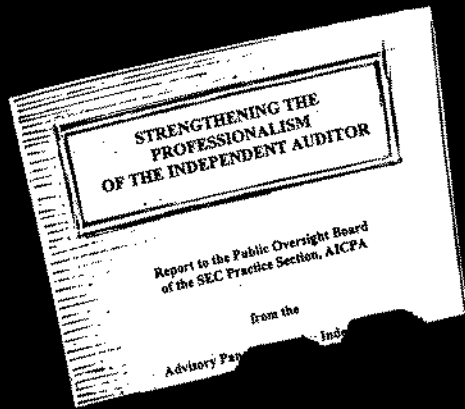


Annual Report / 1993-1994
PUBLIC OVERSIGHT BOARD

SEC Practice Section
American Institute of
Certified Public Accountants



Professionalism and Independence

In January 1994, SEC Chief Accountant Walter P. Schuetze made a presentation titled "A Mountain or a Molehill?" at the AICPA's National Conference on SEC Developments in which he expressed concern that:

"...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."

He cited four specific examples of what he labeled as "incredible accounting" by registrants that were supported by the national offices of the accounting firms involved. He also expressed concern about broader accounting and reporting issues that imply that independent public accountants are ignoring existing accounting literature when certifying financial statements. Finally, he observed that the accounting profession may have become cheerleaders for clients on the issue of accounting for stock compensation granted to employees.

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

Because of the gravity of the Chief Accountant's remarks—*independence and objectivity are the raison d'être of the auditing profession—and its own professed concerns*, the Board decided on March 16, 1994 to appoint an Advisory Panel on Auditor Independence to assess the dimensions of the problem, to recommend appropriate 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, nine as its chairman; currently 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.

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 in

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; chief executive officer of CIGNA Corp.; and currently a director and audit committee member of several companies.

On September 13, 1994, the Advisory Panel issued its report, *Strengthening the Professionalism of the Independent Auditor*, to the Board. The Panel's report has been carefully reviewed by the Board and we believe it to be a thoughtful analysis and description of a critical problem confronting the accounting profession and the American business community. The Board is committed to urging those to whom the Panel's recommendations were directed (corporate boards of directors and their audit committees, the accounting profession, the SEC, and standard setters) to take appropriate steps to improve the relevance and reliability of financial information and to better ensure the independence of auditors.

Of particular concern to the Board are three interrelated recommendations made by the Panel:

1. The independence of boards of directors must be enhanced to protect the interest of corporate investors.
2. The auditor must consider, not corporate management, but the board of directors as the representative of shareholders, to be its audit client.
3. There should be more timely, more frequent, more open, and more candid communication between the auditor and the board.

These recommendations aimed at improving auditor independence and strengthening corporate governance will require action by both the accounting profession and corporate boards of directors. Accordingly, the Board is preparing a booklet, *Auditors and Corporate Boards: Natural Allies in Protecting Shareholder Interests*, for directors of SEC registrants and other interested parties. It explains the Panel's recommendations from the perspective of a corporate director and describes implementation issues.

A synopsis of the Panel's conclusions and recommendations is presented in the POB Commentary section of this report.

Status of Recommendations in the POB Special Report

The March 1993 special report of the Board, *In the Public Interest: Issues Confronting the Accounting Profession*, con-

tains recommendations that address the accounting profession's liability problem, the reliability of financial reporting, and auditor performance.

We are pleased to report that implementation of the report's recommendations by the profession, while far from complete, has been solidly launched. In June 1993, the AICPA's Board of Directors issued a statement entitled, *Meeting the Financial Reporting Needs of the Future: A Public Commitment From the Public Accounting Profession*. In it, the AICPA endorsed all of the POB's recommendations and committed the profession to strengthening its self-regulatory and disciplinary system. A number of the POB's recommendations have already been implemented. Several require action by others outside the profession. A summary of the status of the profession's implementation of the Board's recommendations follows.

Reducing the Number of Audit Failures.

