

PUBLIC OVERSIGHT BOARD

*Annual
Report
1996-1997*



Message From The Board

The primary responsibility of the Public Oversight Board ("POB") is to represent the public interest when the SEC Practice Section ("SECPS" or the "Section") sets, revises or enforces standards, membership requirements, and rules of procedure. Our role is also to represent that interest when SECPS committees consider the results of individual peer reviews or the possible quality control implications of litigation alleging audit failure. The Board interprets its responsibilities to include the monitoring of all matters and developments that may affect public confidence in the integrity of the audit process.

To meet these responsibilities, the POB has focused on two major initiatives during the past year: (1) the creation of a new Independence Standards Board and (2) audit re-engineering. We also report on additional activities that support our goals.

Creation of New

Independence

Standards Board

Since the formation of the POB, no topic has received more attention from the Board than the subject of protecting and enhancing auditor independence. A number of matters caused the Board to believe that the time had come for the profession to evaluate the adequacy of its Code of Professional Conduct to deal with present day independence questions. In December 1995 we sent a letter to the American Institute of Certified Public Accountants ("AICPA") and the SECPS suggesting 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."

The profession and the SEC, as well as the POB, have for some time believed that the existing system of setting independence rules and standards was out of date and did not provide a conceptual framework for addressing auditor independence issues in a rapidly changing technological and global environment. Both business and professional relationships are becoming increasingly complex, the skill sets of accounting firms needed to provide attest services in a wide variety of diverse businesses are growing, and the non-audit service demands of clients are increasing.

In June 1997 the profession and the SEC agreed to establish a new private sector body—the Independence Standards Board ("ISB") to set independence rules and guidance for auditors of public companies.

The POB believes the formation of the ISB demonstrates the profession's commitment to the public interest and provides an appropriate forum in which to address the growing complexity of issues essential to safeguard auditor

independence. The Board pledges its support to the ISB and will assist it by continuing to be an interested and independent observer of and commentator on issues important to maintaining and enhancing the independence of auditors.

Audit Re-Engineering

Audit re-engineering is an expression often used today to cover a variety of efforts on the part of CPA firms—both large and small—to enhance their audit processes with a view to improving the efficiency and effectiveness of the audits of clients' financial statements in a rapidly changing environment.

In April 1997, SEC Chief Accountant Michael H. Sutton in a letter to the POB Chairman asked that the Board evaluate the audit re-engineering efforts of firms in the SECPS to ensure that they do not compromise audit quality. Specifically, the Chief Accountant requested assurance that changes in audit workpaper documentation would not emasculate (1) the effectiveness of audit planning, supervision and review by engagement management, and (2) the ability of the firms' concurring review partners, internal inspection teams, and external peer review teams "to independently reach judgments about the adequacy of the work performed and the propriety of the conclusions reached."

The POB discussed the Chief Accountant's concerns

with the chairs of the Executive and Peer Review Committees at a meeting with the full Board.

Executive Committee Chairman Siegel wrote to the managing partners of all SECPS firms in July 1997 requesting them to carefully consider the documentation in any "audit re-engineering" effort they may undertake and urging them to consult with their peer reviewers before implementing such changes. A task force formed by the Peer Review Committee Chairman McGrath has developed a *Supplemental Questionnaire for Review of a Firm's Redesign of its Audit Processes* which is to be completed for all SECPS reviews beginning after September 1, 1997. The purpose of this questionnaire is to gather information about re-engineered audit systems and to obtain peer reviewers' assessments of the adequacy of audit documentation for an effective concurring review, internal inspection, and peer review.

The Board will continue to monitor the Section's actions and will evaluate the results and implications of information gathered about audit re-engineering.

