

CHAPTER 3 – EARNINGS MANAGEMENT AND FRAUD

3.1 This chapter describes earnings management and fraud. It summarizes the profession's standards that define the auditor's responsibilities for, and provide guidance to auditors on, the detection of fraud. It also explores the concepts of "earnings management" and "quality of earnings," and how earnings management is related to and may constitute fraud. The chapter concludes with the Panel's findings on the effectiveness of audits in detecting fraud and its recommendations for improving the conduct of audits through strengthened standards that would include a number of steps – including a "forensic-type" fieldwork phase – to improve the likelihood that auditors will detect fraudulent financial reporting.

DEFINITIONS AND PROFESSIONAL RESPONSIBILITIES

3.2 Statement on Auditing Standards (SAS) No. 82, *Consideration of Fraud in a Financial Statement Audit*, distinguishes fraud from error on the basis of whether the underlying action that results in a misstatement of the financial statements is intentional or unintentional. The SAS notes that, while fraud is a broad legal concept, the auditor's concern with fraud specifically relates to fraudulent acts that cause a material misstatement of the financial statements.¹ SAS No. 82 not only is a complex and detailed standard, but also calls for the exercise of considerable judgment.

3.3 Two types of intentional misstatements are relevant to the auditor's consideration of fraud – misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets. Fraudulent financial reporting involves intentional misstatements or omissions of amounts or disclosures in financial statements, perhaps as part of a scheme to "manage earnings."

3.4 Misappropriation of assets (sometimes referred to as defalcation) involves the theft of an entity's assets, accompanied by financial statement misrepresentation. Misappropriation of assets can be accomplished in various ways, including embezzling receipts, stealing assets or causing an entity to pay for goods or services not received. Misappropriation of assets may involve one or more individuals among management, employees or third parties.

3.5 SAS No. 82 explains many of the limitations under which an auditor operates, including the fact that fraud may be concealed through falsified documentation, including forgery. A financial statement audit rarely involves authentication of documentation, and auditors are not trained as or expected to be experts in such authentication. Fraud also may be concealed through collusion among management, employees or third parties. Auditors also do not possess investigative powers, such as the power to subpoena witnesses and obtain evidence under oath.

¹ In *Accounting Irregularities and Financial Fraud: A Corporate Governance Guide* (2000 edition), p. 4, Michael R. Young, a litigation partner of Willkie Farr & Gallagher specializing in securities and financial reporting, observes, "Technically, a distinction can be drawn between an irregularity and fraud insofar as an irregularity consists of an intentional misstatement in financial statements, whereas an irregularity evolves into fraud only when those financial statements are shown to another who then justifiably relies on them to his or her detriment. In common parlance, though, the terms are being used interchangeably. . . ."

Furthermore, the evidence that auditors gather in an audit is often only persuasive; it is rarely conclusive. And lastly, audits are designed to detect only *material* misstatements.

3.6 Accordingly, a financial statement audit performed in accordance with generally accepted auditing standards (GAAS) is not a “fraud audit” or a detailed forensic-style examination of evidence. Forensic audit procedures typically are performed on a limited number of accounts – as a separate engagement and not as part of an audit of financial statements performed in accordance with GAAS – to determine the extent of a known or suspected fraud. In the absence of such knowledge, even a forensic-type audit cannot guarantee that fraud will be detected. It is widely believed that converting GAAS audits to fraud audits would involve costs far in excess of the foreseeable benefits to the public. SAS No. 82 recognizes that, because of the nature of evidence generated in a GAAS audit and the characteristics of fraud, a GAAS audit provides only reasonable, but not absolute, assurance that material misstatements will be detected.

3.7 Auditors are required to assess the risk of fraud in all audits. SAS No. 82 requires the auditor specifically to assess the risk of material misstatement from fraud; it indicates risk factors that the auditor should consider and provides guidance on how the auditor should respond to the risk assessment. The auditor has a responsibility “to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.”

3.8 The general standard of due professional care requires the auditor to exercise *professional skepticism*, which means having an attitude that includes a questioning mind and a critical assessment of audit evidence. The standard states that “the auditor neither assumes that management is dishonest nor assumes unquestioned honesty.”² This differs from the assumptions normally made by forensic auditors and investigators empowered by law. Forensic auditors, for example, generally assume dishonesty unless there is evidence to the contrary.

3.9 SAS No. 82 categorizes risk factors related to fraudulent financial reporting. Among the risk factors are those related to management’s characteristics and influence over the control environment, some of which relate to the motivation for management to engage in fraudulent financial reporting, and personal characteristics bearing on integrity and management style. SAS No. 82 also discusses risk factors specifically related to misappropriation of assets: the susceptibility of assets to theft and the lack of controls designed to prevent or detect misappropriations. It provides examples of risk factors in each of these two categories and guidance on other matters that auditors may become aware of that should be considered in assessing the risk of material misappropriation of assets.

3.10 Many of the factors cited in SAS No. 82 are subjective and difficult to assess, and risk factors may exist in circumstances where fraud does not. Even when risk factors are present, the auditor’s response to them is not definitively prescribed by the standard. SAS No. 82 states that “the auditor’s judgment may be that audit procedures otherwise planned are sufficient to respond to the risk factors.”

² Some observers characterize this standard as proffering a “neutral” concept of professional skepticism.

3.11 The Auditing Standards Board (ASB) has commissioned research to evaluate the effectiveness of SAS No. 82. The results of the research are expected to be available in 2000.³

EARNINGS MANAGEMENT: THE CONTINUUM FROM LEGITIMACY TO FRAUD

3.12 Reports and allegations of inappropriate earnings management were influential in prompting the Panel's project, and the Panel devoted considerable attention to earnings management.⁴

Framing the Issue

3.13 The term *earnings management* covers a wide variety of legitimate and illegitimate actions by management that affect an entity's earnings. The Panel neither sought nor formulated a precise definition of earnings management.⁵ Rather, it sought to understand the phenomenon that ranges from legitimate managerial activities at one end of the spectrum to fraudulent financial reporting at the other. It focused on the entire spectrum and how the auditor's role in enhancing the credibility of financial information is affected by the different ways in which earnings can be managed.

3.14 Virtually all managerial activities have a potential effect on earnings, and in that sense constitute earnings management; otherwise, the activities presumably would not be undertaken. Earnings management generally implies, however, that the activities undertaken are designed

³ In October 1998, the AICPA issued a *Request for Research Proposals for an Assessment of SAS No. 82*. The broad objectives sought are to assist the ASB in its assessment of the effectiveness of SAS No. 82 and in its efforts to improve related guidance by addressing how emerging businesses and technology affect the process of detecting material misstatements caused by fraud.

