

*P* U B L I C   *O* V E R S I G H T   *B* O A R D

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*Annual  
Report  
1995-1996*



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# About the **SEC** Practice Section and the Public Oversight Board

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## The SECPS

The SEC Practice Section ("SECPS" or the "Section") was founded in 1977 as part of the Division for CPA Firms of the American Institute of Certified Public Accountants ("AICPA") and its activities are overseen by the Public Oversight Board (the "Board" or the "POB"). The Section imposes membership requirements and administers a number of programs to help insure that SEC clients are audited by member accounting firms with adequate quality control systems. Member firms are required to participate in (1) peer review, through which Section members have their practices reviewed every three years by other accountants and (2) quality control inquiry, which reviews allegations of audit failure contained in litigation filed against member firms relating to SEC clients and certain other entities to determine if the firms' quality control systems require revision or there should be stricter compliance with the firms' quality control policies and procedures and/or the Section's membership requirements.

The requirements of the SECPS affect more than 112,608 professionals at 1,300 member firms that audit more than 14,869 SEC clients.

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## The POB

The POB is an autonomous body of five members with a broad spectrum of business, professional, regulatory and legislative experience. The Board's independence is assured by its power to appoint its own members, chairperson and staff, set its own budget, and establish its own operating procedures. It oversees all SECPS activities.

The Board's primary responsibility is to represent the public interest (1) when the Section sets, revises or enforces standards, membership requirements, rules or procedures and (2) when SECPS committees consider the results of individual peer

reviews or the possible quality control implications of litigation alleging audit failure. The Board believes its responsibilities also include the monitoring of all matters and developments that may affect public confidence in the integrity of the audit process. The 1995 Annual Report of the Securities and Exchange Commission ("SEC") acknowledges that the POB's activities have not been limited to oversight of the profession's self-regulatory programs but also are directed to improving the financial reporting process.

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### Corporate Governance

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### Approach to Improved

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### Financial Reporting

During 1995, the Board prepared and distributed a summary report of one of the key recommendations contained in the report of the Board's Advisory Panel on

Auditor Independence entitled *Strengthening the Professionalism of the Independent Auditor*. That summary, *Directors, Management, and Auditors—Allies in Protecting Shareholder Interests*, urges adoption of a corporate governance approach to improve financial reporting and has been widely distributed to over 50,000 chief executive and financial officers and directors of public companies. The centerpiece of this approach is enhanced communication, particularly between the auditors and the board of directors. In that regard, the report urges corporate boards and the independent auditor to engage in candid communication about the appropriateness, not just acceptability, of accounting principles and estimates and the clarity of the related disclosures of financial information.

The Board is considering other ways to encourage further acceptance and implementation of the corporate governance recommendation among those who have the responsibility for corporate governance. The Board strongly believes that a close relationship between the auditor and the board of directors/audit committee will enhance the ability of directors to discharge their critically important corporate governance responsibilities related to financial reporting while at the same time strengthening auditor professionalism and independence.

The SEC Practice Section has endorsed the recommendation for enhanced communication. A task force of the Peer Review Committee has been formed to identify "best practices" that SECPS firms have adopted to accomplish the objective of more candid communication between the auditor and the board. It has requested information from the firms of the members of the Peer Review Committee and has designed a survey questionnaire that has been used to compile information about implementation on the SEC engagements that are subjected to review in the 1996 peer reviews of firms with five or more such engagements. The results will be summarized with a view to communicating best practices to all SECPS firms.

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## GAO Report on the

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## Accounting Profession

In September 1996 the General Accounting Office ("GAO"), in response to a congressional request, published a study of the manner in which the accounting profession had responded to recommendations of various bodies, entitled *The Accounting Profession—Major Issues: Progress and Concerns*. While identifying continuing problems such as independence and the detection of fraud, the GAO generally found that the profession had responded well to the recommendations that were made. The POB was consulted by the GAO in the course of preparing the report and the POB submitted written

comments in response to the exposure draft. The report commended the SECPS and the POB for their work in strengthening the audit process and took particular note of the Board sponsored report of the Advisory Panel on Auditor Independence.