The Board made several recommendations directed at putting in place mechanisms to analyze audit failures in order to ferret out their causes, the symptoms related to those causes, and the actions that might be taken to avoid their recurrence. We envisioned an expansion of the QCIC mission to ensure that firms carefully identified factors contributing to failed audits, of whatever nature, and took internal actions as warranted to prevent their recurrence. The Board was especially interested in enhancing the potential for detecting management fraud. We recommended that member firms be required to make an analysis of such factors and inform the QCIC of the results during its inquiry. In addition, the effectiveness of the firm's procedures for assuring that such an analysis was made was to be subjected to testing in the firm's triennial peer review.

The Board is satisfied that the essence of that recommendation has been accomplished through actions taken by the SECPS. The QCIC considered how the POB's recommendation might be implemented in a manner that would balance the public interest benefit of implementation against the incremental risk to firms that such action might prejudice a firm's defense in litigation or regulatory actions and revised its procedures to achieve that objective.

Lessons to be Learned. Responding to the Board's recommendation that the Section develop and disseminate practice guidance in a retrievable format, the Section formed the Professional Issues Task Force (PITF) to consider matters requiring additional guidance and emerging or unresolved practice issues that surface through litigation analysis, peer review, or internal inspection. The Board is pleased to note that the PITF has already published guidance material in a new

numbered series known as *Practice Alert*. The first alert provided information about "Dealing with Audit Differences" and the second about "Auditing Inventories-Physical Observations."

The QCIC's recently implemented procedures to identify "lessons to be learned" from allegations of audit failure, discussed above, should benefit the entire accounting profession. These procedures should lead to strengthened auditing procedures, accounting standards, quality control procedures, and risk assessment techniques. The issues identified by the QCIC will be presented to the appropriate AICPA technical committees for their consideration. In addition to the guidance issued during the past year by the PITF, several other subjects are receiving considerable attention, such as auditing guidance for revenue recognition and accounts receivable in high-technology companies, journal entries arising from nonstandard sources, and appropriate procedures relating to the observation of inventories or confirmation of receivables before a client's year-end. The Board commends the QCIC for its initiative in developing procedures to identify issues that will lead to further improvement in the quality of practice.

Concurring Partner Reviews. The SECPS Executive Committee amended the membership requirements to require that the concurring partner provide assurance that those consulted on accounting and auditing matters are aware of all relevant facts and circumstances related to the consultation issue and to the auditee, so that the conclusion reached is an appropriate one. In addition, the Peer Review Committee has amended the standards for conducting peer reviews to require that peer reviewers test and evaluate the quality of conclusions reached in the consultation process.

Client Advocacy. The AICPA's Professional Ethics Division has published for public comment a draft of a proposed interpretation of the profession's *Code of Professional Conduct*, the intent of which is to sharpen the distinction between client advocacy and client service. The Board believes this proposal, while intended to be responsive to the Board's recommendation, falls short of the mark. The proposal puts the emphasis on client service when it should be on the public interest. Firms and individual CPAs should exercise professional independence before committing to client positions on accounting or financial reporting issues.

Accounting for New Types of Transactions. The Auditing Standards Board (ASB) has considered, but so far has not been able to develop, a proposed standard that would require auditors to be satisfied that the accounting policies adopted by an entity for

new types of transactions reflect economic substance. The Board recognizes the difficulty in accomplishing this important goal, and our staff is working with the ASB's Audit Issues Task Force in developing this guidance.

Detecting Fraud. We commend the AICPA Board for its strong statement concerning the profession's responsibility for detecting management fraud and its support of our recommendation that steps need to be taken to improve auditor's performance in this difficult area. Our staff has worked closely this year with the Detection and Prevention of Fraud Task Force, which was formed by the Section's Executive Committee in response to our recommendation, and with the ASB's newly-formed Fraud Task Force. These task forces are coordinating to solve what is undoubtedly the most demanding and difficult-to-resolve auditing problem confronting the profession.

The Detection and Prevention of Fraud Task Force recently issued a document entitled *Client Acceptance and Continuance Procedures for Audit Clients*. An understanding of the components of engagement risk is critical to deciding whether to accept new clients, continue old ones, and in any event to managing the "audit risk" that accompanies those decisions.