⁴ In his speech, *The "Numbers Game"* (NYU Center for Law and Business, September 28, 1998), Arthur Levitt, Chairman of the Securities and Exchange Commission (SEC), remarked, "Well, today, I'd like to talk about another widespread, but too little-challenged custom: earnings management. This process has evolved over the years into what can best be characterized as a game among market participants. A game that, if not addressed soon, will have adverse consequences for America's financial reporting system."

⁵ The Panel is not aware of a single accepted definition of the term *earnings management*. In fact, differing characterizations or definitions of the term can be found. For example, in "Commentary on Earnings Management," *Accounting Horizons* (December 1989), p. 92, Professor Katherine Schipper observes that "by 'earnings management' I really mean 'disclosure management' in the sense of a purposeful intervention in the external financial reporting process, with the intent of obtaining private gain (as opposed to, say, merely facilitating the neutral operation of the process)." In "A Review of the Earnings Management Literature and its Implications for Standard Setting," *Accounting Horizons* (December 1999), p. 368, Professors Paul M. Healy and James M. Wahlen state, "Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers." In *Accounting Irregularities and Financial Fraud: A Corporate Governance Guide* (p. 13) (see note 1), Michael R. Young describes the term as embracing two types of "managed earnings" and observes, "Now in talking about managed earnings, one has got to be careful. There are two types of managed earnings. One type is simply conducting the business of the enterprise in order to attain controlled, disciplined growth. The other type involves deliberate manipulation of the accounting in order to create the *appearance* of controlled, disciplined growth – when, in fact, all that is happening is that accounting entries are being manipulated" (emphasis in original).

either to smooth earnings over two or more interim or annual accounting periods or to achieve a designated earnings level, perhaps to meet securities analysts' forecasts.⁶

3.15 Some earnings management activities involve legitimate discretionary choices of when to enter into transactions that require accounting recognition, not unlike legitimate year-end tax planning decisions made to accelerate deductions or defer taxable income. For example, advertising expenditures, which generally should be expensed when incurred, may be accelerated in the fourth quarter if the entity is exceeding its earnings target or deferred if it is failing to meet that target. Other earnings management activities involve legitimate choices of how to account for transactions and other events and circumstances – particularly those involving accounting estimates and judgments – in conformity with generally accepted accounting principles (GAAP). For example, implementation of a decision to enhance the entity's credit and collection activities may legitimately support reducing the estimate of bad debt expense. These are legitimate management decisions that affect reported earnings whose consequences are accounted for in conformity with GAAP.⁷

3.16 Earnings management also may involve intentionally recognizing or measuring transactions and other events and circumstances in the wrong accounting period or recording fictitious transactions – both of which constitute fraud. Choosing the appropriate period in which to recognize a transaction requires both management's and the auditor's understanding of all the relevant facts and circumstances. For example, assume that an entity announces that – either in response to higher costs, to meet current-period sales targets or for any other reason – it will increase prices at the beginning of the next quarter, thereby stimulating some customers to purchase unusually high quantities before the end of the current quarter. If the sales meet all the criteria for revenue recognition, the entity should recognize the sales when the product is shipped, possibly resulting in an effective and legitimate management of earnings.⁸ If, however, there is an unusual right-of-return privilege and there is no basis for estimating the returns that will take place, the transaction essentially becomes a conditional sale, and recognizing the revenue when the product is shipped violates GAAP and misstates the financial statements. If the right-of-return privilege has been concealed from the auditor as part of a scheme to increase reported earnings, the financial statement misstatement involves fraudulent financial reporting. This suggests that the wide variety of earnings management activities, which cannot always be classified easily, constitutes a continuum that ranges from complete legitimacy at one extreme to fraud at the other.

The Quality-of-Earnings Concept in the Continuum

3.17 Earnings management that constitutes “fraud” is distinctly different from earnings management that is perceived as reducing the quality of earnings. Similar to the term *earnings*

⁶ Many factors may influence how earnings management is carried out, even in entities that do not have “earnings” in the traditional sense. The valuation of securities can be influenced by financial measures such as revenue growth, operating margins, income tax ratios and cash flows from operations, among many others. In this chapter, earnings management subsumes all such factors.

⁷ In certain circumstances, GAAP require disclosure of the effects of these decisions in the financial statements. Disclosures also may be required by the SEC's rules and regulations under Item 303 of Regulation S-K, *Management's Discussion and Analysis of Financial Condition and Results of Operations* (MD&A).

⁸ Disclosure may be required by the SEC's rules and regulations for MD&A (see note 7).

management, the term *quality of earnings* has no universally accepted definition, and what it means to one individual may not be what it means to another. For example, some might say that a company whose fixed asset depreciation policy results in higher reported earnings than it would have using that of competitors has a lower quality of earnings than its competitors. On the other hand, if the particular depreciation policy reflects a better utilization of fixed assets by, for example, implementing asset maintenance programs that extend their lives, the quality of earnings might be equal to or maybe even higher than that of the competitors. In the end, most would agree that inappropriately increasing earnings results in a lower quality of earnings.

3.18 It is the acceptability of an accounting policy under GAAP that draws the line on the continuum distinguishing legitimate earnings management from fraud. However, determining whether or when the behavior in the earnings management continuum crosses the line from legitimacy to fraud in a specific situation is not always easy. Where legitimate earnings management is present, there indeed may be issues and debates about the quality of an entity's earnings, but not about whether the financial statements are presented fairly, in all material respects, in conformity with GAAP. On the other side of the line is fraudulent financial reporting (unless the departure from GAAP is unintentional, in which case it constitutes "error") and not merely a lower quality of earnings.

3.19 The auditor's responsibility to detect fraud was discussed earlier in this chapter, and responsibilities to report fraud to the audit committee were noted in Chapter 2. Auditors' responsibilities with regard to the quality of an entity's earnings, when fraud is not an issue, are distinctly different from their responsibilities to detect and report fraud. SAS No. 90 on audit committee communications requires the auditor to discuss with audit committees the auditor's judgments about the quality, not just the acceptability, of the entity's accounting principles and the estimates and judgments underlying its financial statements. For example, the auditors should inform the audit committee when they believe that an entity's accounting policies are approaching unacceptability, even if the policies have not yet crossed into that territory. (The SAS was prompted in large part by the Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees.) Increased communications between audit committees and auditors should enhance the understanding by audit committees about quality-of-earnings issues and thereby improve financial reporting.