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### *Litigation Reform*

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The Board supported the efforts of the profession to persuade Congress to adopt legislation which would substitute, for the long-standing principle of "joint and several liability" of defendants in private securities cases, the principle of "separate and proportionate liability." Under the former practice, any defendant in a securities action could be compelled to pay the entire amount of a judgment regardless of the extent to which his conduct contributed to the plaintiffs' losses. Under a "separate and proportionate standard" each defendant would only be liable to the extent to which his conduct causes the losses. The Board's support, expressed in testimony before a Congressional committee considering the matter, was the consequence of a careful study of the matter which concluded that the "joint and several" practice imposed significant unfairness on defendants in securities litigation. Late in 1995 Congress overrode the President's veto of the Private Securities Litigation Reform Act which included a provision

for "separate and proportionate liability" in most cases among defendants in securities cases.

It is too soon to judge the impact of this new law on the liability of auditor defendants. However, there are some indications that fewer cases are being filed against auditors, although this may be for reasons other than the new legislation.

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### *Board Meetings*

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The Board and its staff held seven regularly scheduled meetings during the year in connection with its oversight of the self-regulatory programs of the SECPS and its consideration of issues having a bearing on the credibility and effectiveness of the auditor. The three-day October meeting was a "retreat meeting," which the Board periodically holds to (1) review the effectiveness of the self-regulatory programs and the Board's oversight role and (2) evaluate matters relating to the quality of independent auditing and financial reporting in the U.S. At the meeting, the Board exchanged views with the Comptroller General of the U.S. General Accounting Office, the Chief Accountant of the SEC and an Associate Chief Accountant, the chair of the SECPS, and the chair and vice-chair of the Financial Accounting Standards Board. Guests of the Board at other meetings included the immediate past AICPA president, the current AICPA president, the vice-chair of the

AICPA, the Chief Accountant of the SEC, the chair of the Financial Accounting Foundation, the chair of the SECPS Executive Committee, the chair of the AICPA Special Committee on Assurance Services, the chair of the Quality Control Inquiry Committee, the AICPA Vice President-Self-Regulation, and the senior QCIC staff person. Those present at the retreat meeting and other meetings urged the Board to continue to view its role broadly. As one participant observed, the Board has appropriately assumed the role of "creative irritant" to the auditing profession and encouraged the Board to continue that role.

In addition to exchanging views with those present at formal POB meetings, the Board's chairman, other Board members and the Executive Director and staff interacted with SEC Chairman Levitt and the Chief Accountant on a number of occasions on the subject of auditor independence as well as with the SECPS Executive Committee chair and chair of the SECPS Task Force on Auditor Independence; the AICPA president concerning the allocation of resources to support the self-regulatory programs, particularly the Quality Control Inquiry Committee; the Auditing Standards Board on the subject of the proposed auditing standard, *Consideration of Fraud in a Financial Statement Audit*; and with representatives of the

accounting profession in the U.K. on the subject of establishing a public oversight board in the U.K.

The chairman of the POB addressed the spring meeting of the AICPA Council and discussed POB activities with the AICPA board of directors.

The Board's staff participated in the deliberations of SECPS task forces on Auditor Independence, Quality Control Standards, Implementation of and Transition to Revised Quality Control Standards, Best Practices, Oversight in the Year 2000, and Technology.

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### *The John J. McCloy*

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#### *Award*

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The POB awarded the 1996 John J. McCloy Award for Outstanding Contributions to Audit Excellence to David B. Pearson whose career has been characterized by his leadership and commitment to improving the quality of the accounting profession's self-regulatory programs. He has unfailingly placed the public interest in the forefront as a member, then chair, of the SECPS Peer Review Committee and as an engagement partner of several large firm peer reviews. In these activities and in contributing to the auditing standard setting process and to the improvement of the quality of university and continuing education, Mr. Pearson's views have always been shaped by the importance of maintaining public confidence in the profession.