Supporting The

Self-Regulatory System

The recent controversy with regard to appropriate accounting for derivative instruments prompted the Board to take a strong position

against any effort to substitute government regulation for self-regulation in any area where self-regulation presently exists and is effective. On behalf of the Board, the chairman of the Board wrote in a letter to legislators: "Our observation is that self-regulation, under the careful oversight of the Securities and Exchange Commission, in the establishment of accounting principles has served the United States well. In part as a consequence of this procedure for establishing accounting principles, the United States is the envy of the world for the transparency, integrity and usefulness of financial information prepared in accordance with generally accepted accounting principles as established by the Financial Accounting Standards Board ("FASB"). This has resulted in capital markets which, too, are the envy of the world for their efficiency, integrity and fairness to investors, large and small."

"We believe that the intrusion of the government into the process of establishing accounting principles beyond the oversight presently exercised by the Securities and Exchange Commission would be a severe setback to the reputation presently enjoyed by U.S. accounting principles and U.S. capital markets."

The letter concludes: "Based upon our experience

and observation, we strongly urge that Congress forego any action which would interfere with the FASB's commitment to sound accounting and the integrity of financial reporting."

Dissemination of

Best Practices

The Board applauds the Section's efforts to enhance the quality of practice of member firms by developing and disseminating to all SECPS member firms "best practices" guidance. Guidance on three matters was provided during the past year: (a) communications with boards of directors and audit committees, (b) accounting and auditing consultations with engagement teams with "experts" to assist in resolving difficult and sensitive client financial reporting issues, and (c) member firms' discussions with the SEC staff regarding registrants' financial reporting issues. The POB urges firms and their peer reviewers to carefully consider these best practices in evaluating the adequacy of current policies and procedures in these important areas.

The best practices in *Communications with Boards of Directors/Audit Committees* is the result of a survey taken in 1996 of the practices of a sample of peer reviewed firms to implement the recommendations contained in the report,

Strengthening the Professionalism of the Independent Auditor, which was issued by the POB's Advisory Panel on Auditor Independence. The Board continues to view candid auditor communications with boards of directors as a critical element in helping boards discharge their responsibility for the contents of financial reports, and therefore urges member firms that have not initiated meaningful dialogue with boards to implement such practices in their future audits of clients. The POB is pleased to note that another survey of practices in this area is scheduled to be undertaken by the Section in 1998.

New Board

Appointments

We are pleased to announce that Melvin R. Laird who has served on the Board for 14 years has been appointed vice-chairman, succeeding Paul W. McCracken, who retired from the Board on July 1, 1997 after serving as a member for twelve years. Dr. McCracken is Professor Emeritus, University of Michigan, and former Chairman of the Council of Economic Advisers. Dr. McCracken's presence, his wisdom, his learning and his wit have contributed hugely to

the success of the Board in dealing with a host of difficult problems in the last twelve years.

Charles A. Bowsher, who completed his 15-year term as the Comptroller General of the United States and head of the General Accounting Office ("GAO"), has taken Dr. McCracken's place on the Board. Shortly before he left office, the GAO published a comprehensive report on the accounting profession, *The Accounting Profession—Major Issues: Progress and Concerns*. He brings to the POB an outstanding background and experience in both the public and private sectors.

The John J. McCloy

Award

The POB awarded the John J. McCloy Award for Outstanding Contributions to Audit Excellence to David L. Landsittel. His career reflects his commitment to the public interest initially in dealing with audit practice issues as a partner in Arthur Andersen serving a number of major U.S. audit clients. As chairman of the Auditing Standards Board, Mr. Landsittel was active in pursuing solutions to difficult and contentious issues in the setting of auditing standards. More recently, as chairman of an Auditing Standard Board's task force, his leadership was key to the development of the soundly based new auditing standard, *Consideration of Fraud in a Financial Statement Audit*.

As this report is being published, there are pending mergers which will result in further consolidation of the big accounting firms. In 1989, the Big Eight became the Big Six when four of the firms merged. The pending mergers would reduce the Big Six to the Big Four.

It is not the role of the Board to determine whether there are sound economic considerations justifying the mergers; those determinations lie with the partners of the affected firms. Nor is the Board vested with any responsibility for determining the applicability of the antitrust laws in the United States or elsewhere to these mergers; that is for the appropriate legal authorities in each jurisdiction. However, the Public Oversight Board is considering the impact of these mergers upon the programs that it oversees and on the broader public interest which it serves.