Motivation for Earnings Management and Fraud

3.20 The motivation to manage earnings comes in part from management's responsibility to direct the entity's operations in a way that achieves targeted results. The motivation also comes from pressures on management from sources both outside and inside the entity. External pressures come principally from the capital markets. Many observers believe that Wall Street's expectations significantly affect both appropriate and inappropriate management behaviors.⁹ Members of top management are especially subject to pressures to demonstrate that shareholder

⁹ In his speech, *The "Numbers Game"* (see note 4), Chairman Levitt observed, "Increasingly, I have become concerned that the motivation to meet Wall Street earnings expectations may be overriding common sense business practices." He further stated, "As a result, I fear that we are witnessing an erosion in the quality of earnings, and therefore, the quality of financial reporting." Chairman Levitt also remarked, "Many in corporate America are just as frustrated and concerned about this trend as we, at the SEC, are. They know how difficult it is to hold the line on good practices when their competitors operate in the gray area between legitimacy and outright fraud."

value has grown as a consequence of their leadership. Boards of directors are subject to pressures from stakeholders to enhance the value of the entity, and they in turn create internal pressures on management to meet financial and other goals and ensure the growth and prosperity of the entity. Boards oversee the stewardship of management and prescribe the basis for measuring performance and rewarding or penalizing management. Pressures by top management on others at different levels of the entity are everyday occurrences and are a natural part of the performance evaluation process.

3.21 Not only are these pressures commonplace in today's environment, but also the personal consequences to management of meeting or failing to meet financial goals can be extraordinary. The system for financial rewards to management is frequently skewed toward participation in the growth of an entity's worth in the marketplace, especially, although not exclusively, for top management.¹⁰ At many levels within an entity, financial incentives based directly or indirectly on accounting results can be significant. At some point in the continuum, the motivation behind earnings management may become strong enough to result in fraud.

3.22 Opportunity is a necessary feature of fraud, and it explains why management is in a unique position to perpetrate it. As the stewards of the entity, management possesses the power to manipulate the accounting records and prepare fraudulent financial reports.¹¹ Whatever controls might be present in an entity, management often has the ability to override them. Management can solicit whatever "help" it needs to carry out the fraud by directing or enlisting subordinates to assist. Thus, if collusion is needed to carry out the fraud, management can facilitate the collusion. If false documents need to be prepared, management can see that it is done. However, in those entities where the board of directors and management set the proper tone, promote high ethical standards and install appropriate controls to prevent and detect fraud, the opportunities to commit fraud can be reduced significantly.

3.23 Another feature of fraud perhaps is obvious – concealment. Concealment usually is an all-important goal of the perpetrator of a fraud, and the schemes for concealment vary from the patently simple to enormously complex. Concealment of fraud from the auditors often is a paramount objective, and for that reason successfully assessing the risk of fraud and designing audit procedures for its detection can be very difficult. At best, some might assert that observable risk factors present in a given situation could suggest the possibility of fraud.¹²

¹⁰ For example, compensation plans for management-level personnel based on the notion of "pay-for-performance" or "pay-for-value" often involve the use of stock options or other equity-type instruments, the ultimate compensatory value of which depends largely on the increase in the company's stock price over time.

¹¹ The Panel recognizes that, in the vast majority of cases, management exercises a high level of integrity and professionalism in preparing financial reports.

¹² SAS No. 82 lists risk factors relating to misstatements arising from fraudulent financial reporting in three categories: management's characteristics and influence over the control environment, industry conditions, and operating characteristics and financial viability. It also discusses risk factors relating to misstatements arising from misappropriation of assets.

Crossing the Line: From Trickle to Waterfall

3.24 Academics and others have conducted a substantial amount of research on fraud.¹³ Some of the research, as well as anecdotal evidence, suggests that fraud often starts out small, like a trickle.¹⁴ What ends up as a massive financial fraud – in effect, a waterfall – rarely starts with a grand plan or conspiracy. It often starts so small that the participants do not believe they are stepping over the line. Rather, they believe that they are doing nothing more than legitimately managing earnings, merely exploiting ambiguities in the accounting rules.¹⁵

3.25 Frauds often start in one of the first three quarters of an entity's fiscal year.¹⁶ Auditors have limited responsibilities for interim financial information (generally quarterly financial reports). Auditors are engaged to review that information, but it is not subjected to the same scrutiny as are the full year's audited financial statements.¹⁷ Furthermore, matters potentially material to an interim financial report might not be material to the annual financial statements, and therefore may not receive scrutiny from the auditors either in their limited quarterly reviews or the annual audit. Perpetrators may use this fact to their advantage in their efforts at concealment. In addition, manipulations of earnings in interim periods often are rationalized by management as being only temporary "borrowings," since there is plenty of time left in the year to correct the problem. The rationalization also may include a belief that the manipulations are intended to avoid earnings volatility and surprises, and therefore are in the shareholders' best interests.

3.26 The trickle becomes a waterfall when this "borrowing" accelerates and the perpetrators end up either taking positions that are indefensible or developing a scheme for concealment that will avoid discovery.¹⁸ Sometimes by the end of the fiscal year, the "borrowing" is still relatively small, but may continue to grow in future years. Sometimes by the end of the fiscal year, the manipulations have grown but they either may escape detection by the auditors or, if found, are

¹³ Some of that research involves certain "high-profile" cases of fraud involving public entities, while other research focuses on frauds that receive little or no press coverage. An example of research involving public entities is that commissioned by the Committee of Sponsoring Organizations of the Treadway Commission, *Fraudulent Financial Reporting: 1987-1997, An Analysis of U.S. Public Companies*, published in March 1999 (1999 COSO Report). Data from the 1999 COSO Report was used in a study commissioned by the ASB, *Fraud-Related SEC Enforcement Actions Against Auditors: 1987-1997* (August 2000). The Panel also undertook its own study of SEC Accounting and Auditing Enforcement Releases (AAERs), which is described in Appendix F.

¹⁴ Young, p. 11 (see note 1) states, "It starts out small. Massive financial fraud does not start with a grand plan or conspiracy."

¹⁵ While the concept of "materiality" generally is not viewed as an accounting ambiguity, it too can be exploited. For a discussion of the concept of materiality, see "Materiality, Waived Adjustments and Analysts' Expectations" in Chapter 2.

¹⁶ The 1999 COSO Report, p. 34 (see note 13), states, "From our readings of the AAERs, we observed that many frauds allegedly were initiated in a quarterly Form 10-Q, with the first manipulation sometimes at relatively small amounts. After observing that the fraud was undetected in initial attempts, the fraud scheme was repeated in subsequently issued quarterly or annual financial statements, with the fraud amount often increasing over time and generally stretching over two fiscal years."

¹⁷ SAS No. 71, *Interim Financial Information* (as amended), addresses the limitations of auditors' reviews of that kind of information.

¹⁸ "Taking positions" is not limited to management taking positions to justify its actions with the external auditors. Management also can "take positions" with other members of management, internal auditors and boards of directors (or audit committees) unbeknown to external auditors, regulators or others.

judged to be “immaterial errors.”¹⁹ When these manipulations come to light and they are material, they often lead to a restatement of the financial statements and usually to allegations of “audit failure.” Restatements of previously audited financial statements raise questions about whether the system that provides assurances about both the quality of audits and the reliability of financial reports is operating effectively.