# Oversight of the SECPS Executive Committee

One or more Board members and staff members attend each meeting of the SECPS Executive Committee and its Planning Committee and participate as appropriate. The Executive Committee is the SECPS's governing body. It establishes the Section's membership requirements and supervises the activities of the Peer Review Committee ("PRC"), the Quality Control Inquiry Committee ("QCIC"), the SEC Regulations Committee, and the Professional Issues Task Force ("PITF").

The PITF was formed in 1994 in response to a Board recommendation to identify and consider practice issues that present high audit risk and to disseminate relevant guidance. During the year, the PITF issued three *Practice Alerts* entitled "Complex

*Derivatives," "Auditing Related Parties and Related-Party Transactions," and "The Private Securities Litigation Reform Act of 1995."*

The SECPS completed its monitoring of compliance with the requirement that AICPA members that practice before the SEC be enrolled in the SECPS. With assistance from

the SEC Chief Accountant's staff, an Executive Committee task force is conducting an outreach program to identify and invite other firms that are not members of the SECPS but audit SEC clients to join the SECPS.

The SECPS chair wrote to all SECPS firms advising them that applicable membership requirements, including concurring review and partner rotation, are applicable to engagements for which a member serves as principal auditor of record of an employee stock purchase, savings or similar plan that files a Form 11-K with the SEC

pursuant to the Securities Exchange Act of 1934.

The Executive Committee approved a *Memorandum of Understanding* prepared by the QCIC which codified the unwritten understanding that had guided the SEC staff's access to information about closed QCIC cases. This memorandum was transmitted to the Office of the Chief Accountant.

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

Action	Number of Times	
	During 1995-96	Since Inception
Accelerated peer review	1	52
Employment of an outside consultant acceptable to the Peer Review Committee to perform preissuance reviews of financial statements or other specified procedures	8	74
Revisits by the peer reviewers or visits by a committee member to ascertain progress made by the firm in implementing corrective actions	7	194
Review of the planning for and results of the firm's internal inspection program	25	304
Review of changes made to the firm's quality control document or other manuals and checklists	1	43
Continuing Professional Education in specified areas	3	42

\* Since July 1, 1988.

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# Oversight of the Peer Review Process

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A primary responsibility of the Board is to monitor and evaluate the effectiveness of the Section's peer review process, including the activities of its Peer Review Committee. Peer review is an independent, rigorous evaluation of the design of a firm's quality control system for its accounting and auditing practice, and an assessment of a firm's compliance with that system. It is the cornerstone of the CPA profession's self-regulatory program and its principal method of assuring the public that member firms are performing at a level that meets or exceeds professional standards. Because of the significance and magnitude of the peer review process, the Board and its staff allocate substantial resources to the oversight of the peer review process to assure that it is vigorous and effective.

One or more Board members and staff members regularly attend and participate proactively in meetings of the PRC. The Board's staff reports to the Board at each of its meetings on the performance of the committee in setting standards, processing reports, following-up on mandated corrective actions, and dealing with substandard performance of individual peer review teams.

Every peer review administered by the committee is monitored by the Board's staff. The level of oversight varies in intensity according to the characteristics of reviewed firms and the past performance history of reviewed firms and review teams. In 1995-96, the Board's staff attended the reviews of approximately 25% of firms with SEC clients, including 100% of firms with thirty or more SEC clients, for the purpose of testing compliance with the peer review standards. Firms with

SEC clients that received a qualified or adverse opinion on their prior review were visited with greater frequency than others. For all other firms with SEC clients, the staff reviewed selected working papers and the reports, letters of comments and response and discussed significant issues identified with peer reviewers to satisfy itself that all such issues were properly resolved and reported. The staff participated in all the meetings of task forces of the PRC regarding evaluation of individual peer reviews and communicated any concerns it had about the conduct of or reporting on reviews. The staff is satisfied that all such concerns were adequately considered by the PRC.

The Board's staff monitored the activities of task forces of the PRC. One such task force was the Task Force on Associations of CPA Firms. An association of CPA firms is a group of firms that join together to achieve a variety of objectives. These may include pooling resources to enhance

their ability to (a) render professional services—for example, through joint education programs, inter-firm consultation, and peer review—and (b) market such services. Present guidelines proscribe associations that administer peer reviews of its member firms from warranting or making representations regarding the quality of professional services performed by member firms or conducting marketing efforts on behalf of members. The task force concluded and the PRC concurred that the performance of certain marketing activities on behalf of member firms should continue to be regarded as a violation of the independence requirements in the SECPS's *Guidelines for Involvement by Associations of CPA Firms* if the association arranges for and carries out peer reviews of its own members.