In carrying out its oversight responsibilities, the Board has discussed the implications of these mergers with the Chief Executive Officers of the firms involved in them and with high ranking officers of the other two large multi-national firms.

The current self-regulatory system to review audit quality was established after the Congressional hearings of 1976, and in consultation with the SEC at that time. Twenty years later a 1996 General Accounting Office report prepared at the request of Congress stated that the accounting profession's self-regulatory program has improved audit quality.

The ultimate effects of the mergers are difficult to discern at this present time. However, many believe these mergers may be creating a situation which may lead to a further reduction in the number of firms capable of conducting audits of large multi-national corporations. Further, the Board believes that, as constituted, self-regulation may be affected and require modification to protect the public interest. If the mergers are finalized, the Board will monitor carefully to determine if adverse impacts on self-regulation or the public interest emerge. If they emerge the Board will expect the firms, the AICPA and the SECPS to take action promptly to eliminate them.

Meeting Report

Board Meetings

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 relating to the credibility and effectiveness of auditors. Guests of the Board at meetings included the Chairman of the SEC, the Chief Accountant of the SEC, the chairmen of the SECPS Executive, Peer Review, and Quality Control Inquiry Committees, the chairman and a member of the SECPS Task Force on Auditor Independence, the chairman of

Coopers & Lybrand, LLP, the chairman and chief executive officer of TIAA/CREF, and the Senior Partner of Auditing and Business Advisory Services of Price Waterhouse, LLP.

In addition to exchanging views with those present at formal POB meetings, the Board's chairman, another Board member and the Executive Director interacted with SEC Chairman Levitt and the Chief Accountant and with the SECPS Executive Committee chair and chair of the SECPS Independence Task Force on a number of occasions.

The Board's staff participated in the deliberations of SECPS task forces on

auditor independence, implementation of and transition to revised quality control standards, audit re-engineering, revising the standards for performing and reporting on peer reviews and materials used in conducting reviews, and establishing requirements to reasonably assure firm independence when personnel consider or accept employment with an attest services client.

Oversight of the SECPS

Executive Committee

A board member and staff 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, Quality Control Inquiry Committee ("QCIC"), SEC Regulations Committee, and the Professional Issues Task Force ("PITF").

The Board commends the Executive Committee, and particularly its chairman, for the effective manner with which the Section has dealt with a number of very critical and contentious public interest issues.

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

| Action | Number of Times | |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------|-----------------|
| | During 1996-97 | Since Inception |
| Accelerated peer review | — | 52 |
| Employment of an outside consultant acceptable to the Peer Review Committee to perform preissuance reviews of financial statements or other specified procedures | 10 | 84 |
| Revisits by the peer reviewers or visits by a committee member to ascertain progress made by the firm in implementing corrective actions | 8 | 202 |
| Review of the planning for and results of the firm's internal inspection program | 37 | 341 |
| Review of changes made to the firm's quality control document or other manuals and checklists | — | 43 |
| Continuing Professional Education in specified areas | 5 | * 47 |

* Since July 1, 1988, as data for prior years is no longer available.

Frequently Asked

Questions About The

SEC *Practice Section and the Public Oversight Board*

The SECPS

The SEC Practice Section was founded in 1977 as part of the Division for CPA Firms of the American Institute of Certified Public Accountants and is overseen by the Public Oversight Board. The Section imposes membership requirements and administers two programs to help insure that SEC clients are audited by member firms with effective quality control systems: (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 involving SEC clients.

Who belongs to the SECPS?

Altogether about 1,300 firms belong to the SECPS. Membership includes virtually all accounting firms that audit publicly held companies. The requirements of SECPS affect more than 127,000 professionals at member firms that audit more than 15,600 SEC clients.

What are the requirements for membership in the SECPS?