The Panel’s Perspectives About the Responsibilities of Auditors and Others

3.27 The Panel is concerned that the auditing profession has not kept pace with a rapidly changing environment. The Panel believes that the profession needs to address vigorously the issue of fraudulent financial reporting, including fraud in the form of illegitimate earnings management. It believes that audit firms should aspire to “zero defects” as their goal and endeavor to eliminate audit failures completely.²⁰ They should promote that goal to their personnel starting on their first working day. Constant reminders and reinforcements should be present throughout the careers of all professionals, and compliance with firm policies and procedures should be a major factor in their advancement and compensation. Professional skepticism should mean more than only words in the auditing standards – it should be a way of life for auditors. The objectives in an audit should include detecting material financial statement fraud – that goal should drive both auditing standards and the way they are applied. By meeting that objective, audits will serve to deter fraud as well as detect it.

3.28 The Panel accepts the premise that a GAAS audit is not, and should not become, a fraud audit. It accepts the premise that reasonable, not absolute, assurance is a sufficiently high standard of responsibility. It believes that this is a high enough standard to provide the assurance about the reliability of audited financial information that the capital markets need for their proper functioning. While accepting these premises, the Panel nonetheless is concerned that auditors may not be requiring as much evidence to achieve reasonable assurance as they have in the past, especially in areas where they believe that risk is low.

3.29 The Panel’s perspective is that, even in the face of the strengthened auditing standards issued over the past 15 or so years, audit firms may have reduced the scope of audits and level of testing, at least in part as a result of redesigning their audit methodologies.

3.30 The Panel recognizes that the primary responsibility for the prevention and detection of fraud rests with management, boards of directors and audit committees.²¹ Management should

¹⁹ If the errors were judged to be material, the financial statements would not be issued until they had been corrected. If the auditors have determined that evidence of management fraud may exist, they are required to communicate the matter directly to the audit committee, and in certain circumstances to the SEC.

²⁰ The Panel notes that an allegation of an audit failure does not necessarily mean there was one. However, the Panel’s research and analysis of cases alleging audit failures (Appendix F) and cases that have been resolved support its concerns about the effectiveness of audits in detecting fraud. Aspiring to “zero defects” does not imply there would never be an undetected material financial statement fraud, since the standard of responsibility for auditors is that of “reasonable assurance,” not “absolute assurance” (see “Definitions and Professional Responsibilities” earlier in this chapter). Furthermore, a “zero defects” goal does not mean that auditors’ failure to detect a material financial statement fraud implies a lack of compliance with GAAS.

²¹ *Report of the NACD Best Practices Council: Coping with Fraud and Other Illegal Activity, A Guide for Directors, CEOs, and Senior Managers*, issued in 1998 by the National Association of Corporate Directors and Grant Thornton

create a culture that deters fraud and should set and communicate clear corporate policies against improper conduct. Directors and audit committees should oversee management's activities and demonstrate a strong commitment and involvement when problems arise. Auditors serve an important role in detecting material financial statement fraud. While they cannot be a substitute for the enforcement of high standards of conduct by management, boards of directors and audit committees, auditors can be an important factor in promoting high standards.

3.31 It is with these perspectives in mind, as well as its findings, that the Panel has formulated the recommendations in this chapter.

FINDINGS

QPR Findings

3.32 The QPR probed the risk assessment process and responses related to the risk of fraudulent financial reporting, as well as the risk of misappropriation of assets when called for in selected key areas. The QPR also looked into the overall integration of the fraud risk assessment process with engagement risk (client acceptance and continuance) assessments, discussed in Chapter 2. Furthermore, it probed into the involvement of concurring partners in the risk assessments.

Fraudulent Financial Reporting

3.33 The QPR reviewers agreed in virtually all cases with the assessment of the risk of fraudulent financial reporting and agreed that the right people were involved in the assessment. They agreed that the assessment process was appropriate and thorough. The QPR also affirmed that the risk of fraudulent financial reporting was considered in evaluating the overall audit results and in determining whether additional audit tests or follow-up actions were necessary. In general, the QPR found that the engagement risk and fraud risk assessments were appropriately linked. In addition, the QPR confirmed the appropriate involvement of concurring partners in the process. Lastly, the QPR disclosed concern in about 12% of the engagements regarding the adequacy of documentation.

3.34 One area considered by the QPR that is closely related to the issue of fraudulent financial reporting and whether audit tests are adequate to address the possibility of its occurrence is the area of non-standard entries.²² Financial statement misstatements often are perpetrated by using non-standard entries to record fictitious transactions or other events and circumstances, particularly near the end of the reporting period. The QPR disclosed that in about 15% of the engagements the auditors did not have an adequate understanding of the client's system for

LLP, sets forth "basic principles" and "implementation approaches" for corporate directors and independent auditors, among others, to employ in dealing with fraud and other illegal activity.

²² *Non-standard entries* is a term that is not precisely defined, although it is in common use among accountants and auditors. Such entries sometimes are referred to as "top-side entries," "post-closing entries," "manual adjustments," "management entries" or "unusual adjustments." In general, they are financial statement changes or entries made in the books and records (including computer records) of an entity that usually are initiated by management-level personnel and are not routine or associated with the normal processing of transactions.

preparing, processing and approving non-standard entries. Furthermore, in about 31% of the engagements reviewed, the auditors did not perform procedures to identify and review non-standard entries, whether made at the end of the period or at other times. When the auditors did perform such procedures, the reviewers generally believed that the procedures were appropriate and that the individuals who identified and reviewed the entries had the appropriate knowledge and skills to do so in a meaningful manner.

Misappropriation of Assets

3.35 The QPR probed into the risk of material misappropriations of assets in key areas where the reviewers believed that the risk was significant. Only in a few such key areas did the reviewers believe that was the case. For the most part, the QPR reviewers agreed that the risk assessments relating to misappropriation of assets were appropriately made, the right people made them at the right time, and the responses to the results of the assessments were appropriate. In one engagement, the reviewer agreed with the risk assessment but observed that a relatively inexperienced person had made the assessment without the benefit of specialized industry knowledge; however, the reviewer did not disagree with the response to the assessment by the engagement team.

3.36 In these same key areas, the QPR reviewers also reviewed the inherent risk and control risk assessments, distinct from the risk of misappropriation of assets. In addition, the reviewers addressed the involvement of information technology specialists and the appropriateness of the substantive tests carried out in the areas. The QPR reviewers indicated that the procedures performed in these key areas generally were consistent with the procedures in all other key areas. This may indicate that the auditors did not place any special emphasis on the areas where the risk of material misappropriation of assets was considered significant. This fact by itself is neither good nor bad, but it may indicate a tendency of auditors not to place much importance on the risk of asset misappropriation.²³

The Panel's Broader Consideration of Fraud

3.37 The Panel undertook a broad consideration of the auditor's responsibility for the detection of fraud. In addition to the QPR process, the Panel studied the input received from focus groups, interviews with forensic auditors, public hearings and responses to its survey questionnaire. The Panel reviewed the 1999 COSO Report and discussed the results of the litigation research undertaken on its behalf. It also considered the views of the legal profession and regulators, including the testimony received at its October 1999 public hearings. Writings by a number of authors knowledgeable in the area of fraudulent financial reporting also were considered.²⁴

3.38 In some cases, auditors interviewed in focus groups and other settings expressed uncertainty about their *responsibility* to detect fraud. They also expressed doubt about their

²³ The Panel noted during its study of AAERs (see Appendix F) a few instances of materially misstated financial statements resulting from misappropriation of assets.

