endorsing any of them or recommending any action to affected parties.

III. THE PROFESSIONAL ENVIRONMENT

The independent audit fills an essential role for the investing public and creditors by enhancing the reliability of corporations' published financial statements and giving assurance of that reliability to users of those financial statements. Conscious of its public responsibility, the profession has devoted considerable time and money to improving its performance as independent auditors. Over the past quarter century, numerous thoughtful studies of auditor performance have been conducted, many of which are listed in Appendix C. Based on those studies, important and in some cases dramatic structural changes have been made in the way professional standards are set and audits are conducted.

For many years, the profession has enjoyed public goodwill and confidence that remain its greatest assets. However, as the 1993 POB Special Report noted, public respect and confidence are jeopardized if the profession's integrity, objectivity, and independence are questioned. Recently, widely publicized allegations of audit failures and improper financial practices by companies, particularly, although by no means exclusively, those related to the "savings and loan crisis," have eroded the profession's goodwill and public confidence. Those assets can be further dissipated if the profession's audit services—the basis for its franchise—do not meet the needs of corporate boards, stockholders, creditors, and the investing public. As the POB Special Report stated, "attacks on the accounting profession from a variety of sources suggested a significant public concern with the profession's performance."

The profession is at a critical juncture. Even though great strides have been made in ensuring, through peer reviews, that the processes within firms for conducting an audit are of high quality, there are serious issues that remain to be addressed.

New and complex business arrangements and financial transactions have complicated the resolution of accounting questions, challenged the validity of old answers, and increased the risks of auditing. Audit risks also have increased because many industries are now subject to less government regulation. Moreover, information technology has changed the nature and complexity of companies' records and the speed and ease with which those records are produced and changed. Business failures generate wide media attention, litigation, enormous direct and indirect costs to taxpayers, and Congressional scrutiny of the accounting profession and standard setters. Fraudulent financial schemes, while rare, understandably make bold headlines and erode public confidence in corporate financial reporting.

The media, litigants, the Congress, and others often allege, rightly or wrongly, that audit failures contributed to many business failures. In that context, the public views audit failures as including not only the failure to discover and report material negative facts but also the failure of financial statements to serve as an adequate early-warning device for the protection of investors and creditors. Questionable accounting principles[1] or inadequate disclosure are regarded as contributing to audit failures.

The cost of real and perceived audit failures is immense. They have resulted in widespread skepticism about the objectivity of the profession even after the many steps taken to lessen the "expectation gap." They have also resulted in large monetary settlements and judgments and related costs that have made the major accounting firms virtually uninsurable. The risks associated with the auditing function have caused the major firms to manage their exposure more aggressively, for example, by turning down high risk clients and monitoring existing clients more closely. Those risks and competitive pressures have also caused the large accounting firms to encourage detailed accounting and auditing standards and clear guidance or consensus on how to apply them, thereby narrowing the scope of professional judgment that might be questioned by a litigant alleging a loss due to a negligent audit. One consequence has been that audits have become more compliance or rule-book oriented.

There seems to be a growing cynicism at the SEC about the performance of the public accounting profession. Perhaps as a result, the Commission's staff has been less restrained in bypassing established private-sector standard-setting mechanisms. The Commission's staff has used the registration process and the "bully pulpit" to identify what it believes are acceptable or unacceptable accounting practices, short-cutting the work of the FASB Emerging Issues Task Force (EITF). Perhaps sensing the politicization of the process for setting accounting standards, the business community has responded with enhanced and, at times, aggressive lobbying efforts for their preferred solutions with the FASB, with the accounting firms, and in Washington.

All of this has come at the same time as many of the larger firms have combined, spread out globally, and diversified the services offered to clients. Mergers, acquisitions, and restructurings in corporate America have severely aggravated competition among the Big 6 for larger clients. Firms have also decried the quality of undergraduate accounting education and either have not been able or have not chosen to hire graduates of traditional MBA programs. Firms have watched the skills and intellect of financial management staffs of some clients grow to rival those of the engagement teams servicing the client.

During the past decade, the corporate community has increased its involvement in the accounting standard-setting process. Many large companies now assign key people to monitor and influence the work of standard setters, particularly the FASB and the AICPA Accounting Standards Executive Committee (AcSEC). As a result of clients' increasing internal competence in accounting and auditing, the value of the external audit as perceived by corporate financial management is lessened, and the audit is sometimes viewed and priced as a commodity. Some commentators to the Panel observed that independent auditing has increasingly emphasized evidence-gathering and compliance with rules and has left the judgments about accounting policies and disclosure practices largely

[1]In this report, accounting principles include not only broad guidelines of general application but also detailed practices and procedures for implementing them.

to corporate financial managers. Financial managers aggressively control audit activity and costs and are in a position to orchestrate meetings of the external auditor with the audit committee and the full board of directors.

While accounting and auditing remain at the heart of public accounting firms' practices, the larger firms have become less reliant on revenues from this source and increasingly depend on consulting and other services, which carry higher margins and less risk and are more attractive to younger staff recruits. Studies show that the large public accounting firms today earn only about half of their revenue from auditing and accounting services, and some considerably less. Five of the top seven consulting firms in the United States and six of the top seven consulting firms worldwide are reported to be Big 6 firms. Some of the firms now think of themselves not as accounting and auditing firms but as multi-line professional service firms. Marketing materials and advertising present the firms to the world as business consulting organizations, not as auditors.

Overall, the Panel sees the foregoing trends as reducing the stature of the independent audit at a time when public skepticism about the credibility and reliability of corporate financial information has increased. Those trends chip away at the objectivity of the auditor and the value of the independent audit.

Strengthening the professionalism of the auditor requires an environment in which boards of directors and management of client companies have high expectations about the auditing firms' integrity, objectivity, and professional expertise and in which the auditor, in meeting those obligations, recognizes an overriding public responsibility. It requires an environment in which an auditor's professional services truly do add value and are not looked on simply as a regulatory requirement imposed on the company. It requires an environment in which auditors can pursue their professional activities without undue fear of liability and in which government and regulators balance their responsibilities for oversight against the need to let the profession function effectively in the private sector. These requirements are interconnected, and the future of the profession rests on coming to grips with each of them. However, there are no quick fixes—in the words of the POB's charge to the Panel— "to better assure the independence of auditors and the integrity and objectivity of their judgments on the appropriate application of generally accepted accounting principles."

IV. THE PANEL'S OBSERVATIONS AND SUGGESTIONS

The Panel was appointed by the Public Oversight Board of the AICPA's SEC Practice Section. Consequently, this report focuses on audits in the context of public companies. Nonetheless, many of the Panel's observations and suggestions are applicable more broadly to the entire independent auditing function of the public accounting profession. An auditor's integrity, objectivity, and independence should not depend on whether the audit client's securities are publicly traded.

The Need for Additional Rules or Legislation on Auditor Independence

In March 1994, the staff of the Office of the Chief Accountant (OCA) of the Securities and Exchange Commission published a comprehensive *Staff Report on Auditor Independence*. The OCA Report concludes:

> The OCA believes that the combination of the extensive systems of independence requirements issued by the Commission and the AICPA, coupled with the Commission's active enforcement program, provide to investors reasonable safeguards against loss due to the conduct of audits by accountants that lack independence from their audit clients. The enactment of detailed legislation or the promulgation of additional rules is not necessary.
>
> The OCA believes that further legislation or fundamental changes in the Commission's regulations are not necessary at this time for the protection of investors. [page 55]

The SEC and AICPA independence rules and interpretations focus on and guard against relationships that create the fact or perception of a conflict of interests between auditor and client. The Panel has found no evidence of a need for actions by the SEC or by the AICPA to add to or amend the extensive existing body of rules and regulations relating to auditor conflicts of interest. There is, of course, an ongoing need to keep those rules and regulations up to date to reflect changes in the business environment. The Panel also concurs with the view of OCA that further legislation is not necessary for protection of investors.

The OCA Report discusses whether the SEC should adopt a rule mandating periodic rotation of accounting firms conducting the audits of the financial statements of public companies. The OCA staff concludes that the Cohen Commission finding that the cost of mandatory rotation would exceed the benefits is still valid. The OCA Report states that "[t]he SECPS requirement for a periodic change in the engagement partner... when coupled with the... second partner review" is effective and that "a well-informed, independent audit committee may be in the best position to decide when the benefits of a change in auditors outweigh the costs" (page 54). It also should be noted that the SECPS recently reconsidered the mandatory rotation question and, in March 1992, issued a report, *Statement of Position regarding Mandatory Rotation of Audit Firms of Publicly Held Companies*, making a case in opposition to mandatory rotation. **The Panel concurs with the conclusions of the Cohen Commission, OCA, and SECPS reports that a rule mandating the rotation of audit firms is impractical and not needed because of the significant costs and questionable benefits and because of other safeguards presently in place, such as partner rotation and second-partner review.**

The OCA Report also discusses whether the performance of management advisory services (MAS) by auditors has an impact on auditor independence. After analyzing the nature and magnitude of such services performed by the firms, the Report concludes that "the lack of an apparent, dramatic increase in MAS provided to SEC audit clients, however, suggests that a fundamental change in the Commission's regulations is not necessary at this time" (page 34).