The PRC's Oversight in the Year 2000 Task Force is close to completing its efforts and expects to issue a report in 1997. Its recommendations are intended to assure that the peer review process continues to be relevant and results in continuous improvement in the quality of member firms' audit practices.

The Board's staff participated, with the AICPA Joint Task Force on Quality Control Standards, in the drafting of the *Guide for*

*Establishing and Maintaining Quality Control for a CPA Firm's Accounting and Auditing Practice*. This guide contains recommendations to assist CPA firms in implementing revised Quality Control Standards.

While improving the quality of audits of individual member firms continues to be the primary focus of peer review, the PRC believes that the program should be a source of information to the standard-setters to assure that quality control and auditing standards are relevant and effective in assuring that firms are prepared to deal with emerging practice issues in their individual practices. Consequently, the PRC referred a number of such issues to standard-setters, which described the issues for practitioners, principally in Audit Risk Alerts.

It is the Board's conclusion, based on its oversight program, that the SECPS peer review program contributes to the quality and consistency of auditing in the United States.

The SEC, through the office of the Chief Accountant, oversees the peer review process and POB oversight of the process by randomly inspecting peer review working papers and POB files. The SEC's inspection of the 1995 reviews is complete and the Board expects the SEC to continue to endorse the SECPS's Peer Review Program in its 1996 annual report.

# Oversight of the Quality Control Inquiry Committee

The Quality Control Inquiry Committee determines whether allegations of audit failure against SECPS member firms involving SEC registrants indicate a need for those firms to take corrective actions to strengthen their quality control systems or to address personnel deficiencies. The quality control inquiry process complements the peer review process.

The committee's work also on occasion raises questions that suggest the need to reconsider or interpret professional standards or suggest audit practice issues where practical guidance would benefit practitioners. The QCIC refers such matters to the PITF or other bodies responsible for issuing professional guidance.

Section member firms are required to report and provide to the QCIC copies of complaints and amendments of complaints within 30 days of being served. This requirement includes all litigation involving the firm or its 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 also has the authority to inquire into complaints involving non-public entities where there is significant public interest and also into complaints filed against auditors by federal and state regulators alleging audit failure in the conduct of an audit of a financial institution.

The QCIC reviews the complaints, financial statements and regulatory filings, trustee reports, SEC enforcement releases, and other publicly available documents. If the committee's preliminary analysis indicates that the complaint is not frivolous, the QCIC meets with representatives of the accused firm. The QCIC also may review audit documentation and firm guidance material for the purpose of determining whether the allegations against the firm indicate a need for the firm to strengthen quality

controls or issue additional internal guidance. The QCIC reviewed firm technical guidance material and/or audit documentation related to the allegations in eight (8) cases during this past year. The QCIC occasionally becomes aware of behavior by individual CPAs that warrants investigation. The QCIC refers such matters to the AICPA Professional Ethics Division. In rare cases, the QCIC becomes aware of regulatory rules that, if amended, would better protect the public interest. In such cases, appropriate regulatory agencies are so informed.

The Board and its staff monitor and evaluate the effectiveness of all QCIC

activities. All committee and task force meetings are attended by the Board and/or its staff and the Board has unrestricted access to all committee deliberations and files. During the 1995-96 year, the Board's staff participated in all 35 QCIC task force meetings at which QCIC members and AICPA staff discussed the allegations contained in specific cases with representatives of the firms reporting the litigation. The Board's staff prepares comprehensive reports on individual cases for the Board's information and responds to Board inquiries about the process. The Board and its staff are also actively involved in the identification and communication of areas where professional standards should be augmented.

The Board believes that the QCIC process effectively complements the peer review process and that appropriate consideration was given to the 46 cases closed during the year.