²⁴ For example, the Panel considered Young (see note 1) and Joseph T. Wells, *Occupational Fraud and Abuse* (1997). Mr. Wells, CFE, CPA, is founder and chairman of the Association of Certified Fraud Examiners.

ability to detect fraud, especially fraud involving collusive activities or falsified documentation. While many auditors expressed general familiarity with forensic auditing techniques, no evidence pointed to any significant use of such techniques in GAAS audits.

3.39 The Panel’s analysis of recent SEC AAERs (Appendix F) involving the Big 5 audit firms or their clients provided insights into the apparent causes of actual or alleged fraudulent financial reporting or audit failures (or weaknesses in the auditing procedures employed) and into some of the characteristics that frequently were present.

3.40 Most of the misstatements involved relatively routine accounts and transactions as opposed to complex judgmental areas and more esoteric accounts and transactions, such as derivatives or other complex financial instruments, restructuring reserves, business combinations, or in-process research and development charges. Approximately 70% of the cases involved the overstatement of revenue – resulting from either premature revenue recognition or fictitious revenue.

3.41 The entities with the most sophisticated frauds often were concerned about concealing them from the auditors and particularly about making the numbers and the relationships among them “look right” to the auditors when they performed their analytical procedures. A favorite technique for accomplishing this was to “play around” with the numbers, often through the use of non-standard entries, until they “looked right.”

3.42 Other common characteristics of the cases included entities using information technology to facilitate the frauds, significant changes in an entity’s business that increased inherent risk, management override of controls, material frauds at relatively small divisions or subsidiaries that the auditors did not visit, inadequate substantive tests, and audit engagement personnel not appearing to have adequate training, experience or supervision.

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3.43 The Panel arrived at certain fundamental conclusions. First, the basic responsibility of auditors to obtain reasonable, but not absolute, assurance that the financial statements are not materially misstated sets the responsibility at an appropriate level.²⁵ To raise the level of assurance from that of *reasonable* to a higher standard, such as *high* or *virtually certain*, would put an unreasonable burden on the auditing profession and place an unjustified cost burden on entities subject to audit. Survey respondents and commentators at the October 1999 public hearings generally agreed with that assessment.

3.44 Second, the premise of professional skepticism being based on an assumption of neither management’s honesty nor dishonesty should be continued, but auditing standards need to provide better guidance on how to implement that concept. The cooperation of management is critical to both an effective and an efficient audit. Converting GAAS audits to forensic, fraud-type audits would not be justified from a cost–benefit perspective and because of the potentially

²⁵ Some commentators observed that attempts should be made (or continued) to educate users about the responsibility of auditors to provide only reasonable assurance. The Panel does not discourage such efforts, but it believes that such efforts might be perceived as overly defensive on the part of the auditing profession.

detrimental effects on the conduct of business. For example, a forensic audit likely would require significant additional time by management in dealing with the auditors and might distract management from effectively performing its day-to-day operations.

3.45 The Panel realizes, however, that management generally is the party that precipitates fraudulent financial reporting.²⁶ Management ordinarily is in a position to collude or cause others to collude, and management may create or facilitate the creation of falsified documentation, all to the end of avoiding detection by auditors through normal auditing procedures. Management may have some motivation to perpetrate financial reporting fraud. Moreover, it is in a position to create opportunities for doing so and can facilitate its concealment. This poses a quandary to auditors: On the one hand, to accomplish the audit requires the cooperation of management; on the other hand, management is in a position to mislead the auditors in their quest for valid evidence.

3.46 In summary, the Panel found that:

- The risk assessment and response process called for by SAS No. 82 falls short in effectively deterring fraud or significantly increasing the likelihood that the auditor will detect material fraud, largely because it fails to direct auditing procedures specifically toward fraud detection.²⁷
- GAAS do not provide sufficient guidance to adequately implement the concept of professional skepticism because management usually is judged as possessing integrity (despite the fact that management may have at least some motivation to perpetrate fraudulent financial reporting). Presumably, if auditors judged management to not possess integrity, they would not continue to serve those clients. The Panel's findings, however, suggest that auditors do not always pursue sufficiently conditions discovered during an audit or corroborate adequately management representations made to them.²⁸
- GAAS dismiss collusion as impossible or too difficult to detect and pointedly explain the lack of expertise of auditors with respect to determining the authenticity of documents. The Panel acknowledges that these factors are and will continue to be inherent limitations of an audit. The reality is, however, that all or most financial reporting frauds involve collusion and many involve falsified documentation.

²⁶ The 1999 COSO Report disclosed that top senior executives frequently were involved in financial statement frauds. For example, it notes that in 72% of the cases reviewed, the chief executive officer was named in the SEC's AAER, and in 43% of the cases, the chief financial officer was associated with the financial statement fraud. Other management individuals named included controllers and chief operating officers. The Panel noted similar findings in its study of AAERs (see Appendix F).

²⁷ All of the audits reviewed in the QPR were subject to SAS No. 82. Furthermore, the Panel understands that the audits of a number of entities for which there have been allegations of audit failure also were subject to SAS No. 82.

²⁸ The term "red flags" is sometimes used to describe these conditions. The term often is used in a pejorative way, however, to imply an auditor's failure to pursue the obvious. The Panel recognizes that what might appear obvious in hindsight is not always obvious at the time and accordingly avoided use of the term.

- Auditors do not appear to place any special emphasis on the areas where the risk of misappropriation of assets is considered significant.
- Audit committees rarely address the potential for management to commit financial statement fraud or request auditors to perform specific tests to detect that possibility.

3.47 Based on these findings, the Panel sought to develop substantive recommendations consistent with the auditor's responsibility to obtain reasonable assurance that would both enhance the prospects for the detection of material financial statement fraud and implicitly serve to deter or prevent such fraud.²⁹ The Panel was cognizant of the dangers of either going too far, or not going far enough.

RECOMMENDATIONS

To the Auditing Standards Board:

3.48 The Panel recommends that the ASB develop stronger and more definitive auditing standards to effect a substantial change in auditors' performance and thereby improve the likelihood that auditors will detect fraudulent financial reporting.