The Panel was not specifically charged with assessing the appropriateness of non-audit services offered by firms. Those services and their impact on firms' independence have been the subject of many earlier studies. A report prepared by the Big 6 accounting firms, "The Public Accounting Profession: Meeting the Needs of a Changing World" (January 1991), suggested a new framework for defining independence. That proposed framework, which was rejected by the SEC staff and not adopted by the profession, downplayed concerns about the appearance of conflicts of interest in arrangements with clients. For example, the report stated: "Business relationships between public accountants and audit clients do not impair independence as long as they result from the ordinary course of business and are not material to either party." That position fails to recognize the special responsibilities of the independent auditor and the importance of avoiding the appearance of a conflict of interest. The position of the Big 6 firms in that report was that "all services delivered under the umbrella of a public accounting firm are subject to the same high professional standards of objectivity, integrity, competence and due professional care required of audit services." However, the public responsibilities of the independent auditor hold the independent audit to an even higher standard.

While the existing conflict-of-interest rules and the various mechanisms for improving those rules are appropriate and adequate, there are important steps that should be taken in other ways to enhance the objectivity and strengthen the professionalism of independent auditors. The balance of this report sets forth the Panel's suggestions for achieving those goals.

Independent Auditing Imposes Special Responsibilities on Accounting Firms

The Role of Auditing in Public Accounting Firms

In *United States v. Arthur Young & Co.*[2] the Supreme Court of the United States described the independent audit as a "public watchdog" function and noted that "if investors were to view the auditor as an advocate for the corporate client, the value of the audit might well be lost." The growing trend to view client service as the objective of all firm activities runs the risk of failing to recognize the unique responsibility that attaches to the audit function. Client service can easily be equated with serving the management of the corporate client, for example by searching for imaginative analogies to get an accounting result desired by the management. The Panel recognizes that the AICPA's Code of Conduct expects CPAs to "serve the public interest," "honor the public trust,"

[2] *United States* v. *Arthur Young & Co.*, 465 U.S. 805 (1984).

and be objective in all their activities. Therefore, **firms need to emphasize to all professional staff, many of whom are not yet CPAs and may not have read the Code, that auditing is not just one of many services offered to clients. It is special. It involves a "*public* responsibility transcending any employment relationship with the client."**

The Panel finds worrisome the trend of accounting firms, in wanting to grow, to add or expand nonaudit services and thereby reduce their reliance on and the relative importance of auditing. The increasing fact and threat of litigation in the absence of meaningful tort reform, along with competition and fee-cutting, have made auditing less and less financially attractive. Auditing is also beset by such personnel issues as a declining percentage of the best and brightest college graduates going into the accounting profession and the unattractiveness of beginning assignments in audit activity.

Growing reliance on nonaudit services has the potential to compromise the objectivity or independence of the auditor by diverting firm leadership away from the public responsibility associated with the independent audit function, by allocating disproportionate resources to other lines of business within the firm, and by seeing the audit function as necessary just to get the benefit of being considered objective and to serve as an entrée to sell other services.

Further, by creating specialties along industry lines, large firms have sought to be in a better position to market their services to potential clients and to audit existing clients more effectively. However, industry specialization has a downside. It may result in a loss of objectivity if the specialists get so close to the industry that they fail to challenge industry practices that fall short of providing the most relevant and reliable accounting information. The Panel believes that, in addition to the more focused industry expertise, the accounting and auditing judgments that arise in audit engagements require that broader expertise be brought to bear, for example, through consultation with the accounting firm's national technical office.

The independent auditing firms need to focus on how the audit function can be enhanced and not submerged in large multi-line public accounting/management consulting firms. To do that may require that firms' senior management rethink their organization structures and business strategies. The regulators and overseers of the accounting profession should support the profession's efforts in this regard.

Organization of the Firms' Technical Accounting Functions

Two of the principal functions of an auditing firm's technical accounting office are to respond to accounting questions from client service personnel and to develop firm positions on accounting questions under consideration by the FASB, the SEC, or other accounting standards bodies or professional committees.

Internal Consultations

In its 1993 Special Report, the POB found in their review of alleged audit failures that "in too many cases, however, the preference of client management—influenced at least in part by objectives other than producing the most reliable financial reporting possible in the circumstances—nevertheless prevailed over the preference of the auditing or consulting partner."

Firms have tightened internal controls over technical accounting advice given to practice office partners. While no single form of structure or process is necessarily suitable for all firms, the objective in all cases should be a coordinated system that insures that disparate answers are not given to similar questions and that internal consultations take place on troublesome questions.

The importance of firms' internal consultation procedures is underscored in the following communication distributed to partners by the Senior Partner of Price Waterhouse:

> Part of my job as Senior Partner is to get involved when some sort of serious client service issue arises, and, lately, I've become involved in several troublesome situations where we've strayed down a path *thought* to be that of responsive client service. So let me briefly re-emphasize what outstanding client service is *not*.
>
> Clients can and do become aggressive and demanding about wanting us to approve a particular treatment. But outstanding client service *does not mean* stretching rules beyond sound professional practice to satisfy a client whim—for, often, this leads to future problems for the client and the firm. It does not mean compromising our credibility with the SEC, IRS, or other regulatory bodies by championing a questionable client proposal that goes beyond the bounds of sound, reasonable practice. It does not mean going along with a client's too aggressive stance in an audit situation, rationalizing that there's an offsetting item elsewhere in the accounts; going way out on a limb in approving a tax treatment in order to please a client for the moment; bending too far in supporting a client's arguments—or its attorney—in a DA&CR [dispute analysis and corporate recovery] engagement; or cutting corners in a consulting engagement to meet unrealistic deadlines or budgets. Such activities not only demean us professionally, they really don't help the client, and certainly not the firm, in the long run.
>
> I know how tough it can be out there. That's why we need to share the tough decisions with each other. In addition to easing the pressure on us as individuals, it makes it easier for us to arrive at the best professional decision. So as I've said many times before: Don't feel you have to go it alone—consult with your partners when you're confronting those tough calls.

Public accounting firms should adopt mechanisms that ensure that (1) their national technical offices are independent of practice partners who feel the direct pressure from client companies; (2) the standard to which the national technical office personnel should be held in advising engagement partners is not just "what practices are acceptable" but "what is the most appropriate accounting in the circumstance;" (3) client accounting positions are not brought before the SEC until that consultation has taken place; and (4) full information about the facts and circumstances has been made available to the national technical office.

The importance of internal consultation on accounting matters was recognized by the POB in their recommendations V-5, V-7, and V-8. The Panel concurs with the thrust of those recommendations and has more to say, later in this report, on the subject of the appropriateness of accounting choices and accounting estimates.

Submissions to the FASB and the SEC

All of the large public accounting firms participate actively in the development of accounting standards, and all have adopted internal procedures for reaching positions taken in submissions to the FASB and the SEC. At the same time, the business community, The Business Roundtable, and other industry associations have become increasingly organized and effective in lobbying the standard setters and their auditors.

Developing positions for submission to the FASB, the SEC, and AcSEC is part of an accounting firm's public responsibility. Therefore, it is essential that the firm's internal organization and processes for developing those positions be insulated from undue pressure from or on behalf of clients. In addition, communications about firm positions on FASB proposals must be done in a judicious, professional way that does not appear to curry favor with clients or appear to be part of an organized campaign. Client-related motivations, or even the appearance thereof, in reaching or communicating accounting policy decisions can contribute to a decline in the integrity, objectivity, and professionalism of public accounting firms and in public respect for the profession. More is said on this subject later in this report under the heading of "Responsibilities of Accounting Firms in the Standard-Setting Process."

POB Recommendations V-3, V-4, and V-5 address matters of client advocacy and recognize that special care is needed to ensure that accounting firms' "participation in the standard setting process is characterized by objectivity and professionalism." The Panel endorses those recommendations and strongly supports the POB's suggestion that standard setters and leaders of the profession regularly discuss issues related to client advocacy.

Accounting firms should give careful thought to their policies and procedures for participating in the establishment of professional standards. In that regard, the Panel commends an approach similar to that expressed by Deloitte & Touche:

> ...We weigh the issues and alternatives and form our conclusions about the potential effectiveness of proposed standards in improving the relevance and reliability of financial reporting. In evaluating input received from clients and others, we recognize that virtually every proposed professional standard will be perceived negatively by some clients and that many proposed standards will be viewed favorably by some clients and negatively by others. While it is important to understand the basis for concerns others may have about a proposed standard, and to give appropriate thought to those views, our positions reflect the independent view of our Firm and not merely a consensus of the views of many diverse interests.