The SEC staff actively oversees the QCIC process and the attendant POB activities. The SEC staff visited the POB's offices several times during the year to review the QCIC prepared closed case summaries and the POB files on each case, which include POB memoranda on task force meetings.

During the past year, the QCIC experienced delays in the consideration and processing of cases. These delays primarily resulted from the departure of experienced QCIC staff who were responsible for analyzing complaints and related financial statements, preparing staff summaries and schedules, and participating in task force meetings. In the fall of 1996, the Section hired two senior staff persons and substantial progress has been made in eliminating the backlog of open cases.

## QCIC Activity

	7/1/95 through 6/30/96	11/1/79 through 6/30/95	Totals
<b>Actions Related to Firms</b> <i>Either a special review was made, the firm's regularly scheduled peer review was expanded, or other relevant work was inspected</i>	3	62	65
<i>A firm took appropriate corrective measures that were responsive to the implications of the specific case</i>	8	97	105
<b>Actions Related to Standards</b> <i>Appropriate AICPA technical bodies were asked to consider the need for changes in, or guidance on, professional standards</i>	—	45	45
<i>The Professional Issues Task Force was asked to consider the issuance of a practice alert</i>	5	7	12
<b>Actions Related to Individuals</b> <i>The case was referred to the AICPA Professional Ethics Division with a recommendation for investigation into the work of specific individuals</i>	—	28	28
	16	239	255

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

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### Fraud Detection

In the Board's 1993 Special Report, *In the Public Interest*, the Board observed:

"No problem confronting the profession is as demanding or as difficult to resolve, as the problem of management fraud and its detection by auditors. Before the turn of the century both auditors and users of audited financial information regarded the detection of fraud as one of the primary purposes of an audit. For many reasons the profession has moved from acceptance of that purpose to the view that its role in detecting fraud is secondary to the other purposes of audits. In contrast, the public has continued to regard fraud detection as an important goal of the audit process—and now attaches even greater importance to that goal."

"The Board believes that, to a greater extent than it now does, the profession must accept responsibility for the detection of fraud by management. The profession cannot, and it cannot be expected to, develop methods that will assure that every fraud, no matter how cleverly contrived, will be unearthed in the course of the audit, but it must develop means of increasing significantly the likelihood of detecting fraud."

"The Board also recommends that the profession develop comprehensive guidelines to further assist auditors in identifying symptoms that indicate the heightened likelihood of management fraud involving the manipulation of financial information and specify additional audit procedures when such symptoms appear. This undertaking should be broad in scope and include the development of guidance to facilitate the analysis of both financial data and non-financial factors that may be indicative of management fraud."

The Auditing Standards Board ("ASB") is in the final stages of developing improved guidance of the nature that the Board suggested in its Special Report. The Board has carefully followed and provided comment on the ASB's proposed standard *Consideration of Fraud in a Financial Statement Audit* and believes that it clarifies the auditor's responsibility to detect fraudulent financial reporting and will substantially assist the auditor in meeting that responsibility by including risk factors identified by research of past frauds, and explaining how the auditor should assess, document and respond to those risk factors.

The ASB has done its job well and it will now be the responsibility of auditing firms to implement the new standard by revising their quality control systems, educating their personnel, and conducting their audits with heightened and experienced skepticism. As many firms are now "reengineering" their audit approaches for other

reasons, this will be both a challenge and an opportunity.

### Auditor Independence

Since the inception of the Public Oversight Board, no topic has been the subject of more Board discussion than the subject of auditor independence. In 1979, the Board undertook a review of non-audit services performed by auditors of publicly held companies, concluded that some services were incompatible with perceptions of independence, and counseled the profession to undertake new non-audit activities with caution and circumspection. A Board sponsored survey of public perceptions about non-audit services conducted in 1986 found considerable misgivings among knowledgeable groups about the performance of certain services for audit clients. More recently, in 1993 the Board published *In the Public Interest* which reiterated the Board's strongly held belief

about the importance of the audit function in multi-line service firms and the need to enhance the perception of auditor independence in assuring the credibility of financial reporting. In 1994, in response to concerns expressed by the then SEC Chief Accountant about auditor independence, the Board formed an Advisory Panel on Auditor Independence. The Panel's report was referred to above.