3.49 The Panel envisions that the new requirements would be over and above those that are now contemplated by a GAAS audit. The degree to which these requirements would require additional audit effort is likely to vary with a number of factors, such as the size and complexity of the entity's operations and the difficulty of applying accounting principles that call for management to make judgments involving subjective estimates. The additional audit effort also would be influenced by the auditors' risk assessments – including their assessments of management's motivations (potentially at many levels of an entity) to manage earnings and meet the expectations of the financial community or of higher levels of management – and their understanding and tests of internal control. The Panel believes that the incremental audit effort that would result from this recommendation ordinarily would neither constitute a dominant part of the audit nor be inconsequential. Under "Consideration of Exposure Draft Comments on the Forensic-type Phase" at the end of this chapter, the Panel provides the ASB with its observations on factors that ordinarily would influence how much additional audit effort would be required.

3.50 The Panel further believes it is reasonable that the strengthened standards be effective starting with audits of financial statements for periods commencing after December 31, 2001.

3.51 To implement the foregoing recommendation, the Panel recommends that the ASB require the following in all audits:

²⁹ The Panel recognizes that, notwithstanding its recommendations, complying with GAAS cannot and will not guarantee that auditors will detect all material fraud.

Planning and Supervision

- Discussion by supervisory engagement personnel (including the auditor with final authority, usually the engagement partner) with other engagement team members about the vulnerability of the entity to fraud.

This discussion should encompass what is expected of team members in dealing with a potential for fraud in the specific areas of the audit assigned to them. An important objective of these discussions would be to identify the appropriate engagement team members to address the potential for fraud (e.g., the engagement team members who should interview company personnel) and how their work is to be supervised and reviewed.

This recommendation requires a significant strengthening of the first standard of fieldwork that “the work is to be adequately planned and assistants, if any, are to be properly supervised.” The objective of a strengthened standard is to ensure a substantive dialogue among members of an engagement team about “what could go wrong” and “how fraud might be perpetrated.” This dialogue should guide how engagement team members address the possibility of fraud, including how procedures (including inquiries) might be designed to address that possibility. The strengthened standard should be sufficiently specific that these activities are carried out by engagement teams (and thus involve engagement partners) at all significant locations. The engagement team members to be involved in this dialogue should include information technology and other specialists assigned to the audit. Decisions about the actions to be taken by individual engagement team members should be documented.

Forensic-type Fieldwork Phase

- Introduction of a “forensic-type fieldwork phase.” Not unlike the traditional planning, interim, final and review phases of audits, this new forensic-type phase should become an integral part of the audit, with careful thought given to how and when it is to be carried out. A forensic-type fieldwork phase does not mean converting a GAAS audit to a “fraud audit.” Rather, the characterization of this phase of a GAAS audit as a forensic-type phase seeks to convey an attitudinal shift in the auditor’s degree of skepticism. Furthermore, use of the word *phase* does not mean that the work cannot be integrated throughout the audit.³⁰

During this phase, auditors should modify the otherwise neutral concept of professional skepticism and presume the possibility of dishonesty at various levels of management, including collusion, override of internal control and falsification of

³⁰ The use of the word *forensic* in this recommendation also does not imply that the ASB needs to use that term in developing or modifying its standards. Similarly, the word is not being used in a legal sense and it does not imply that the results of the procedures necessarily would be suitable for use as “legal evidence.”

documents.³¹ The key question that auditors should ask is “Where is the entity vulnerable to financial statement fraud if management were inclined to perpetrate it?”

Auditing standards should require in this phase:

- Performance of substantive tests directed at the possibility of fraud, including tests to detect the override of internal control by management (recognizing that management includes many levels of personnel in an entity, including personnel outside of the United States, and not just top corporate-level management). The nature, timing and extent of such tests should be guided (at a minimum) by the following criteria.³²
- Tests should be centered around the balance sheet date for balance sheet accounts and throughout the year (including the latest quarter) for income statement accounts, in the following areas (some of which may overlap)³³:
 - High-risk areas (at the specific account and assertion level) identified by the engagement team as areas where the opportunity to perpetrate fraud is higher than normal.³⁴ Candidates for such identification would include balance sheet or income statement accounts affected by revenue recognition policies, deferred costs, asset additions resulting from complex transactions such as business combinations accounted for as purchases, reserves that are highly dependent on management’s intentions or representations, accounts (or elements of them) not subject to systems-driven controls, and related party transactions.
 - Areas for which Accounting Principles Board Opinion No. 20 requires disclosure of significant accounting policies³⁵

³¹ See note 2 regarding the “neutral” concept of professional skepticism in the auditing standards. The Panel recognizes that to presume the possibility of management dishonesty may be thought by some to imply a distrust of management. That would be erroneous.

³² The ASB might consider providing guidance on procedures thought to be especially useful in forensic (fraud-type) audits that also could be applied, as an option, in GAAS audits. The Panel recognizes that fraud-type audits usually are conducted only after fraudulent activity has been suspected or detected and that many procedures employed in those audits would be impractical or impossible to apply in a GAAS audit. For example, in some fraud-type audits, company personnel are interviewed with their own legal counsel present or under grants of immunity.

³³ Centering certain tests around the balance sheet date may, in some cases, put pressure on auditors because of deadline considerations. These pressures may be exacerbated unless management fully cooperates with these audit efforts. Auditors may wish to emphasize the importance of this cooperation, for example, in their engagement letters.

³⁴ Identifying the high-risk areas calls for risk assessments involving the exercise of professional judgment. These risk assessments, of necessity, involve an understanding of the control environment and the entity’s policies and procedures for preventing financial statement fraud. To provide guidance for making such risk assessments, the ASB may wish to consider the outcome of the academic research on the efficacy of SAS No. 82 (see note 3) and other similar undertakings (see note 13 to Chapter 2). See also “Consideration of Exposure Draft Comments on the Forensic-type Phase” at the end of this chapter.

³⁵ A number of cases of fraudulent financial reporting have involved these areas, and the disclosed accounting policies inaccurately portrayed the entity’s actual accounting policies. Accounting policy disclosures often relate to industry practices or matters unique to the specific entity.

- Material balance sheet accounts that generally “turn over” several times throughout the year (e.g., trade receivables, inventory, payables, cash and securities)
- Non-standard entries (including entries made to computer records) requiring management’s involvement or approval. (The ASB should define the term *non-standard entries* for this purpose.³⁶)
- Auditors should consider incorporating a surprise or unpredictability element in their tests. Examples of what they should consider include the following:
 - Recounts of inventory items or unannounced visits to locations
 - Interviews of financial and non-financial company personnel in different areas or locations. Interviews of company information technology personnel may be appropriate to inquire about possible overrides of computer-related controls. Inquiries of company personnel (including legal personnel) responsible for addressing reports by company employees or others alleging irregularities also should be made. (For example, some companies have employee “hot lines” that enable confidential reporting of possible improprieties or violations of company policies.)
 - Requests for written confirmations from company employees regarding matters about which they have made representations to the auditors
 - Requests for written confirmations from customers or vendors that otherwise would not be undertaken and that are carefully tailored to address the nature and specific terms of the underlying transactions, for example, to assist in identifying “side agreements” allowing a right of return or other concessions
 - Tests of accounts not ordinarily performed annually
 - Tests of accounts traditionally or frequently deemed “low risk”
- The tests should be either tests of details or precise substantive analytical procedures, but not tests of controls. (Tests of controls may not be effective in detecting fraud because management can override controls.)