There are different ways to translate that type of policy into action. Arthur Andersen & Co., for example, has had a recognized tradition of developing a consistent and well-regarded body of firm-wide professional positions along with the courage to defend those positions even if they are unpopular. Some attribute that tradition to the firm's own "conceptual framework" of financial reporting. Others cite a "tone at the top"—a willingness to defend what the firm believes is the best answer for users of financial statements even in the face of organized preparer opposition. Whatever the cause, the result is worthy of emulation.

The Panel recognizes that the SECPS peer-review process expressly includes a review of the firm's internal controls over its technical accounting consultation function. A firm's process for developing firm positions on technical accounting and auditing standards matters is more difficult to review. The POB and the SECPS should consider whether the POB's oversight or the peer review process can be strengthened in this regard. **Through its oversight of the peer review process, the POB should identify effective policies and procedures that accounting firms have adopted for internal technical consultation, for providing technical guidance to professional staff, and for developing firm positions on technical standards. The POB should encourage adoption of those "best practices."**

Strengthening the Relationship Between the Board of Directors and the Independent Auditor

<u>Responsibilities of Boards of Directors</u>

One important result of the litigation stemming from the corporate takeovers and business failures of the 1980s has been the rise in power of corporate boards of directors and a growing recognition by large institutional shareholders of their obligation (and power) to monitor diligently the performance of boards of directors as the shareholders' elected representatives. Judicial decisions were the principal catalyst for those changes, with added impetus from several legislative and regulatory initiatives. Over the past decade, the dominance of the process of corporate governance by management has ebbed as boards of directors have assumed the long-acknowledged but seldom-practiced role as "the fulcrum of accountability" in the corporate governance system.

Ira Millstein (Senior Partner at the law firm of Weil, Gotshal & Manges and a nationally recognized expert on corporate governance) has described the new challenge to the board under the evolving governance system as follows:

> The board's challenge is to stay sufficiently informed of current performance, to be concerned with the future of even apparently great companies, to know when it is time to change, and to be sufficiently independent to make the change.
>
> Additionally, CEOs should recognize that the best defense against shareholder misunderstanding—which today is a serious threat to a CEO's tenure—is the existence of a strong independent board. This board must be in a position to "certify" to shareholders—especially institutional shareholders—that the CEO is evaluated regularly, and is doing what the board expects, according to a strategic plan agreed to in advance by the board and the CEO.

A similar point of view has been expressed by Martin Lipton (Partner at the law firm of Wachtell, Lipton, Rosen & Katz) and Jay W. Lorsch (Senior Associate Dean of the Graduate School of Business Administration, Harvard University), also nationally recognized experts in corporate governance:

> Corporate governance in the United States is not working the way it should. The problem is not the system of laws, regulations, and judicial decisions which are the framework of corporate governance. It is the failure by too many boards of directors to make the system work the way it should....
>
> This state of affairs suggests clearly to us that more effective corporate governance depends vitally on strengthening the role of the board of directors.

Lipton and Lorsch cite lack of time, unwieldy board size, complexity of information, lack of cohesiveness, the power of top management, and confused accountabilities as the principal "constraints on the board's role as an effective monitor." They make a number of proposals that companies could adopt unilaterally and in their own self-interest, without regulation or legislation, including a ratio of at least two outside directors for each management director, reduced board size, increased frequency and duration of meetings, improved information, a program for regular evaluation of corporate performance and that of the CEO, and regular meetings with groups of institutional shareholders. All of those recommendations are intended to strengthen the accountability of the board to the shareholders.

In some companies, the chairman of the board of directors is an independent nonmanagement director. In most companies, though, the chairman is also the chief executive officer of the company, a member of management. Two evolving trends in the governance of companies whose board chairman is also the CEO are (1) more frequent meetings of the outside directors without the presence of any insiders and (2) the identification of an outside director as "lead director"—to serve as the leader of the outside directors and as their liaison with the CEO on matters in which the outside directors may have a special interest, such as what information the outside directors receive and the agenda of board meetings. The Panel endorses the lead-director idea not only to bolster independence of directors and board committees but also to provide a link between the independent auditor and the outside directors on matters that the auditor believes should be considered by a larger group of nonmanagement directors than only those serving on the audit committee. Strengthening the independence of the outside directors should reinforce the objectivity and independence of the auditor.

The Panel urges the Public Oversight Board, the SEC, and others to encourage the adoption of proposals, such as those cited above, to enhance the independence of boards of directors and their accountability to shareholders. Stronger, more accountable boards will strengthen the professionalism of the outside auditor, enhance the value of the independent audit, and serve the investing public.

Role of the Board and Its Audit Committee

Today, in most companies, the auditor's interaction with the board of directors is through the board's audit committee. The audit committee assists the board in fulfilling its oversight responsibilities in the areas of financial reporting, internal controls, financial policies, and the independent and internal audit processes. While it is certainly appropriate and effective for the board to delegate those responsibilities to the audit committee, the Panel believes that the auditors can add to the effectiveness of the board in monitoring corporate performance on behalf of the shareholders without detracting from the important role of audit committees by direct involvement with the full board and particularly its independent directors.

The importance of the role of audit committees is well documented. For over 50 years, the SEC has recommended that companies form audit committees of independent directors—a recommendation that the Panel believes is even more important today. The SEC strengthened that recommendation during the 1970s with required disclosure in proxy materials of the existence, composition, and responsibilities of those committees. A number of "blue ribbon" studies not only in the United States but also in Canada and the United Kingdom have made recommendations to strengthen the functioning of audit committees. And the POB Special Report made three specific recommendations with respect to audit committees (recommendations V-9, V-10, and V-11, set forth in Appendix A).

A comprehensive study, *Improving Audit Committee Performance: What Works Best*, that was prepared last year for the Institute of Internal Auditors, identified organizational and operating practices that enable audit committees to function more effectively. The study noted:

> Highly publicized frauds and business failures involving the culpability of executive management have raised questions about the adequacy of corporate governance. The credibility of financial reporting is also being questioned. It is important for all parties involved in the financial reporting process to help close the credibility gap by reexamining their roles in the process. Audit committees play a key role in assuring the credibility of financial reporting by providing, on behalf of the board of directors, oversight of the financial reporting process as well as internal controls. It is vital, therefore, that they function effectively. [page 1]

The report notes that the effectiveness of audit committees is affected, first and foremost, by the expertise of members of audit committees in the areas of accounting and financial reporting, internal controls, and auditing:

> The single most important finding, and the key to audit committee effectiveness, is background information and training. Audit committee members must be provided with more background and training to enable them to be more effective. Management, internal auditors, and independent accountants are identified as sources of this information. [page 2]

The Panel recognizes that time availability and committee members' backgrounds constrain what an audit committee can do. For that reason, the Panel would not encourage that specific responsibilities be placed on audit committees through legislation or regulation (such as the Federal Deposit Insurance Corporation Improvement Act of 1991[3] or the legislation recently proposed that would establish audit committee responsibility to investigate financial derivatives transactions). Legislated responsibilities would tend to make the audit committee compliance-oriented rather than shareholder-oriented. **Instead of legislating how audit committees should function, the Panel would place responsibility on the independent auditor to be more forthcoming in communicating first with the audit committee and then with the full board.**

The Panel believes it essential that the full board and particularly the independent directors have more exposure to the outside auditor to assist the board in meeting its responsibilities to shareholders. The independent auditor can provide the board a wide and objective

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[3]The Panel finds troublesome certain provisions of that Act that impose specific auditing and reporting procedures on independent auditors of insured banks and impose specific duties on audit committees. The Panel acknowledges that those provisions of the law were well intentioned but is concerned that imposing auditing and reporting procedures and board responsibilities by law can undermine the professionalism and independent judgments of outside auditors and boards of directors by making the audit function compliance oriented. The Panel is also concerned that this might be "the camel's nose under the tent" with regard to legislating auditing and reporting procedures and board responsibilities.

perspective of the company's operations as well as its financial reporting policies and practices.

As the shareholders' representative, the board is accountable to them for monitoring the company's performance in achieving its goals and plans. That accountability is discharged, in part, by ensuring that shareholders receive relevant and reliable financial information about the company performance and financial position.[4] The board should expect the auditor to assist it in discharging that responsibility to the shareholders, and the auditor should assume the obligation to do so. Therefore, the full board needs to have direct exposure to the auditors at least once a year prior to reappointment of the auditor.

The involvement of the auditor with the full board of directors is not intended in any way to bypass the audit committee or to replicate the committee's work at the full board level. The committee would continue to review with the auditors the details of the company's financial statements, management's discussion and analysis [MD&A], other financial data and systems, and audit findings and judgments related thereto. It is the intention of the Panel's suggestions that audit committees would report the auditor's views at meetings of the full board and would ask the auditor to be present at such meetings as frequently as necessary, but at least once a year.