There are a number of requirements, the most critical of which is adhering to quality control standards established by the AICPA and having a "peer review" every three years. (see below for details). As part of the quality control inquiry process, member firms must also report to the Section within 30 days the commencement of any litigation against them arising out of an audit of a publicly held company, as well as certain other companies. They must then submit to inquiries by a task force concerning their quality controls. In addition, every audit of a publicly held company must be reviewed by another firm partner to assure that the engagement personnel have performed the audit in accordance with professional standards. Other membership requirements are directed at improving the quality of audits of member firms and enhancing their independence.

What is the Public Oversight Board?

The Public Oversight Board is an independent private sector body created in 1977 for the purpose of overseeing and reporting on the self-regulatory programs of the SEC Practice Section. The POB is responsible for monitoring and commenting on matters which affect public confidence in the integrity of the audit process. While the POB is funded by dues paid by SECPS members, 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.

Who are members of the POB?

The Board consists of five members, primarily non-accountants, with a broad spectrum of business, professional, regulatory and legislative experience. The Board chairman is A. A. Sommer, Jr., counsel to Morgan, Lewis & Bockius, an international law firm. Other current members are Melvin Laird, former Secretary of Defense and long-time member of Congress; Robert Froehlike, former Secretary of the Army and former chairman of Equitable Life Assurance Co. and IDS Mutual Funds; Donald Kirk, former member and chairman of the Financial Accounting Standards Board; and Charles Bowsher, who recently completed a fifteen year term as Comptroller General of the United States.

What is a peer review?

Peer review is an independent examination and assessment of the design of a firm's quality control system for its accounting and auditing practice. It also includes a review of a carefully selected sample of specific accounting and auditing engagements to evaluate compliance with that system and applicable professional standards. Peer review is the foundation of the profession's self-regulatory program and its principal means of assuring the public that member firms are performing at a level that meets or exceeds the standards established by the accounting profession.

What happens when a peer review is completed?

Reviewers meet with the firm's senior management to discuss their findings. They then prepare a written report, similar to an auditor's opinion, stating their conclusions. Even when the reviewers find no major fault with a firm's quality controls, they often prepare a "letter of comment" detailing areas in which the firm might improve its audit work. The firm being reviewed responds to the report and letter of comment, detailing plans to remedy any identified problems. That letter, along with the peer review report and letter of comment, are placed on file at the offices of the AICPA at Harborside Financial Center, 201 Plaza Three, Jersey City, New Jersey, where they are available for inspection by the public.

What is the role of the POB in the peer review process?

The peer review program is administered by the Peer Review Committee of the SECPS. To effectively discharge its mandate, one or more POB members and staff attend and participate in the meetings of the Peer Review Committee.

The Board's staff evaluates each peer review administered by the committee to assure that the reviews are performed by qualified individuals in accordance with rigorous standards. This evaluation varies in intensity depending on the characteristics of the reviewed firms and the past performance history of reviewed firms and review teams. (See POB Reports on Peer Review Process.)

The Board's staff reports to the entire Board at each of its meetings on the performance of the committee in setting peer review standards, processing peer review reports, evaluating compliance with committee mandated corrective actions, and the performance of individual peer review teams as they discharge their responsibility to perform rigorous peer reviews.

What is the quality control inquiry process?

The Quality Control Inquiry Committee looks into complaints containing allegations of audit failure involving SEC registrants. Section member firms are required to report 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 firm must provide to the QCIC copies of complaints within 30 days of being served. The QCIC also has the authority to inquire into litigation 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.

How are quality control inquiries conducted?

The QCIC obtains from the defendant firms relevant financial statements, regulatory filings and trustee reports. SEC Accounting and Enforcement Releases, where relevant, are also reviewed to obtain further background and specific information relative to the allegations.

The QCIC carefully analyzes the complaints and all appropriate publicly available documents. The committee assesses any possible audit quality implications of the allegations of audit failure. If the case is considered frivolous (for instance, the complaint misstates the requirements of professional standards or the allegations refer to periods in which the defendant firm was not the auditor), then the case is closed without further inquiry. If the case is not deemed frivolous, the quality control implications identified through this analysis are summarized.