Improving the Auditor's Report. The ASB is considering the implications of developing guidance that would improve communications in the standard auditor's report by disclosing the prospective nature of certain accounting information to users of financial statements and to describe the extent of the auditor's responsibility for the internal control structure in a financial statement audit.

Disclosure of Risks and Uncertainties. We are pleased to note that the Accounting Standards Executive Committee (AcSEC) adopted the proposed Statement of Position, *Disclosure of Certain Significant Risks and Uncertainties*. Equally important, the FASB has cleared the Statement for publication. Quite appropriately, the current version of the Statement reflects extensive changes in response to the many thoughtful comments received. It supplements FAS No. 5, *Accounting for Contingencies*, by requiring disclosure of uncertainties not deemed to be loss contingencies. Some estimates, for example, are particularly sensitive to change in the near term, like the carrying amount of long-lived assets whose value may become impaired in the near term. In addition, it requires disclosure of certain concentrations that make an entity vulnerable to greater risk of loss than it would have if it had mitigated its risk through diversification. The Board believes that if this Statement, in combination with recently adopted FASB standards

on financial instruments, had been in place ten years ago, some of the misfortunes of the savings and loan debacle could have been avoided.

Continuing Professional Education. In response to a recommendation of the Board, the SEC Practice Section's membership requirements were amended to require that professionals with substantive involvement in auditing client financial statements spend a substantial number of the minimum annual required hours of continuing professional education in courses relating to accounting and auditing.

Other Recommendations. The Board also made several recommendations to the SEC. These were:

- Require registrants to disclose information about the results of their peer review.
- Require in the annual report a statement of audit committee responsibilities and how they were discharged.
- Require in the annual report a report by management on the effectiveness of the company's internal control structure.
- Require a report by the auditor on the registrant's internal controls over financial reporting.

We also recommended to audit committees that they:

- Review financial statements and confer with management and the independent auditor about them.
- Affirm that the audit fee is sufficient to assure a comprehensive and complete audit.

Since there is no mechanism for assessing audit committees' responses to these recommendations, we are uncertain about the extent to which they have been implemented.

In summary, the Board is pleased with the progress made by the profession and the FASB in considering and working to implement the Board's recommendations. The Board intends to continue to press those to whom the recommendations were made to adopt them as a means of improving the reliability of audited financial statements.

Litigation Reform

In its March 5, 1993 special report, the Board stated its support for the proposition that the standard for the allocation of liability among multiple defendants should be changed from the existing joint and several principle to one of separate and proportionate responsibility. This method of allocating

liability was incorporated in legislative proposals introduced in both Houses during the last Congress and presumably these proposals will be reintroduced in the forthcoming Congress.

Both the Tauzin bill (H.R. 417) in the House of Representatives and the Dodd bill (S. 1976) in the Senate include, along with separate and proportionate allocation provisions, other litigation reform measures. The Dodd bill contains an elaborate series of provisions that would create a self-disciplinary organization for the accounting profession. These provisions bear some resemblance to the disciplinary practices of the National Association of Securities Dealers discussed in the Board's 1993 report. They would provide for an investigatory and trial process when it was alleged that the auditor of a company registered with the SEC had performed a defective audit. The proceedings under this proposed legislation would not be determinative with respect to any other type of proceeding arising out of the same audit—criminal, civil or SEC administrative.

The Securities and Exchange Commission, while indicating a belief that reform with respect to civil litigation under the securities laws is needed, has nonetheless expressed opposition to the separate and proportionate provisions of the proposed legislation. Experience suggests that the opposition of the Commission to legislative proposals in the securities area can be a significant barrier to their enactment.

The Board strongly believes, and urges, that the Commission translate its expressed concern over the excesses of securities litigation into firm proposals. The accounting profession leadership, in turn, should (1) recognize the difficulties posed by the SEC's opposition to the proposed legislation and (2) work with the Commission to develop alternative forms of legislative relief from the dangers that existing litigation practices pose to the profession. SEC Chairman Levitt indicated, in his July 22, 1994 testimony before the House Committee on Energy and Commerce, a willingness "to work with the Subcommittee on fashioning other approaches to address the concerns that have given rise to [separate and proportionate liability] proposals." The profession should quickly and flexibly respond to this willingness.