The audit committee should:

- **expect the auditor, as an expert in accounting and financial reporting, to express independent judgments about the appropriateness, not just acceptability, of the accounting principles[5] and the clarity of the financial disclosure practices used or proposed to be adopted by the company;**

- **hear directly from the auditors on whether management's choices of accounting principles are conservative, moderate, or extreme from the perspective of income, asset, and liability recognition, and whether those principles are common practices or are minority practices;**

- **be informed of the auditor's reasoning in determining the appropriateness of changes in accounting principles and disclosure practices;**

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[4]Relevance and reliability are identified as the two key qualities of financial information in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*. The opening sentence of the November 1993 report, *The Information Needs of Investors and Creditors*, of the AICPA Special Committee on Financial Reporting (Jenkins Committee), states: "Investment and credit decision making based on information that is less than timely, relevant and reliable inevitably leads to unfulfilled expectations about financial reporting and less effective capital markets."

[5]As noted earlier in this report, accounting principles include not only broad guidelines of general application but also detailed practices and procedures for implementing them.

- **be informed of the auditor's reasoning in determining the appropriateness of the accounting principles and disclosure practices adopted by management for new transactions or events;**

- **be informed of the auditor's reasoning in accepting or questioning significant estimates made by management;**

- **be informed of and discuss the appropriateness of all new accounting principles and disclosure practices on a timely basis;**

- **discuss with the auditor how the company's choices of accounting principles and disclosure practices may affect shareholders and public views and attitudes about the company; and**

- **review the auditor's fees to insure that they are appropriate for the services they render.**

The auditors' reviews with the audit committee and with the full board at least once a year would help provide a basis for the committee to recommend to the board, and for the board to recommend to the shareholders, the appointment or ratification of the auditor for the new fiscal year.[6]

<u>**Responsibilities of Auditors to the Board**</u>

In *United States v. Arthur Young & Co.*, the Supreme Court of the United States concluded that the independent public accountant "owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust."

While "public watchdog" is an apt description of the auditor's public interest responsibility, the Panel does not believe that it is useful or workable, for purposes of defining the auditor-client relationship, to say that "the public" is the auditor's true client. Nor is it practical for "the shareholders" to be the auditor's client, though clearly, as noted by the FASB in its conceptual framework, investors and creditors are the key user groups to whom corporate financial reports are directed and, therefore, the principal beneficiaries of the audit.

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[6]Though not a specific legal requirement, it is a widespread practice among publicly traded companies to ask shareholders to approve the selection of independent auditors or to ratify the prior approval by the board of directors. The proxy rules do require disclosure, in proxy statements for annual shareholders' meetings, of the identity of the auditing firm proposed for the current year, a change of auditor from the prior year and whether such change was approved by the board or audit committee, disagreements with the auditor, and whether representatives of the current and prior year auditing firm will attend the annual meeting.

Unfortunately, the auditor's public responsibility can be undermined when financial management becomes the primary intermediary between corporations and auditing firms. As one observer noted, financial management has, at times, "captured the auditors." That situation should be changed. By no means is the Panel advocating that the auditor-client relationship become adversarial. On the other hand, too close a relationship between the auditor and management can inhibit independent judgments.

In most companies today, management selects or recommends auditors and changes in auditors, negotiates fees, guides the audit, prepares the financial statements, selects accounting principles, and makes estimates. Clearly, a smooth working relationship between auditor and management is important, but there is a downside. Too close a relationship can discourage the auditor from speaking up if the auditor questions the accounting principles selected, the clarity of disclosures, or the estimates and judgments made by management. Such a relationship can inhibit or foreclose the auditor from openly communicating with the board of directors or audit committee.

The Panel believes that it is essential for the accounting profession to bring greater clarity to the issue of who is the auditor's client. The board of directors, as the representative of the shareholders, should be the client, not corporate management. Boards, particularly independent directors, and auditors are, or should be, natural allies in protecting shareholder interests. The auditor should be brought into the mainstream of corporate governance.

The trend in corporate governance is to hold the board more accountable to shareholders and management more accountable to the board. Clarifying the role of auditors in helping the board exercise its responsibility would place the management-auditor relationship back in balance. Shareholders and boards should expect auditors to challenge management's views on accounting principles, disclosure practices, and accounting estimates and to inform the board about how shareholders' interests are affected by management's accounting choices within the range of acceptable practice.

Independent auditors have not played a forceful role in assessing and communicating about the clarity of the disclosures and the appropriateness of the accounting principles adopted and estimates made by their clients. **Independent CPAs are licensed as auditors and experts on accounting and financial control matters. They should be willing to express their views as experts to the audit committee and the full board of directors about the appropriateness of the accounting principles and financial disclosure practices used or proposed to be adopted by the company and, particularly, about the degree of aggressiveness or conservatism of the company's accounting principles and underlying estimates and the relevance and reliability of the resulting information for investment, credit, and similar decisions.**

Several of the foregoing recommendations entail discussion of accounting principles by the auditors with the audit committee and the full board. In making those recommendations, the Panel is not addressing the nature or degree of detail of the formal guidance that should be provided for making accounting choices and accounting estimates or whether the range of choices should be limited. Those are matters for the accounting standard setters. Nor are the Panel's recommendations intended to change, in any way, the auditor's obligation to speak out if it is the auditor's professional judgment that a chosen accounting principle or estimate is outside the bounds of acceptable practice.

What the Panel is seeking is an open dialog between the members of the board and the auditor regarding the particular choice that was made within the range of acceptable practice—how that choice affects the relevance and reliability of the company's reported financial data and, ultimately, how that choice affects the shareholder and public views and attitudes about the company.

Under the Panel's approach, the auditor would not only evaluate the company's compliance with generally accepted accounting principles but also express, to the audit committee and the board of directors, a qualitative judgment about the company's choices of principles, disclosures, and estimates. For years, the auditing standards have required the auditor to judge whether the accounting principles selected and applied are "appropriate in the circumstances." The standard to which the auditor has been held in making that judgment has been whether the selected principle falls within the range of acceptable practice. The Panel would hold the auditor to a different standard in communicating with the board of directors.

The Panel also believes that the audit committee, the board, and the auditor need to have an *earlier* involvement in accounting questions than is often the case today. Management should recognize its obligation to bring new transactions and proposed new accounting policies to the attention of the auditors, the audit committee, and the board while they are being contemplated, not after the fact or after financial information based on those transactions or policies has been released publicly. Candid discussion between management and the auditors may lead to complete agreement about the most appropriate practices to recommend to the board or may, in some cases, define differing views of management and the auditing firm. In making this suggestion, the Panel does not intend to imply that any changes in auditing standards for field work or reporting are needed but, rather, simply wishes to encourage more timely, more frequent, and more open communication between the board and the auditor.[7]

The Panel's suggestions are intended to help the board of directors fulfill its responsibilities to the shareholders—responsibilities in which the board and the

[7]A possible exception relates to Section 380 of the current auditing standards, which requires communication to the audit committee "about the process used by management in formulating particularly sensitive accounting estimates and about the basis for the auditor's conclusions regarding the reasonableness of those estimates" (AU 380.08). There is no comparable requirement for reporting on the rationale for and the auditor's conclusions regarding "the initial selection of and changes in significant accounting policies or their application" (AU 380.07). While most of the suggestions that the Panel makes in this report are in the form of encouragement and expectation-building rather than proposed rule changes, if the Panel's suggestions about expanding the auditor's responsibilities to the Board are adopted, it may be appropriate to modify Section 380 accordingly.

independent auditor have a coincidence of interest—and are not in any way intended to suggest that auditors usurp the responsibilities of directors or management.

Greater involvement by all board members with the auditors would have a salutary effect of insuring that firms are likely to elevate the quality of the people they assign to the account, and it would offer the board an independent view of the company's accounting choices, internal controls, and, if warranted, business operations.

Moreover, the broader responsibilities that the Panel would impose on auditors would make appointing the auditor more than a routine, symbolic act. Those responsibilities would acknowledge that the board expects the auditor to take an active role in overseeing and strengthening the company's financial reporting process. And they would make clear that the board's decision on auditor reappointment will be based on how well the auditor has helped the board to fulfill its responsibility to protect shareholder interests. **Assisting the board in its fiduciary mission is the essence of the auditor's own obligation to the public—and the hallmark of the auditor's professionalism.**

The Auditor's Evaluation of the Appropriateness of Accounting Principles, Disclosure Practices, and Estimates

Recommendations V-6, V-7, and V-8 in the March 1993 POB Special Report would seem to hold auditors to a higher standard than "falling within a range of acceptable limits" in evaluating the appropriateness of accounting policies. The Panel's recommendation that auditors express their expert views to the audit committee and, in summary, to the board of directors about the appropriateness of the company's accounting principles and underlying estimates and the clarity of the related financial disclosure practices is consistent with the objective of those POB recommendations. However, the Panel would go a bit further.