A task force of the committee then meets with appropriate representatives of the accused firm to discuss the analysis of the allegations and their quality control implications. When appropriate, the task force also reviews firm guidance material and firm policies and procedures, as well as selected audit documentation. After the committee concludes its work, a determination is made whether there is a need to require the firm to take corrective actions to strengthen its quality control system or to address personnel deficiencies.

What is the role of the POB in the quality control inquiry process?

The Board and its staff monitor and evaluate the effectiveness of all QCIC activities. All committee meetings are attended by a Board member and its staff and the Board has unrestricted access to all committee deliberations and files. Board members attend selected task force meetings. During the past year, the Board's staff participated in all 36 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 identified by the QCIC's work where it appears professional standards should be augmented.

POB Reports On *Peer Review Process*

During the past year, the Board's staff directly observed the performance of peer reviews at all firms with thirty or more SEC clients and also directly observed approximately 20% of the reviews of other firms with SEC clients, including 60% of the firms that received a modified report on their prior peer review. For all other firms with SEC clients the staff reviewed selected working papers, reports, letters of comments and firms' responses. Staff also discussed significant issues with peer reviewers to satisfy itself that all such issues were properly resolved and reported on. The staff participated in all committee task force meetings where individual peer reviews were evaluated. They communicated any concerns they had regarding the performance or reporting of reviews. The Board is satisfied that all matters relating to peer reviews conducted during the year were appropriately handled by the committee and its staff.

Rigors of Peer Review

Cited

The rigor of peer review can be illustrated by a recent peer review of an SECPS firm. In 1995 the firm received an adverse report because of serious deficiencies in its quality control system. The committee had required significant remedial actions by the firm which resulted in, among other things, the firm withdrawing its report on its one SEC registrant client which was found not in compliance with professional standards. Subsequently, numerous articles appeared in the financial press suggesting financial reporting fraud by that registrant and, in addition, the SEC commenced an

enforcement action against the registrant and the auditing firm, focusing primarily on the same matters addressed by the peer review. The Board believes this peer review, as well as many other actions taken by the Peer Review Committee during the course of the year, demonstrate the commitment of the profession's self regulatory programs to the public interest.

QCIC Activity

Actions Related to Firms

Either a special review was made, the firm's regularly scheduled peer review was expanded, or other relevant work was inspected

A firm took appropriate corrective measures that were responsive to the implications of the specific case

Actions Related to Standards

Appropriate AICPA technical bodies were asked to consider the need for changes in, or guidance on, professional standards

The Professional Issues Task Force was asked to consider the issuance of a practice alert

Actions Related to Individuals

The case was referred to the AICPA Professional Ethics Division with a recommendation for investigation into the work of specific individuals

that the SECPS peer review program has been carried out in accordance with the established purposes and objectives.

The SEC, through the office of the Chief Accountant, oversees the SECPS peer review process, including the POB oversight, by extensively interacting with the Board's staff and inspecting peer review and POB staff working papers. In its most recent Annual Report the SEC stated that the peer review process "contributes significantly to improving the quality control systems of member firms and, therefore, enhances the consistency and quality of practice before the Commission."

Peer Review Standards

Revised

During the year, the committee revised the Peer Review Standards and the related guidance for performing peer reviews to conform them with Statements on Quality Control Numbers 2 and 3, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice and Monitoring a CPA Firm's Accounting and Auditing Practice*. At the same time, the committee revised the peer review practice aids to improve their effectiveness and efficiency.

Summary and

Conclusions

Based on its extensive oversight, the Board concludes

| | 11/1/79 through 6/30/96 | 7/1/96 through 6/30/97 | Totals |
|--|-------------------------------|------------------------------|--------|
|--|-------------------------------|------------------------------|--------|

| | | | |
|--|----|---|----|
| | 65 | 4 | 69 |
|--|----|---|----|

| | | | |
|--|-----|----|-----|
| | 105 | 11 | 116 |
|--|-----|----|-----|

| | | | |
|--|----|---|----|
| | 45 | — | 45 |
|--|----|---|----|

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|--|----|---|----|
| | 12 | 2 | 14 |
|--|----|---|----|