The Board believes that the threat to the profession from litigation continues to be a serious one and that the profession should continue to pursue legislative and other relief. Moreover, in the estimation of the Board, the threat of excessive liability continues to hamper efforts to effect desirable changes in financial disclosure practices and the willingness of auditors to provide assurances about more relevant disclosures. An

example of this is posed by the recent report of the AICPA Special Committee on Financial Reporting. Notwithstanding the clear benefits that would flow from adoption of many of the recommendations by that committee, a major obstacle to such adoption is the criticism that proposed expanded reporting would pose additional liability dangers to issuers and auditors alike.

About the SECPS

The SEC Practice Section (SECPS or Section) is an organization of over 1,250 CPA firms formed to improve the quality of practice by CPA firms before the Securities and Exchange Commission. Membership requirements are established by the Section's Executive Committee. The practice of each member firm is reviewed by peers on a triennial basis under the supervision of the Peer Review Committee. The emphasis in that review is on compliance with membership requirements and the profession's quality control standards. The Section, through its Quality Control Inquiry Committee, inquires into allegations made in litigation against member firms to ascertain whether the firms involved in the litigation need to take measures to strengthen their quality control systems.

The SECPS also serves as a forum for the dissemination of practice guidance on matters relating to the quality of practice of its member firms. Prior to the 1993-94 year, such guidance was limited and usually appeared in the form of articles in the *Journal of Accountancy* or letters to reviewers and firms. In the spring of 1993, the Section initiated a publication known as *SECPS News and Views*, which provides timely information to member firms on a variety of subjects. Three issues have been published so far. Examples of topics covered are lessons learned from litigation, maintaining professionalism in a competitive marketplace, and the need to improve timeliness in reporting litigation to the QCIC. The Section is to be commended for its efforts to bolster audit quality of practice of its members through enhanced communication and development of practice guidance.

About the POB

The Public Oversight Board (POB) is an autonomous body of five members with a broad spectrum of business, professional, regulatory and legislative experience. It oversees all SECPS activities. The Board's primary responsibility is to represent the public

interest (1) when the Section sets, revises and enforces standards, membership requirements, rules and procedures and (2) when SECPS committees consider the results of individual peer reviews and the possible implications of litigation alleging audit failure. However, the Board believes its responsibilities also include the monitoring of all matters and developments which may affect the integrity of the audit process. The Board's independence is assured by its power to appoint its own members, chairman and staff, set its and its staff's compensation and its budget, and establish its own operating procedures.

Board Activities

One or more Board members attend each meeting of the SECPS Executive Committee and its Planning Committee, and participate as appropriate.

The Board and its staff held seven meetings this year. In addition, members of the Board, its chairman, and staff met with representatives of the profession, standard-setting bodies, and agencies responsible for the regulation of the profession to discuss a variety of issues confronting the accounting profession and its self-regulatory program. Such meetings included discussions with the SEC Chairman, the SEC Chief Accountant, the Comptroller General of the U.S., officials of the SECPS and the AICPA, the AICPA Board of Directors, the Chairman and members of the FASB, the Financial Accounting Standards Advisory Council, and the chief executives of the six largest accounting firms. Discussions at such meetings identify not only matters of interest to the Board, but also matters that should be considered by other bodies concerned with the quality of the audit function.

The Board continued its practice of holding "outreach meetings" with members of SECPS firms and representatives of state CPA societies and state boards of accountancy. This year the Board met with members and officers of the Texas Society of CPAs and the Texas State Board of Accountancy to discuss their professional concerns. Practitioners attending such meetings have often expressed concerns that are then brought to the attention of the appropriate professional bodies.

Our Executive Director addressed the fall 1993 meeting of the AICPA Council and our Chairman addressed the spring 1994 meeting of the Council.

The POB staff's oversight of SECPS peer reviews in 1993-94 was comprehensive. Our oversight plan reflected a risk analysis of the firms to be reviewed in the 1993-94 year.