Recommendations V-6 and V-8 focus only on an accounting principle adopted for a new kind of transaction or event and would impose a special duty on the auditor and, separately, on the "concurring partner" to be satisfied that the new accounting principle properly reflects the economic substance of the transaction in accordance with basic concepts of financial reporting. Recommendation V-7 suggests that peer reviewers not only should evaluate the consultation process by which a firm's technical office reaches specific accounting conclusions but also "should inquire whether that process leads to accounting that is appropriate in the circumstances [and] evaluate the quality of the conclusions reached."

Recommendations in the POB Special Report would, in effect, ask the audit committee to judge (V-9) and opine (V-10) on the appropriateness of all of a company's accounting principles, not just those for new transactions and events.

The Panel agrees with the POB's objectives in Recommendations V-6 through V-10, but the Panel would achieve those objectives by making the auditor more proactive rather than reactive and by making it explicit that disclosure practices, and the clarity thereof, are integral to relevant and reliable financial information.

The Panel would place the initial burden on the auditor, rather than the audit committee, to judge the appropriateness, not just the acceptability, of a company's accounting principles. In fact, the Panel has reservations about requiring public reporting by audit committees regarding the appropriateness of the company's accounting principles, as POB Recommendation V-10 suggests. Further, the Panel would place the burden on the auditor to discuss with the audit committee the clarity of disclosure practices and the appropriateness and effect of the accounting estimates made by management. Finally, the auditor should assume responsibility to evaluate not only the appropriateness of an accounting principle proposed for a new type of transaction or event but also the continuing appropriateness of old accounting principles. As suggested earlier in this report, the audit committee and the board of directors should expect the auditor to assume those responsibilities.

The Panel's objective is not to narrow the range of acceptable accounting practices for a particular kind of transaction or event (that may follow in due course) but to encourage open communication with the audit committee and the board of directors about new as well as ongoing policies and the professional auditor's expert views thereon. The expectation that auditors will express their expert views to the committee and the board will enhance their objectivity in considering management's chosen practices—both principles and estimates.

The Panel is hopeful that expecting auditors to judge and communicate to the audit committee and the board the appropriateness of accounting principles and practices may discourage the auditing profession from seeking authoritative "bright line" guidance for every accounting and auditing question that arises. The independent audit is in danger of becoming totally rule-driven and compliance-oriented. The search for "bright lines" is a symptom of a problem, not a solution. Auditors often ask standard setters for rules that enable the auditor to draw lines with clients and not run the risk of a competitor not drawing the same line. The *SEC Staff Report on Auditor Independence* acknowledges the SEC's own push for "simple, bright-line accounting principles and auditing standards." Standards, no matter how detailed, should be regarded as a framework or constraints within which professional judgment should be exercised; they are not a substitute for that judgment.

Accounting firms have procedures for providing guidance to practice partners and staff in difficult or unusual accounting situations. Some firms have written policies setting forth the firm's own view as to the "best" or "preferred" or "appropriate" accounting practice. Those procedures and policies can be the basis for supporting the auditor in communicating with the board about the appropriateness of accounting principles. Knowing that they will have to communicate about accounting principles, disclosure practices, and estimates to the audit committee and the full board of directors will be further impetus for the firms' technical offices to develop procedures and policies to assist partners in making qualitative judgments.

The Panel's suggestions for enhancing the value of the independent audit to the board are consistent with one of the key conclusions at a special 1993 Audit/Assurance Conference jointly sponsored by the AICPA and the Big 6 accounting firms:

> The conference participants... concluded that the assurance function should place a renewed emphasis on meeting user needs. That function should be redefined and expanded to (1) focus on a wider array of information and information processes, (2) provide a means for auditors to provide their own qualitative comments and add to the information presented, and (3) evaluate the relevance of the information presented.

That conference led to the recent appointment by the AICPA Board of Directors of a Special Committee on Assurance Services that will critically examine auditing and related assurance services in the same way as the AICPA Special Committee on Financial Reporting (Jenkins Committee) is examining the information needs of users of financial reports. The Panel encourages those and other efforts currently under way within the accounting profession to improve the usefulness of accounting data and the value of the independent audit. The Panel encourages the POB to prod the profession to follow through on implementation of those efforts.

The Panel's suggestion that auditors report to the board on the appropriateness and aggressiveness of accounting principles is not without potential dangers. One undesirable result could be "opinion shopping" among accounting firms. While the common starting point from which all would assess appropriateness should be the relevance and reliability of the resulting information, the Panel recognizes that other accounting firms or even management might think differently from the auditor. One commentator referred to such differences of opinion as "creative tension" between management and the auditors, which the Panel regards as healthy by alerting the board to the choices the corporation has and the merits of alternative courses of action.

With the right atmosphere—directors recognizing their responsibilities and auditors fulfilling theirs—the result will be a forthright interchange of professional views, thereby giving directors a better basis for influencing corporate practices. However, that right atmosphere can be quickly dissipated if directors do not encourage auditors' forthrightness and, if necessary, discourage any management efforts to inhibit the auditor. Some corporate boards might not welcome auditor forthrightness, but that does not relieve the auditor of what the Panel believes is—or should be—an overriding professional responsibility always to express an objective, expert judgment even if not welcomed.

Another potential problem is that the SEC might look on the auditor's forthright discussion as leverage to force changes in principles, disclosures, or estimates. That would defeat the Panel's objective. If it is the auditor's view that the client's accounting is "acceptable" but "liberal" or "aggressive" or not the "most appropriate," the SEC should not insist that such observations are a basis for forcing the registrant to change accounting. The SEC must foster the auditor's professionalism. The SEC must recognize that the auditor's professional judgment may differ from that of management, another firm, and, indeed, the SEC. The SEC should encourage boards of directors to consider the auditor's viewpoint together with that of management and take whatever action they deem in the best interests of the shareholders.

The Panel's Suggestions Are a Three-Part Package

In summary, the Panel's suggestions for strengthening the relationship between the board of directors and the auditor are a three-part package. All three steps are needed to ensure that the company's financial reports meet the shareholders' need for relevant and reliable information. (1) The board must recognize the primacy of its accountability to shareholders. (2) The auditor must look to the board of directors as the client. (3) The board must expect and the auditor must deliver candid communication about the appropriateness, not just acceptability, of accounting principles and estimates and the clarity of the related disclosures of financial information that the company reports publicly.

Are Additional Public Reports Needed?

A number of proposals have been made recently for additional reports detailing the roles and relationships between the auditors, the board, the audit committee, and/or management to be included in proxy materials or annual reports. Examples of the proposed reports include the Treadway Commission's recommendation that the annual report include a letter from the audit committee describing its responsibilities and activities; Recommendation V-10 in the POB Special Report proposing a similarly detailed statement from the audit committee; Recommendation II-1 in the POB Special Report that the SEC require registrants to disclose whether the auditors have had a peer review and its results; Recommendation V-12 in the POB Special Report that the SEC require registrants to include, with the annual financial statements, separate reports by management and the independent accountant on the effectiveness of the company's internal control system relating to financial reporting; and the various reports mandated for banks by the Federal Deposit Insurance Corporation Improvement Act of 1991 (which include reports on internal control, compliance with laws and regulations, and reviews of interim financial statements).

The Panel is concerned that these additional reports can become lengthy "boilerplate" that does not get to the heart of the underlying issue of strengthening auditor accountability . **Instead of the lengthier proposed reports, the Panel would encourage a simple statement in the proxy that the board meets at least annually with its auditors to obtain their observations, review their performance, and set the terms of their engagement.**

Relationship among Auditors, Standard Setters, and the SEC[8]

Because they share common objectives with respect to the public interest, there must be more cooperative, less adversarial relationships among the public accounting profession, the standard setters, and the SEC. The main goal of all should be to reflect in financial statements the most useful information about the business transactions and events occurring during the reporting period.

The working relationships among the accounting profession, the standard setters, and the SEC have been damaged and need to be repaired. Evidence of that damage includes the speeches by the Chief Accountant of the SEC cited earlier, actions by the large public accounting firms in connection with the FASB's project on accounting for stock-based compensation (characterized by the Chief Accountant as possible "cheerleading" for their clients), and the SEC's effort to establish accounting standards on accrual of restructuring costs through the minutes of the FASB Emerging Issues Task Force.

The auditors, standard setters, and the SEC all have an interest in improved financial reporting. Though the three groups have distinct roles in the corporate financial reporting process, their mutual concern for the public interest requires that they communicate, treat each other with respect, and cooperate in the standard-setting process. Only more cooperative relationships and the give and take of professional discussions can bring these groups together to assure prompt and thoughtful improvements in financial reporting.

Responsibilities of Accounting Firms in the Standard-Setting Process

Earlier in this report, the Panel noted ways in which the firms' professionalism in dealing with standard setters might be enhanced. Those enhancements are particularly important since efforts to influence the outcome of FASB deliberations have become much more organized and effective in recent years.