³⁶ See note 22.

- The external auditor should not use the work of internal auditors in carrying out tests directed at the possibility of fraud.³⁷ The internal auditors may provide limited direct assistance to the external auditor, and may perform similar procedures to supplement the work of the external auditor.
- Use of technologically advanced auditing tools should be encouraged.
- Non-corporate and non-U.S. locations should be covered by substantive tests directed at the possibility of fraud. Some rotation over a reasonable number of audit periods would be acceptable.³⁸
- Re-review by supervisory audit personnel, at the conclusion of the audit, of high-risk areas to reassess whether conditions identified during fieldwork or test results (e.g., exceptions and related explanations by entity personnel) might call for additional tests.

Retrospective Audit Procedures

- Introduction of retrospective audit procedures, calling for an analysis of selected opening balance sheet accounts of previously audited financial statements. The accounts should be selected using risk-based or other criteria specified by the ASB. The ASB also should provide guidance on the types of tests to be applied to the accounts. The objective of the audit tests should be to assess how certain issues involving accounting estimates and judgments, for example, an allowance for sales returns, were resolved with the benefit of hindsight. This retrospective look at and testing of accounts that previously had been audited is intended to act as a fraud deterrent by posing a threat to the successful concealment of fraud, not to second-guess reasonable judgments based on information available at the time the financial statements were originally issued. Consequently, the auditor should modify the otherwise “neutral” concept of professional skepticism, as discussed above.

Review and Documentation

- Review and documentation as follows:

³⁷ The admonition not to use internal auditors in the forensic-type phase should not be construed as rejecting the concepts in SAS No. 65, *The Auditor’s Consideration of the Internal Audit Function in an Audit of Financial Statements* (see “Internal Auditors” in Chapter 2). To the contrary, the Panel sees many opportunities for internal auditors to address issues of financial statement fraud, including interacting with the external auditors in helping them develop their assessments of risk, and conducting their own internal audit tests to detect fraud. Furthermore, external auditors may take into consideration the results of internal audit tests designed to detect fraud in deciding on their own tests. However, because the essence of the forensic-type phase involves an attitudinal shift in the professional skepticism of the external auditors in performing tests and evaluating their results, ceding that responsibility to internal auditors would not be appropriate.

³⁸ In Chapter 2, the Panel made related recommendations under “Multi-location Audits” and recommendations on materiality used in planning the audit under “Establishing Auditing Standards.” The ASB may wish to consider those recommendations in providing guidance on the coverage of locations in the forensic-type phase. See also “Consideration of Exposure Draft Comments on the Forensic-type Phase” at the end of this chapter.

- Debriefing of engagement team members assigned to perform retrospective procedures and procedures during the forensic-type phase by supervisory personnel, and assessing the propriety of follow-up actions and conclusions reached, both of which should be documented
- Specific documentation relating to the retrospective procedures and the procedures carried out during the forensic-type phase of the audit, including the results of the assessments made

The Panel also recommends, with respect to interim financial information, that the ASB:

*Procedural Guidance for Interim Periods*³⁹

- Include in its standards specific guidance for the application of procedures in interim periods using a forensic-type approach equivalent to that described above. In this connection, the Panel believes that the ASB should consider the observations in the 1999 COSO Report that many frauds are initiated in interim periods.⁴⁰
- Provide criteria for the areas that should be addressed in reviews of interim financial information. Such criteria might include, for example, areas involving a high degree of subjectivity (e.g., merger-related or restructuring reserves), areas involving complex accounting standards (e.g., software revenue recognition), related party transactions and areas where controls are particularly susceptible to being overridden (e.g., sales cut-off).
- Provide guidance on how procedures employed in interim periods that address the potential for fraud in financial reporting also may be useful as “continuous auditing” techniques to improve full-year audits.⁴¹ The Panel understands the need to separate auditors’ responsibilities in an audit of financial statements from those in a limited review of interim financial information. However, it encourages the ASB to research and address concepts of continuous auditing in furtherance of a more effective audit model.

³⁹ The ASB may choose to modify SAS No. 71 for this purpose, or, alternatively, to provide the guidance as an *integral* element of a full-year audit, or both. This recommendation is not intended to imply a new or different standard of responsibility for auditors conducting and reporting on reviews pursuant to SAS No. 71.

⁴⁰ The 1999 COSO Report states, “These observations highlight the importance of active review of quarterly financial statements by audit committees and external auditors. Close scrutiny of quarterly financial information and a move toward continuous auditing strategies may increase opportunities for earlier detection of financial statement improprieties.”

⁴¹ The Panel is aware that the ASB adopted a strategic plan in 1997, *Horizons for the Auditing Standards Board: Strategic Initiatives Toward the Twenty-First Century*, which it updates annually. Those initiatives include defining and developing guidance on “continuous auditing” or “continuous assurance.” Another initiative involves evaluating the efficacy of SAS No. 82, which the ASB plans to review in the context of the academic research that it commissioned (see note 3).

To audit firms:

3.52 The Panel recommends that audit firms:

- Begin working immediately with the concepts in the recommendations to the ASB to enhance the auditor's ability to detect financial statement fraud. The results of those efforts should be shared with the ASB for consideration in developing its standards, with the intent of expediting the standard-setting process.
- Develop or expand training programs for auditors at all levels oriented toward responsibilities and procedures for fraud detection. These programs should emphasize interviewing skills and the exercise of professional skepticism, as well as testing techniques. They also should emphasize (especially to staff and in-charge personnel) that misappropriation of assets is a significant risk and that being alert to its possibility at any level in an entity is necessary.⁴² Training programs should include case examples of how defalcations might be effected, the types of controls over the safeguarding of assets that are effective in preventing and detecting defalcations, and how defalcations are concealed. Special emphasis should be given to how information technology might be used to misappropriate assets and disguise the results.

Using auditors with forensic audit backgrounds to assist in this training would be beneficial. Personnel with experience in industries where the risk of material misappropriations of assets is believed to be high (e.g., in certain cash-intensive industries) also might be used to assist in such training.

These programs should be implemented as soon as practicable, but in any event no later than when the ASB issues its strengthened standards. Furthermore, training programs of this nature should not be one-time events. Firms should be committed to refreshing and improving these programs as circumstances in clients and industries evolve and more is learned about fraud.