Because most of the firms reviewed this year had previously undergone peer review and had received unqualified peer review opinions, the number of firms visited this year was less than in prior years. Four retired partners from SECPS firms, who reside in geographic areas with a high number of SECPS firms, assisted the Board's four permanent staff members to maximize geographic coverage while minimizing cost.

Our oversight of the QCIC process was also comprehensive. Our staff actively participated in all task force meetings at which the quality control implications of the allegations in complaints were discussed with firm representatives.

We believe, based on our intensive monitoring, that the Section's self-regulatory programs are working effectively and contribute to the quality of auditing in the U.S. The staff of the SEC has completed its oversight of the 1993-94 peer review cycle and QCIC processes, and our monitoring thereof, and has indicated to our staff its concurrence with the POB's assessment of the self-regulatory program.

The John J. McCloy Award. The POB awarded the 1994 John J. McCloy Award for Outstanding Contributions to Audit Excellence to Wallace E. Olson for his leadership, as president of the AICPA, during the formation of the profession's self-regulatory program. At a time when the profession was under criticism from Congress and the Securities and Exchange Commission and the threat of legislation which would have destroyed the tradition of self-regulation of

the profession, Mr. Olson led the AICPA, in the face of opposition from many of its members, to embark upon the bold venture of creating the mechanism for auditors to subject themselves to periodic reviews by their peers and adopt the stringent requirements for participation in the program. This mechanism was, of course, the Division for CPA Firms, out of which has grown a profession-wide commitment to peer review and audit quality improvement.

Oversight of the Quality Control Inquiry Committee

The Quality Control Inquiry Committee was formed in 1979 to determine whether allegations of audit failure against SECPS member firms involving SEC registrants indicated a need for those firms to take corrective actions to strengthen their quality control systems or to address personnel deficiencies. Consideration of such allegations may also raise questions that lead to reconsideration or interpretation of professional standards. The inquiry process was established because of criticisms of the original self-regulatory program because peer review did not deal with alleged audit failures.

SECPS member firms are required to report to the QCIC, within 30 days of being served, litigation against them or their personnel, or any publicly announced investigation by a regulatory agency, that alleges deficiencies in the conduct of an audit of an SEC registrant. The QCIC may also request the

Executive Committee to add cases involving non-public companies to the QCIC's agenda if it believes that there is a significant public interest in the alleged audit failure. The QCIC reviews copies of complaints, financial statements, trustee reports, and other publicly available documents. If the case is not considered frivolous, the QCIC usually meets with representatives of the accused firm, obtains non-public information, including, at times, audit documentation which may have a bearing on the case. All this is for the purpose of determining whether the allegations against the firm indicate a need for the firm to strengthen its quality controls or for the profession to issue additional guidance. Compliance with the requirements of the QCIC are tested in the peer review process.

The Board and its staff actively oversee all QCIC activities. The Board has unrestricted access to all committee deliberations and files. The Board's staff reviews all complaints filed against member firms, reviews financial statements and other public documents, researches relevant professional literature, and reviews non-public information, such as audit documentation. During the 1993-94 year, the Board's staff participated in all of the forty QCIC task force meetings when QCIC members and AICPA staff discussed the allegations of specific cases with representatives of the firms reporting the litigation and attended, often with Board members, all QCIC meetings. Based on this intensive oversight of the process, the Board's staff provides the Board with comprehensive reports on individual cases at each Board meeting and responds to Board inquiries. The Board and its staff have also been actively participating in the process of identifying and suggesting areas where professional guidance should be augmented. As a result, several matters which resulted in referrals to senior AICPA technical committees and the PITF arose as a result of active Board member participation in the process. The Board continues to believe that the QCIC effectively complements the peer review process and that appropriate consideration was given to the 65 cases closed during the year.