Until the past few years, accounting firms and business enterprises, for the most part, put forth their views individually. More and more, group responses are prepared (some groups are organized solely for one FASB project and some written responses look like political petitions), and commentators disseminate their views widely in the hope of influencing others. Even corporate chief executive officers have a hand in developing and espousing accounting positions. The most aggressive lobbying effort ever is currently taking place in opposition to the FASB's proposal to require that compensation expense

[8]In the course of its study, the Panel interviewed and received written input from representatives of the SEC and several banking regulators. Those interviews and communications were helpful to the Panel in gaining insights into issues affecting auditors' objectivity, integrity, and independence. The observations in this section of the Panel's report concentrate on the auditor's relationships with the SEC and the accounting standard setters, though some of our observations may also be applicable to relationships with other regulators.

be recognized in the income statement for the estimated fair value of stock options granted to employees.

The Big 6 senior partners now meet regularly and are a natural target for those lobbying activities. We understand that those meetings are occasionally with representatives of The Business Roundtable. While there may be legitimate reason for those senior partners to meet and to communicate publicly on issues affecting the profession as a whole, communicating a single view in jointly signed letters on accounting for stock compensation, first on February 17, 1993, before an FASB Exposure Draft was issued, and then again on July 15, 1994 after meeting with representatives of The Business Roundtable, gives the appearance of trying to impress the FASB with clout rather than reasoning. Those letters are being used by lobbyists and cannot help but create the impression that those senior partners and the firms they represent have responded both to peer pressure and to pressure from organized business groups that include the firms' major clients.

The perception problem in the stock compensation matter is accentuated by the fact that the firms' joint position in the 1993 and 1994 letters differed from that taken in a 1984 letter to the FASB from AcSEC. That letter urged the FASB to undertake the project and to make a "major change" by recognizing compensation cost based on a measure of the "minimum value" of an option at the grant date, and many of the firms themselves had expressed similar views to the FASB. Clearly, over time a firm may change its view on a technical accounting issue without being guilty of subordination of professional judgment. In the stock compensation case, the firms whose views changed explained those changes in submissions to the FASB during the intervening period. However, to be considered independent in matters of accounting principle, the Big 6 accounting firms should go to great lengths to avoid the appearance of being unduly influenced by clients or exerting undue pressure on the FASB. Even the appearance of such behavior can undermine the public's respect for the profession.

The Big 6 senior partners should recognize that joint actions instigated by them or jointly approved by them, particularly those impacting on the standard setting process, just reopen the door for the conspiracy theories investigated by Congressional committees in the mid-1970s (see, for example, *The Accounting Establishment,* a 1,760 page staff study prepared by a Senate subcommittee, which criticized the SEC for "delegating its public authority and responsibilities on accounting matters to private groups with obvious self-interests in the resolution of such matters" and "the alarming lack of independence and lack of dedication to public protection shown by the large accounting firms.") **For reasons of public perception, the Panel believes that communications to the FASB (or other standard setters) on accounting policies should not come jointly from the Big 6. Individual firms and duly constituted committees of professional organizations such as the AICPA are the appropriate vehicles for communicating with standard setters.**

Further, individual firms should be careful in how they communicate their views to their clients and the public at large. Selective or unusually wide distribution of those views, particularly when the firm opposes a proposed action of standard setters, can easily be read as resulting from client pressure or unprofessional lobbying by the firm. Moreover, actions of this sort are transparent and are seen by the standard setters, the regulators, and the investing public as an indication that the business community has captured the public accounting profession.

Responsibilities of the Standard Setters in the Private Sector

The standard setters should be committed to setting standards that will result in the most useful—that is, relevant and reliable—information in the financial statements. For the FASB and AcSEC that means never to lose sight of the primacy of relevance and reliability in their decision process. In the case of the Auditing Standards Board it means standards that increase the likelihood that the financial statements are free from material misstatement.

Standard setters should be committed to addressing and resolving issues on a timely basis. While the SEC certainly cannot dictate the FASB's agenda, there should be a presumption that an accounting issue called to the FASB's attention by the SEC Chief Accountant warrants careful and timely consideration. The FASB itself needs to be more aggressive in bringing issues to the table for discussion.

Responsibilities of the SEC

Enforcing accounting and auditing standards is a separate matter from establishing those standards. Enforcement is clearly the SEC's bailiwick, not the FASB's or the EITF's or AcSEC's or the Auditing Standards Board's. In the area of setting accounting and auditing standards, the SEC's principal focus should involve constructive assistance to those and other private-sector professional groups in their efforts to resolve complex questions. The SEC should be a standard setter of last resort, acting only if the profession is unable to do what is necessary in a timely fashion and, even then, only after appropriate due process. Recently, some SEC accounting guidelines have been announced in speeches or comments at public meetings rather than through formal Staff Accounting Bulletins or rule-making, and accountants in public practice and industry have nicknamed them "turbo-SABs."

The links between the SEC and the various standard-setting bodies already are in place to enable the SEC to provide the constructive assistance that the Panel envisions. However, in the judgment of the Panel, some adjustments are needed—to replace what some view as impatience and second-guessing on the part of the SEC (OCA and the Division of Corporation Finance) with tolerance and respect.

The Panel believes that a better dialog should take place between the SEC and the profession when a firm or a registrant wishes to propose a new or different accounting treatment. There is need for restraint and balance. Advocacy or acceptance of a practice should not be publicly labeled as "incredible" unless it has resulted in an ethics action or a Rule 2(e) proceeding.

The SEC must also recognize that, on occasion, an accounting firm may support a registrant's request that the SEC regard a particular accounting principle or disclosure practice as acceptable even though the accounting firm may have expressed a preference for a different principle or practice in earlier discussions with the registrant's board of directors and management. As the Panel noted earlier, the SEC should not use the auditor's frank discussions with the board of directors as leverage against the registrant. If the Panel's suggestions for strengthening the relationship between the board and the auditor are implemented, the number of these situations should decline.

The EITF

The FASB established its Emerging Issues Task Force in 1984 to help the Board identify emerging accounting issues and problems in implementing authoritative pronouncements. EITF members include the senior technical partners of major national and regional public accounting firms as well as representatives of major associations of preparers, such as the Financial Executives Institute, The Business Roundtable, and the Institute of Management Accountants. The SEC's Chief Accountant and a member of the AICPA's Accounting Standards Executive Committee (AcSEC) also participate.

The composition of the EITF is designed to include persons in a position to be aware of emerging issues before divergent accounting practices become entrenched. The participation of the SEC Chief Accountant is important to the process of the EITF. Often, EITF agenda issues are problems that have been identified by the SEC as a result of the securities registration and annual reporting process. And the Chief Accountant's involvement is strong impetus for a private-sector self-imposed solution to a problem.

The EITF meets approximately six times a year and publishes a record of its proceedings. Often, as a result of discussing an issue at an EITF meeting, the group reaches a general consensus on appropriate accounting practice, which the FASB can usually take as an indication that no Board action is needed. On the other hand, the inability of the group to reach a consensus may be an indication that action by the FASB is necessary.

Most observers regard the EITF's first ten years as successful in identifying emerging problems and reaching solutions to most of them that are "acceptable" to the both the FASB and SEC, avoiding the need for FASB Interpretations and Technical Bulletins or SEC Staff Accounting Bulletins.

Critical to the work of the EITF are leadership of the FASB, the willingness of public accounting firms to identify and resolve problems, and restraint and constructive assistance by the SEC. That restraint recently appeared to have broken down, in the view of the Panel, when the Chief Accountant of the SEC added detailed guidance on accounting for restructuring charges to the minutes of an EITF meeting even though the EITF had not reached a consensus on that guidance and the guidance had not been stated at the meeting.

To foster professionalism, the SEC must monitor the EITF process but exercise restraint and let the system work. Simply put, the SEC must recognize that "bright lines" may not be apparent to all. If the EITF cannot resolve an issue and the SEC cannot wait for the FASB, the SEC should follow its process of rule-making or issuing a Staff Accounting Bulletin or other form of release. The FASB and its EITF should not be used as a vehicle for communicating the views of the SEC that have not been discussed by the group following its established processes.

The Panel believes that the SEC, through its registration and annual reporting process, can and should serve as an early-warning mechanism for the kinds of accounting practice problems that have been criticized in the media or have been classified as "incredible." (For example, how did the restructuring issue get so far along in its life cycle that it reached crisis proportions before the problem was taken up by EITF?) In the environment of mutual trust and cooperation that the Panel envisions, the SEC would inform the FASB and its EITF of the matter and look to them for resolution. FASB-EITF would have the obligation to meet on short notice to deal quickly with developing problems identified by the SEC or others. With the advent of increasing technology, time has become of the essence. Certainly, this approach ought to dispose of the frivolous and unmeritorious proposals quickly, leaving only a few for more in-depth analysis.

The mechanism that the Panel describes is not new. It is in place today. What is missing is an attitude of mutual respect and cooperation and a commitment to resolving accounting questions quickly within established procedures.