In 1995 and 1996, a number of matters led the Board to conclude that the time had come for the profession to reevaluate the adequacy of the profession's Code of Professional Conduct to deal with present day independence questions. In a December 27, 1995 letter to officials of the American Institute of CPAs and the SEC Practice Section, we urged that "it is timely and appropriate for the profession to consider whether the Code of Professional Conduct provides an adequate framework and guidance for addressing in a timely manner the implications of new service lines."

As a result of the Board's letter, the chair of the Executive Committee formed the Task Force on Auditors' Independence When Performing Non-Audit Services for an Attest Client. This task force has held a number of meetings to address a number of conceptual issues concerning the nature of services that CPA firms may render directly, or indirectly through related entities, for their SEC registrant audit clients. The Board's staff has participated in all the meetings of this task force. Staff of the Office of the Chief Accountant of the SEC has also participated in the meetings. The task force's work is ongoing at the date of this report and many of the issues under discussion are contentious and consensus has not yet been reached.

The Board is encouraged by the substantive attention that is being given to the issues being discussed by the task force and the professionalism of the deliberations. However, the proliferation of non-audit services continues to grow, and the character of some services underlying this growth have evolved away from being of an advisory nature. For example, firms now provide outsourcing arrangements for many corporate functions. The implications of some of the new services on auditor independence are difficult to assess; and thus they result in skepticism by many observers of the profession about auditor objectivity. Because the root causes of skepticism about independence are not well understood, efforts to deal with scope of service issues through rules and other measures have not been effective in addressing that skepticism. As non-audit services continue to grow, that growth must be fostered in a manner that avoids providing services to audit clients that undercut the perception of auditor independence. Thus, we believe that public perceptions about auditor independence need to be better understood and that non-audit services provided to public companies need to be measured against a more conceptually sound independence framework than currently exists. It may be that, with better understanding of public perceptions and a more consistent conceptual framework, concerns about the impact of certain non-audit services on auditor independence may be mitigated.

The profession must again demonstrate its ability to succeed in creating institutions and procedures commensurate with the needs of the times. We urge the profession to continue its efforts to preserve and strengthen self-regulation in the accounting profession.



Copies of the reports *Strengthening the Professionalism of the Independent Auditor and Directors, Management, and Auditors—Allies in Protecting Shareholder Interests*, or additional copies of this report, can be obtained by contacting the Public Oversight Board's offices.



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## Public Oversight Board

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### BOARD

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*Assistant Technical Director*

From the POB 1995 Report

### ***DIRECTORS, MANAGEMENT, AND AUDITORS— ALLIES IN PROTECTING SHAREHOLDER INTERESTS***

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#### *What the Audit Committee*

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#### *Should Do*

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The POB urges that audit committees take action to ensure that their charter or terms of reference include or provide for the following:

- An instruction to the independent auditor that the **board of directors**, as the shareholders' representative, is the **auditor's client**.
- An expectation that financial management and the independent auditor perform a **timely analysis** of significant financial reporting issues and practices.
- An expectation that financial management and the independent auditor discuss with the audit committee their **qualitative judgments about the appropriateness, not just the acceptability, of 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 its accounting principles and underlying estimates.
- An opportunity for the full board of directors to meet with the independent auditor annually to help provide a basis for the board to recommend to shareholders the appointment of the auditor or ratification of the board's selection of the auditor.

The audit committee discussion with the independent auditor about the appropriateness of accounting principles and financial disclosure practices should generally include the following:

- the auditor's independent qualitative judgments about the appropriateness, not just the acceptability, of the accounting principles and the clarity of the financial disclosure practices used or proposed to be adopted by the company;
- the auditor's views about 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;
- the auditor's reasoning in determining the appropriateness of changes in accounting principles and disclosure practices;
- the auditor's reasoning in determining the appropriateness of the accounting principles and disclosure practices adopted by management for new transactions or events;
- the auditor's reasoning in accepting or questioning significant estimates made by management;
- the auditor's views about how the company's choices of accounting principles and disclosure practices may affect shareholders and public views and attitudes about the company.