The SEC oversees the QCIC process and the attendant POB oversight activities. Since 1986, the SEC has had direct access to the process through its review of QCIC "closed case summaries" and POB oversight files. When the QCIC concludes its inquiries and closes a case, a closed case summary is prepared. The summary provides the SEC staff with a description of the company, the matters that led to the litigation, the allegations in the complaint, the inquiry procedures followed and documents read by the QCIC, and the results of such procedures. The conclusions reached by the QCIC relate to deficiencies identified in the firm's quality control

Results of QCIC Activity	11/1/79 through 6/30/83	7/1/83 through 6/30/94	Totals
Actions Related to Firms			
Either a special review was made, the firm's regularly scheduled peer review or inspection was expanded, or other relevant work was inspected	58	2	60
A firm took appropriate corrective measures that were responsive to the implications of the specific case	78	11	89
Actions Related to Standards			
Appropriate AICPA technical bodies were asked to consider the need for changes in, or guidance on, professional standards	40	0	40
The Professional Issues Task Force was asked to consider the issuance of a practice alert	0	6	6
Actions Related to Individuals			
The case referred to the AICPA Professional Ethics Division with a recommendation for investigation into the work of specific individuals	23	2	25
TOTAL	199	21	220

(Note: Frequently more than one action is taken by the QCIC or by the firm.)

system, if any, compliance with that system by firm personnel, and whether broader issues are identified which suggest a need for changes in professional standards or additional guidance material. In addition to reviewing the closed case summaries, the staff of the SEC's Office of the Chief Accountant visits the POB's offices several times each year to review the POB's oversight files and to discuss the cases with the POB and QCIC staffs.

Commentary on the Quality Control Inquiry Process

In past years the Board and the SEC staff have been critical of SECPS member firms for not reporting cases to the QCIC within the required 30 day reporting period. The peer review process also noted delays and commented on such in several firms' letters of comments. Although the Section published an article about this matter in its publication, *SECPS News and Views*, and the percentage of cases reported on time has significantly improved since last year, there is room for further improvement. The Board will continue to monitor compliance in this area and urges firms to adhere to the reporting requirements of the Section.

Oversight of the Peer Review Process

The Board considers the peer review process to be the cornerstone of the Section's self-regulatory program and therefore closely observes that process. Peer review encompasses a rigorous examination of the design of a firm's entire quality control system for its accounting and auditing practice and a review of selected engagements to evaluate compliance with that system. Because of the significance and magnitude of the peer review process, the Board allocates substantial resources to its oversight. The Board closely monitors both the performance of the Peer Review Committee in setting standards, processing reports and in the follow-up of mandated corrective actions, and the performance of individual peer review teams as they discharge their responsibility to perform rigorous peer reviews. The Board's staff reviewed each peer review processed by the Peer Review Committee during the year. The level of intensity of a POB staff review varies depending on a risk assessment of the characteristics of the population of firms and an evaluation of the review teams.

Representatives of the Board's staff and usually a Board member attended all meetings of the Peer Review Committee.

Comprehensive reports, prepared by the POB staff, on the peer review process are provided to the Board for review and discussion at each of its meetings.

Commentary on the Peer Review Process

During the year, the Peer Review Committee implemented new procedures to accelerate the report acceptance process and to allow more time at its meetings for the discussion of matters involving improvement of the peer review process. Task forces of the committee have been formed to process peer reviews between committee meetings and to consider reports on committee-imposed follow-up actions. The result has been a demonstrated improvement in the timeliness with which peer review reports are processed and appropriate corrective actions implemented by member firms. The committee is to be especially complimented for processing all the 1993 peer review reports by June 30, 1994. The Board's staff performed a review of each peer review processed by the Peer Review Committee during the year. The level of intensity of a POB staff review varies depending on a risk assessment of the characteristics of the population of firms and an evaluation of the review teams.

During the year, the Peer Review Committee made significant progress on its broad-based "visioning" project which is a "zero-based" re-evaluation of the peer review process. The principal objective is to assure that the peer review process results in continuous improvement in the quality of member firms.

An early product of the visioning project is a document entitled "Follow-Up Action Criteria" that identifies appropriate follow-up actions depending on the severity of deficiencies noted during the peer review. For instance, a firm which receives a clean opinion requires no follow-up; a firm receiving an adverse report obviously has an inadequate quality control system and significant follow-up is warranted. These criteria will also assist the committee in more uniformly determining the circumstances when follow-up action should be imposed and will standardize reporting to the committee by reviewers who conduct follow-up procedures.