The FASB has recently formed a committee to review the structure and operation of the EITF now that it has completed its tenth year of operations. The review will consider the EITF's mission ("to assist the Board in its efforts to provide timely guidance on emerging issues and implementation questions,") whether it is adequately fulfilling that mission, and whether the mission should be revised. The review will also consider the EITF's relationship with the FASB, AcSEC, and the SEC as well as procedural matters relating to the EITF's operations. The Panel commends the FASB for undertaking this review.

While the Panel believes that seeking "bright-line" standards and EITF guidance is a symptom of the audit function's slide into a compliance and rule-oriented approach, it is also mindful that deciding what is acceptable for purposes of opining on the fairness of financial statements is the profession's primary responsibility. The EITF is a good private-sector response that fits the present professional environment.

A Better Legal Environment for Auditor Professionalism

Litigation has had a damaging and costly impact on the profession—and on the public it serves—by discouraging new entrants into auditing, by focusing business strategies and management efforts within larger firms on nonaudit services entailing lower litigation risks, by encouraging a proliferation of detailed standards to serve as a protection against second-guessing by litigants and thereby making audits more compliance and rule-book oriented, and by creating an atmosphere in which auditors are reluctant to make independent professional judgments.

A better legal and regulatory environment will permit auditors, without fear of exposure to unwarranted and excessive liability, to express their professional judgments to boards of directors as experts in accounting and financial reporting on the matters described earlier in this report. Further, a better legal environment would encourage the profession to analyze and learn from audit failures. After all, prompt,. constructive self-analysis of mistakes is a hallmark of a profession.

For those reasons, prompt tort reform to reduce accountants' liability is of vital importance to the future of the profession and its ability to serve the investing public. Looking ahead, the efforts now underway in the profession to enhance the value of the attest function and to improve financial reporting may make tort reform and possibly some legal or regulatory safe harbors even more important.

Currently under consideration is the "Private Securities Litigation Reform Act of 1994," introduced in the Congress early in 1994 by Senator Christopher J. Dodd. Under that bill, the SEC would create or designate a "Public Accounting Self-Disciplinary Board" to register all firms of independent auditors of public companies and investigate and discipline accounting firms. The bill would also provide certain tort reforms. The AICPA and the Big 6 accounting firms are supporting the bill.

The time has come for the SEC to take the lead in helping the profession reduce its exposure to unwarranted litigation. The SEC has an enormous stake in the viability of the profession. The Commission commands great respect with the Congress and with the investing public. In the Panel's judgment, there are dangers not just to the profession but to the investing public if the current liability situation continues to drift without SEC leadership.

Tort reform is necessary but will not be sufficient alone to enhance the integrity, objectivity, and professionalism of the independent auditing function. **The Panel believes that the suggestions in this report can be considered separately from, and need not await, legislative action on litigation reform. These suggestions for improving auditor professionalism will need the vigorous support of the SEC in helping to create the kind of supportive environment described earlier in this report.**

V. CONCLUSIONS

The Panel stated at the beginning that the profession is at a critical juncture. While much has been done to enhance auditors' integrity, objectivity, and independence, there are fundamental developments at work that could over time undermine the independent role of the profession in the private sector. The Panel does not pretend to have detailed recommendations offering instant solutions. Rather, the Panel has pointed out the underlying issues facing the profession and offered suggestions as to what should be done to *bring auditing into the mainstream of corporate governance and to restore auditing to its important role in our society*. The Panel's principal conclusions are:

1. There is no need at this time for additional rules, regulations, or legislation dealing with the conflict-of-interest aspect of auditor independence. There are, however, important steps that should be taken in other ways to strengthen the professionalism of independent auditors.

2. Auditing is different from other services accounting firms render. It imposes special and higher responsibilities. Independent auditing firms, regulators, and overseers of the public accounting profession need to focus on how the audit function can be enhanced and not submerged in large multi-line public accounting/management consulting firms.

3. The Public Oversight Board, the SEC, and others should support proposals to enhance the independence of boards of directors and their accountability to shareholders. Stronger, more accountable corporate boards of directors will strengthen the professionalism of the outside auditor, enhance the value of the independent audit, and serve the investing public.

4. To increase the value of the independent audit, corporate boards of directors and their audit committees must hear from independent auditors their views as professional advisors on the appropriateness of the accounting principles used or proposed to be adopted by the company, the clarity of its financial disclosures, and the degree of aggressiveness or conservatism of the company's accounting principles and underlying estimates.

5. The accounting profession should look to the representatives of the shareholders—the board of directors—as the client, not corporate management. Boards and auditors are, or should be, natural allies in protecting shareholder interests.

6. Auditors must assume the obligation to communicate qualitative judgments about accounting principles, disclosures, and estimates. By doing so, independent auditors can add to the effectiveness of boards of directors in monitoring corporate performance on

behalf of shareholders and in assuring that shareholders receive relevant and reliable financial information about company performance and financial condition.

7. By making these suggestions to boards and auditors, the Panel's objective is not to narrow the range of acceptable accounting practices (that may follow in due course) but to give directors a better basis for influencing corporate practices. These suggestions should also enhance the objectivity and strengthen the professionalism of the auditor.

8. Because they share the objective of providing the public with relevant and reliable financial information, the public accounting profession, the standard setters, and the SEC must have more cooperative, less adversarial relationships. CPA firms should be careful in how they communicate their views to the FASB, the SEC, their clients, and the public at large. The SEC should help identify accounting practice problems and look to the private sector standard setters to solve them. It should only be a standard setter of "last resort" and then only after appropriate due process.

9. It is urgent that the SEC take the lead in helping the profession to reduce exposure to unwarranted litigation. There are dangers, not just to the profession but to the investing public, if the current liability situation continues to drift without SEC leadership.

10. While tort reform is necessary, the other suggestions in this report can be considered separately from, and need not await, legislative action on litigation reform.

For the future, the Panel believes that the SEC and the POB should consider devoting resources to stay informed on a continuing basis about developments in the auditing profession and in the market for audit services. As described in this report, some of those developments could materially affect the viability of the independent audit as a private-sector activity. By having the facts, the SEC and the POB will be in a position to anticipate and take appropriate steps to strengthen auditor professionalism.

APPENDIX A
POB 1993 RECOMMENDATIONS DIRECTLY RELEVANT TO THE WORK OF THE ADVISORY PANEL

Recommendation V-3
The AICPA should undertake a project to sharpen further the distinction between client advocacy and client service and incorporate that distinction into the profession's Code of Professional Conduct. Individual accounting firms should constantly review their programs regarding client advocacy and client service to strengthen the desire of each audit partner to protect the firm's independence.

Recommendation V-4
Accounting firms should take special care to ensure that their participation in the standard setting process is characterized by objectivity and professionalism. Standard setters and leaders of the profession should discuss and address the issues related to client advocacy in the standard setting process and establish ways of identifying and correcting aberrant behavior when it occurs.

Recommendation V-5
Firms' consultation policies and procedures should ensure that client accounting issues are not discussed with SEC staff without the benefit of consultation at the appropriate level within the firm.

Recommendation V-6
The following recommendation of the Macdonald Commission [of the Canadian Institute of Chartered Accountants] should be adopted by the Auditing Standards Board in the United States:

> **When new accounting policies are adopted in response to new types of transactions or new kinds of assets or obligations, the auditor should be satisfied that the accounting policies adopted properly reflect the economic substance of the transaction, asset, or liability in accordance with the broad theory governing present-day financial reporting and the established concept of conservatism in the face of uncertainty.**

Recommendation V-7
Peer reviewers should evaluate the consultation process by which specific accounting conclusions are reached, as they do now, and should also inquire whether that process leads to accounting that is appropriate in the circumstances. In testing compliance with the consultation policies and procedures in a firm, the peer review team should evaluate the quality of the conclusions reached.

continued...

APPENDIX A (continued)

Recommendation V-8
The concurring partner, whose participation in an audit is a membership requirement of the SEC Practice Section, should be responsible for assuring that those consulted on accounting matters are aware of all of the relevant facts and circumstances, including an understanding of the financial statements in whose context the accounting policy is being considered. The concurring and consulting partners should know enough about the client to ensure that all of the relevant facts and circumstances are marshalled, and also possess the increased detachment that comes from not having to face the client on an ongoing basis. The concurring partner should have the responsibility to conclude whether the accounting treatment applied is consistent with the objectives of Recommendation V-6.

Recommendation V-9
Audit committees (or the board if there is no audit committee) should assume the following responsibilities relating to an SEC registrant's preparation of annual financial statements: (a) review the annual financial statements; (b) confer with management and the independent auditor about them; (c) receive from the independent auditor all information that the auditor is required to communicate under auditing standards; (d) assess whether the financial statements are complete and consistent with information known to them; and (e) assess whether the financial statements reflect appropriate accounting principles.