| | | | |
|--|----|---|----|
| | 28 | 1 | 29 |
|--|----|---|----|

| | | | |
|--|-----|----|-----|
| | 255 | 18 | 273 |
|--|-----|----|-----|

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

The Quality Control Inquiry Committee, which inquires into complaints containing allegations of audit failure involving SEC registrants and certain others, completed an active year. Notwithstanding passage of the Private Securities Litigation Reform Act of 1995 (the "Act") and a robust economy and stock market, litigation involving accounting firms showed little sign of abatement. Many of the new cases were filed in state courts apparently in order to avoid the more stringent federal pleading requirements and procedural provisions of the Act. The QCIC began the year with 27 open cases. Thirty seven new cases were reported by SECPS member firms, and the QCIC completed its work and closed its files on 34 cases. At year end, there were 30 open cases.

Review of Technical

Guidance Material

During the past year, the QCIC reviewed firm technical guidance material in connection with nine cases and audit documentation related to the allegations in connection with three cases. If a firm has recently had a peer review or has a peer review scheduled, the QCIC may review its findings with the firm's peer review team captain to better assure that appropriate focus was or is placed on quality control issues that have been identified. The QCIC reviewed peer review documentation in two situations during the past year.

Analysis of

Litigation

The QCIC analysis of litigation also results in identifying matters that it believes the accounting profession would

benefit from additional interpretive guidance to better assist auditors in performing their procedures in difficult high risk areas of an audit. These matters are referred to the SECPS Professional Issues Task Force which then develops "best practices" guidance in the audit area identified. Occasionally, issues surface in the analysis of complaints that raise questions about the adequacy of auditing or accounting professional standards. Those matters are referred to the appropriate professional standard setting bodies for their consideration.

Monitoring Quality

On two occasions, a QCIC task force met with senior management of Section firms to discuss important issues relevant to their firms. In one situation, the QCIC was concerned with both the cooperation by the firm in providing information to enable the QCIC to carry out its responsibility and with the procedures followed by the

firm in evaluating engagement personnel involved in reported matters. In the second situation, as a result of two reported cases, the QCIC believed that certain aspects of the firm's quality control system needed reevaluation and enhancement. In the first situation, the QCIC received assurances from senior management that the firm will be more timely in providing information to the QCIC. In addition, the firm indicated that it will, on a more timely basis, evaluate other audit engagements supervised by partners and senior staff involved in allegations of alleged audit failure. In the second situation, the firm engaged an outside consultant to perform a comprehensive review of selected portions of the design of the firm's quality control system. That review resulted in a series of recommendations to strengthen the firm's system. The firm has already begun the process of implementing those recommendations. The changes to the firm's system and the firm's compliance with the revised system will be tested in the firm's next peer review. Both the QCIC and the POB are satisfied with the resolution of these matters.

Summary and

Conclusions

The Board believes that the QCIC process effectively complements the peer review

process and that appropriate consideration was given to the 34 cases closed during the year.

As part of its oversight responsibilities over the accounting profession, the SEC staff actively oversees the QCIC process and the attendant POB activities. The SEC staff visited the POB's offices during the year to review the QCIC prepared closed case summaries, the POB files on each case, which include the completed POB oversight program and the POB staff memoranda on task force meetings. In addition, the SEC staff discussed the cases in considerable detail with the POB and QCIC staffs.

In its most recent Annual Report, the SEC noted that "the QCIC process provides added assurances, as a supplement to the peer review process, that major quality control deficiencies, if any, are identified and addressed on a timely basis. Therefore, the Commission believes that the QCIC process benefits the public interest." During the current year, the SEC staff has expressed similar views of the QCIC process.

During the previous year, the QCIC experienced delays in the consideration and processing of cases. The Board expressed its concern to the Section and the AICPA. As a result, additional senior staff were hired. With the support of expanded and competent staff, the QCIC has significantly improved the timeliness of dealing with newly reported cases despite the increase in volume.

The Public Oversight Board

BOARD

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From the POB 1995 Report

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

What the Audit Committee

Should Do

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.

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