Certain other visioning projects nearing completion include proposing to the Auditing Standards Board possible revisions to the standards of quality control and the development of guidance for reviewers faced with extensive engagement documentation deficiencies.

In prior annual reports the Board has stated its belief that letters of comments did not always communicate findings clearly to public users. The committee has been responsive to this concern and we have observed significant improvement in this regard.

SECPS Executive Committee

The SECPS Executive Committee, among its other responsibilities, establishes membership requirements for member firms and establishes operating policies for, and monitors the activities of, the QCIC and Peer Review Committees. The Executive Committee provided the direction and leadership for the actions described elsewhere in this report and for the profession's response

Major Corrective Measures Imposed by the Peer Review Committee to Ensure that Quality Control Deficiencies are Corrected

Action	Number of Times	
	During 1993	Since Inception
Accelerated peer review	1	48
Employment of an outside consultant acceptable to the Peer Review Committee to perform preissuance reviews of financial statements or other specified procedures	2	59
Revisits by the peer reviewers or visits by a committee member to ascertain progress made by the firm in implementing corrective actions	3	174
Review of the planning for and results of the firm's internal inspection program	15	242
Review of changes made to the firm's quality control document or other manuals and checklists	0	42

to many of the recommendations included in the Board's special report.

The Executive Committee previously adopted a membership requirement that directs member firms to notify the SEC within five business days whenever the client-auditor relationship with an SEC registrant ceases. SEC statistics indicate that compliance with this requirement by member firms needs to be improved. The Executive Committee has agreed to several actions which are intended to improve the rate of compliance in the future.

**POB Commentary –
Strengthening
the Professionalism of the
Independent Auditor**

As explained elsewhere in this report, the Board's appointment of the Advisory Panel on Auditor Independence was triggered by the issues raised in a January 1994 speech by the Chief Accountant of the SEC and also because of the Board's concerns about the independence and objectivity of the auditing profession expressed in its March 1993 report, *In the Public Interest: Issues Confronting the Accounting Profession*.

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

The Panel concluded there are important steps that should be taken to better assure the integrity and objectivity of auditors' judgments. Their report emphasizes there are no quick and easy "fixes." Several of the Panel's suggestions are specific, but most are broad in scope and constitute serious challenges to the profession and to other participants in the financial reporting process.

In formulating its conclusions and recommendations, the Panel assessed the current professional environment based on written submissions, interviews, and the panel members' own experiences. The cumulative effect of their findings convinced the Panel that the profession is at a critical juncture and that there are fundamental changes in relationships necessary to better assure the objectivity of the independent audit.

Following are the Panel's principal findings:

First, the public concern about audit failures has not abated. Allegations of audit failures and improper financial practices by companies have eroded the profession's goodwill and the public's confidence in the accounting profession and financial report-

ing. Those allegations have resulted in widespread skepticism about the objectivity of the profession even after the many steps taken to lessen the "expectation gap." Alternative accounting principles and inadequate disclosure are regarded as contributing to misleading financial statements. The Panel is convinced that confidence in the profession will be further dissipated if the profession's audit services—the basis for its franchise — are not strengthened to meet the needs of corporate boards, stockholders, creditors, and the investing public.

Second, the cost of real and perceived audit failures is immense. Such costs include large monetary settlements and judgments 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 cautiously, for example, by turning down, or turning out, high risk clients.

Third, the increased audit risk associated with new and complex business arrangements, intricate financial transactions, and rapidly changing information technology have complicated the resolution of accounting questions and challenged the validity of old answers and auditing techniques.

Fourth, as a result of litigation risks and the tendency of corporate managements to press for favorable accounting treatments, the large accounting firms seek detailed accounting and auditing standards and guidance. One consequence of this has been that audits have become more compliance or rule-book oriented. Some commentators to the panel observed that independent auditing has increasingly emphasized evidence-gathering and compliance with rules and has neglected judgments about accounting policies and disclosure practices.