Recommendation V-10
The SEC should require registrants to include in a document containing the annual financial statements a statement by the audit committee (or by the board if there is no audit committee) that describes its responsibilities and tells how they were discharged. This disclosure should state whether the audit committee members (or, in the absence of an audit committee, the members of the board): (a) have reviewed the annual financial statements; (b) have conferred with management and the independent auditor about them; (c) have received from the independent auditor all information that the auditor is required to communicate under auditing standards; (d) believe that the financial statements are complete and consistent with information known to them; and (e) believe that the financial statements reflect appropriate accounting principles.

Recommendation V-11
The audit committee or the board of directors should be satisfied that the audit fee negotiated by it or management for the entity's audit is sufficient to assure the entity will receive a comprehensive and complete audit.

APPENDIX B
THE CHIEF ACCOUNTANT'S 1994 SPEECH

Chief Accountants of the SEC have a long and healthy tradition of candor with the accounting profession, often using professional meetings and conferences to alert the profession to important issues. On January 11, 1994 Chief Accountant Walter P. Schuetze did that in a speech in which he called into question the independence of accounting firms in situations where they condoned "incredible" accounting principles in financial statements, or advocated such principles before the staff of the SEC, or were overly influenced by client views in formulating their own positions on subjects under scrutiny by the FASB. Mr. Schuetze had made similar charges in an August 1992 speech.

The points made in the January 1994 speech are as follows:

- "Auditors [are] not standing up to their clients on financial accounting and reporting issues when their clients take a position that is, at best, not supported in the accounting literature or, at worst, directly contrary to existing accounting pronouncements."
- Four specific cases argued before the Chief Accountant are examples of the national offices of major firms advocating accounting contrary to the spirit, if not the letter, of GAAP.
- There continue to be other "more broadly applicable" cases of accepted accounting practices contrary to accounting literature, such as "funded catastrophe covers" which spread the losses from catastrophes rather than recognizing the losses at the time of the catastrophe as required by FASB Statement 5; not updating discount rates used in measuring obligations for pensions and healthcare benefits, contrary to the requirements of FASB Statements 87 and 106; and inappropriate accounting for investments in debt securities in 1992.
- "CPAs may have become cheerleaders for their clients on the issue of accounting for stock options issued to employees."

Subsequent to the appointment of the Panel, the Office of the Chief Accountant (OCA) submitted its *Staff Report on Auditor Independence* (March 1994) to Congressman Edward J. Markey in response to his earlier request. The Panel believes the *Staff Report on Auditor Independence* puts in their proper context the comments of Mr. Schuetze regarding client advocacy in meetings with the Commission's staff:

> Client Advocacy.
>
> In addition to the numerous independence issues that surround the conduct of an audit, the SEC staff is concerned that certain accounting firms may have compromised their objectivity with respect to proposed or actual client accounting treatments with the SEC staff. The Commission staff wishes to stress that the number of instances in which questionable client advocacy has been established is very small in relation to the number of audited financial statements filed with the

Commission. The staff continues to believe that the vast majority of audits are conducted in an appropriate skeptical manner. The staff also appreciates that reasonable people may come to different conclusions on accounting issues and, in good faith hold and represent views that differ from those of the staff. The OCA encourages registrants and their auditors to discuss and resolve financial accounting and reporting issues with the staff. A different situation arises, however, when high levels of authority within major accounting firms appear to argue unfounded positions before the staff. Some of these instances cause the staff to question the appearance of auditor independence. [Footnote omitted.]

The staff believes that these events raise questions about whether the auditor has maintained an appropriate relationship to his or her audit client. The staff recognizes, however, that the problem of an appearance of "client advocacy" may not be susceptible to correction through additional, objective independence interpretations or rules. The current sanction for this type of conduct is a possible reduction in the credibility before the public on the accounting issues being considered. This is a serious sanction, indeed. To prevent such a loss of confidence in a firm's views, the firm, when accompanying audit clients to meetings with the Commission staff or providing written substantiation for the proposed accounting should present positions that are well-founded in, or logical extensions of, authoritative accounting literature. [Footnote omitted]

The Four Cases

The Panel invited the auditors for each of the four cases described by Mr. Schuetze as "incredible" to submit a written summary of the case, including the facts as the accounting firm saw them, the accounting issues identified, the positions taken by the company and the auditor, the circumstances of the auditor's "advocacy" of the client's position before the SEC. All four auditing firms responded to the Panel's request.

With the knowledge of the four auditors, the Panel provided a copy of the auditors' responses to the Office of the Chief Accountant of the SEC, which prepared staff memoranda responding to the auditors' responses.

While Mr. Schuetze's description of the four cases as "incredible" was part of the reason that the POB appointed the panel, it is not the purpose of the Panel to be an arbiter of who was right and who was wrong in each of the four cases or whether they were, in fact, incredible. The Panel believes that by concluding that "the number of instances in which questionable client advocacy has been established is very small in relation to the number of audited financial statements filed with the Commission," the OCA *Staff Report on Auditor Independence* removes much of the sting from the four cases. Also the issues, at least in part, do not appear to be as black and white as Mr. Schuetze portrayed them.

There are lessons that can be learned from this incident by both the firms and the SEC—lessons that can help achieve the objective of bolstering the independence, objectivity, and integrity of independent auditors. Those lessons relate to relationships and selection and retention of accounting principles and practices and alertness to changes in the business environment.

First, the presence of a registrant's auditor at the SEC is not necessarily inappropriate behavior by the auditor, even if the auditor has a preference for an accounting principle different from that proposed by the registrant. Accounting principles are not natural laws, and reasonable people can reach different conclusions on accounting questions. Auditors do not always agree with their clients on accounting matters, and the Panel believes that an auditor has the expertise and a professional obligation to encourage the client to adopt accounting principles that produce the most relevant and reliable financial information. At the same time, supporting in a restrained, reasoned, and professional manner a client's position that the independent auditing firm believes is appropriate in the circumstances is not advocacy or at least not an unacceptable kind of advocacy.

Second, as the Panel noted earlier in this report, public accounting firms should adopt mechanisms that ensure that their national technical offices are independent of practice partners who feel the direct pressure from client companies; that the standard to which the national technical office personnel should be held in advising engagement partners is not just "what practices are acceptable" but "what is the most appropriate accounting in the circumstance;" that client accounting positions are not brought before the SEC until that consultation has taken place; and that full information about the facts and circumstances has been made available to the national technical office.

Third, an SEC Staff Accounting Bulletin encourages registrants to discuss accounting questions with the Commission's staff. When a company does so, the SEC's reaction should not be antagonistic if the position is reasoned, even if the Commission's staff takes issue with the registrant's proposed solution to the problem. The SEC staff reported to us that meetings with registrants are professional and nonconfrontational. Subjecting those registrants at a later time to public criticism is counterproductive.

Fourth, if a company follows an unusual industry accounting practice or the minority practice from among a range of acceptable alternatives, special scrutiny by the auditor and the board is essential, as is clear disclosure.

And, finally, changed economic or business circumstances can call into question the ongoing appropriateness of a long-standing accounting practice. Special scrutiny by the auditor and the board is warranted.

The "More Broadly Applicable" Accounting Issues Cited by the Chief Accountant

The Chief Accountant's January 1994 speech cited several other "more broadly applicable" cases of questionable accounting practices, including funded catastrophe covers, out-of-date discount rates to measure pension and medical obligations, and accounting for investments in debt securities. The Panel is not convinced that the "right answers" to these accounting questions were as obvious as implied. Further, the Panel notes that the matters had been addressed and resolved by the standard setters prior to January 1994 and that their characterization as "questionable" was with the benefit of hindsight. Therefore, the Panel sees little benefit from its delving further into these issues.

Cheerleading for Clients

Mr. Schuetze's speech also expressed concern that CPAs may have become cheerleaders for their clients on the issue of accounting for stock-based compensation. Elsewhere in this report the Panel has expressed its thoughts on matters of client advocacy.

APPENDIX C
SOURCES

Reports and Other Materials Reviewed by the Panel

The Panel reviewed a wide variety of published studies, reports, and articles, as well as a substantial body of information submitted in response to requests from the Panel. This appendix lists only the principal published documents reviewed by the Panel.

American Institute of Certified Public Accountants, Board of Directors. "Meeting the Financial Reporting Needs of the Future: A Public Commitment from the Public Accounting Profession." A statement of position by the Board of Directors of the AICPA, June 1993.

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Public Oversight Board of the SEC Practice Section, AICPA. *In the Public Interest.* A Special Report. Stamford, Conn.: Public Oversight Board, March 5, 1993.

Schuetze, Walter P. "Relevance and Credibility in Financial Accounting and Reporting." Speech presented at the Annual Meeting of the American Accounting Association, August 12, 1992.

Schuetze, Walter P. "A Mountain or a Molehill?" Speech presented at the Twenty-First Annual AICPA National Conference on Current SEC Developments, January 11, 1994.

Securities and Exchange Commission, Office of the Chief Accountant. *Staff Report on Auditor Independence,* March 1994.

Persons Interviewed by the Committee

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