Fifth, clients' increasing internal competence in accounting and auditing and the compliance orientation of the external audit decrease its value as perceived by corporate financial management. To them, the audit is sometimes viewed as no more than a required commodity. Auditing firms have contributed to this trend. As mergers and acquisitions have increased the competition for clients, firms have become more willing to reduce fees.

Sixth, many of the larger firms have combined, expanded globally, and diversified the services offered to clients. 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. Those services result in higher margins and less risk, and so are more attractive to younger staff recruits. 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.

This growing reliance on non-audit services has the potential to compromise the objectivity or independence of the auditor. This can happen if those other services divert firm leadership away from the public responsibility associated with the independent audit function, for example, by allocating disproportionate resources to other lines of business within the firm and using the audit as an entrée to sell other services.

The Panel sees those six trends and others identified in its report as reducing both the attractiveness of the auditing function as a career and its stature as an important public service profession.

These trends are also occurring at the same time that questions are being raised about the performance of corporate directors as representatives of shareholders.

To counter those trends and strengthen the professionalism of the auditor, actions are required to create a professional environment —

- in which boards of directors and managements of client companies have high expectations about the auditing firms' objectivity and professional expertise;
- in which auditors, in meeting those expectations, recognize an overriding public responsibility;
- in which an auditor's professional services truly do add value and are not looked on simply as a regulatory requirement;
- in which auditors can pursue their professional activities without fear of undue 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.

While there are no quick solutions to better assure the independence of auditors and the integrity and objectivity of their judgments, the Panel and the Board believe the report's suggestions offer a way to counter those trends, to create a better professional environment, and to restore auditing to its important role in our society. That can best be done by making auditing an important element in corporate governance, teaming independent auditors with independent directors to protect the rights of investors to receive adequate, reliable, and understandable financial information.

The Panel's principal suggestions to achieve those objectives are:

First, firms need to emphasize to all pro-

fessional staff that auditing is not just one of many services offered to clients. It is special. It involves, as the Supreme Court has stated, a "public responsibility transcending any employment relationship with the client."

Second, the 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 undoubtedly will require that firms' senior management rethink their organization structures and business strategies. They urge regulators and overseers of the accounting profession to encourage and support the profession's efforts in this regard.

Lastly, to bring the audit function into the mainstream of corporate governance requires a three-part, interrelated approach.

The first part is a suggestion to the POB and others to encourage adoption of proposals that enhance the independence of boards of directors and their accountability to shareholders. 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. The Panel is convinced that stronger, more accountable boards will strengthen the professionalism of the outside auditor, enhance the value of the independent audit, and serve the investing public.

The second part deals with the identity of the auditor's client. The Panel suggests the focus should shift from management to the board of directors. The auditor's public responsibility may be neglected when finan-

cial management becomes the primary intermediary between corporations and auditing firms. The Panel believes that it is essential for the accounting profession to bring greater clarity to the identification of the auditor's client. Boards, particularly independent directors, and auditors should be natural allies in protecting shareholder interests. By building this natural alliance the auditor can be a significant contributor to corporate governance.

The third part of the Panel's suggestions is that to serve shareholders' interests, the board of directors should expect to hear from the auditor a candid evaluation of the appropriateness, not just technical acceptability, of accounting principles, financial statement estimates, and the clarity of the related disclosures in company reports. The Panel's report stated that:

"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."

Independent auditors have not played a forceful role in assessing and communicating such judgments. But independent CPAs

are licensed as auditors and experts in 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, particularly, the degree of aggressiveness or conservatism of the company's accounting principles and underlying estimates.

For years, the auditor's opinion has said that "an audit...includes assessing the accounting principles used," and 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 those assessments and judgments has been whether the selected principle falls within the range of acceptable practice. The panel would hold the auditor to a different and higher standard in communicating with the board of directors.

The Panel believes the time has come to put substance and meaning behind those two words, "assessing" in the opinion on financial statements, and, "appropriate" in the auditing standards.

The Board believes the Panel's report 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.

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Copies of Strengthening the Professionalism of the Independent Auditor, the report of the Advisory Panel on Auditor Independence to the Public Oversight Board of the SEC Practice Section of the American Institute of Certified Public Accountants (September 13, 1994), can be obtained by writing to the POB's offices.