- Discuss with audit committees the vulnerability of the entity to fraudulent financial reporting and the entity's exposure to misappropriation of assets.

To the SEC Practice Section Peer Review Committee:

3.53 The Panel recommends that the SECPS Peer Review Committee request that peer reviewers:

- Evaluate the implementation of the strengthened auditing standards issued by the ASB and evaluate the training programs developed in response to the Panel's recommendations to audit firms. The Peer Review Committee should develop guidance for peer reviewers to conduct these evaluations. The evaluations should address the priority given by the firms to fraud-related training; the involvement of

⁴² See note 23.

supervisory engagement personnel in planning, supervision and review; and the adequacy of documentation.

- Include their findings in this area in their reports to the SECPS Peer Review Committee.

To audit committees:

3.54 The Panel recommends that audit committees:

- Request management to report on the control environment within the entity and how that environment and the entity's policies and procedures (including management's monitoring activities) serve to prevent and detect financial statement fraud.⁴³ Such reporting should acknowledge, in explicit terms, that fraud prevention and detection are primarily the responsibility of management. It also should help audit committees assess the strength of management's commitment to a culture of intolerance for improper conduct. Furthermore, audit committees should seek the views of auditors on their assessment of the risks of financial statement fraud and their understanding of the controls designed to mitigate such risks.
- Accept responsibility for ascertaining that the auditors receive the necessary cooperation from management to carry out their duties in accordance with the strengthened auditing standards to be developed by the ASB.

To the SECPS Quality Control Inquiry Committee:

3.55 The Panel recommends that the SECPS Quality Control Inquiry Committee (QCIC):

- Assess the results of the ASB's research on the effectiveness of SAS No. 82, together with information that it has on litigation involving allegations of fraud, to determine whether it believes that the ASB should consider providing further guidance on fraud risk assessment.⁴⁴
- Initiate ongoing reviews with the ASB, the SECPS Peer Review Committee and the AICPA's Professional Ethics Executive Committee regarding factors that appear to be influencing audit performance, with a view toward enhancing auditors' fraud detection capabilities.⁴⁵ (QCIC is in a unique position to conduct these activities because it usually is the group that addresses allegations of audit failure on a timely basis and thus can act as a catalyst for appropriate action.)

⁴³ Reports by management may be accompanied by or made jointly with those of internal auditors.

⁴⁴ The Panel recognizes that QCIC's access to information about allegations of audit failure in litigation cases is limited.

⁴⁵ QCIC should endeavor to conduct these reviews as a continual reexamination of lessons that might be learned. It also should consider the possibility of implementing a more encompassing process, including the development and maintenance of a comprehensive database of information on fraud.

CONSIDERATION OF EXPOSURE DRAFT COMMENTS ON THE FORENSIC-TYPE PHASE

3.56 The Panel strongly believes that its recommendation that the ASB develop stronger and more definitive auditing standards to effect a substantial change in auditors' performance and thereby improve the likelihood that auditors will detect fraudulent financial reporting is appropriate. It also has expressed its belief that the incremental audit effort that would result from its recommendation ordinarily would neither constitute a dominant part of the audit nor be inconsequential. Key to the implementation of its recommendation is that the ASB introduce into its standards the concept of a "forensic-type phase" in *all* audits. To that end the Panel has offered some guidance on implementation.

3.57 A number of respondents to the Panel's Exposure Draft expressed objections to or reservations about the forensic-type phase and asserted that it would result in numerous, extensive and unnecessary or ineffective procedures, especially if applied across-the-board to all audits without regard to the individual or unique circumstances of the entity being audited.⁴⁶ Others expressed the view that the Panel's approach would discard traditional concepts of materiality to the point that auditors would be forced to deal with insignificant matters. Still others expressed the view that the introduction of any forensic concepts to a GAAS audit would exacerbate the so-called "expectation gap" and possibly create additional litigation risk to audit firms.

3.58 Many respondents asked the Panel to either drop its recommendation or defer it until completion of the ASB-commissioned research on SAS No. 82.⁴⁷ Some respondents also asserted that new research should be undertaken. Some suggested that other research be given greater weight and carefully evaluated, including recent research on large audit firms' methodologies.⁴⁸ In addition, some respondents asked that the Panel recognize the need for the involvement of all corporate-governance constituencies (e.g., boards of directors, audit committees, management, and internal and external auditors) as part of a broad effort to deal with fraud, including fraudulent financial reporting. Furthermore, some respondents emphasized that auditors' risk assessments should govern the extent of work undertaken. Others pointed out the importance of internal control in preventing and detecting fraud and implored the Panel not to "give up" on controls.

3.59 The Panel believes it has considered the views of and issues raised by all of the respondents to the Exposure Draft, and accordingly it has expanded upon or clarified a number of its recommendations. It also believes, however, that the ASB and audit firms might benefit from an expanded discussion of the Panel's consideration of the factors that would influence how

⁴⁶ Respondents to the Exposure Draft include those parties that provided testimony at the Panel's July 2000 public hearings (see Appendix N).

⁴⁷ See note 3.

⁴⁸ See note 13 to Chapter 2 on the research commissioned by the Joint Working Group. Some respondents to the Panel's Exposure Draft called for a collaborative effort among the ASB, the International Auditing Practices Committee (IAPC) and possibly other standard setters to address the audit risk model, including considering this research. In Chapter 7, the Panel has made recommendations to the ASB and the IAPC regarding collaborative efforts.

much additional audit work would be needed in the forensic-type phase and the nature of that work.

3.60 The following discussion serves as additional implementation guidance, including the role of risk assessments and the importance of internal control, to assist in determining the nature and amount of additional audit effort in the forensic-type phase.

- *Risk Assessments*

Risk assessments alone are not a sufficient basis to eliminate the need for substantive tests in the forensic-type phase.⁴⁹ This basic premise applies to risk assessments made at either a broad level (i.e., engagement, inherent and control risk, including fraud risk) or an individual account or class of transactions level. Risk assessments are an important foundation – but only one aspect – for making decisions on which individual accounts or classes of transactions will be selected for testing and the nature, timing and extent of the tests.⁵⁰

- *Preparation of Financial Statements*

The processes for preparing financial statements differ widely from entity to entity. At one extreme, entities rely heavily on automation (i.e., using computer technology) to process transactions and “close the books,” to the point that their financial statements can be prepared virtually without human intervention. This would be especially true when the financial statements do not require significant estimates and judgments by management. Entities at the other extreme rely to a high degree on manual systems (either literally manual or essentially manual, e.g., where the financial statement accounts are developed from data that is processed or summarized on computer-generated spreadsheets). The processes for preparing the financial statements of many entities lie somewhere between these two extremes and circumstances within a given entity can vary widely. Auditors need to analyze and assess the entity’s particular circumstances and its processes for preparing financial statements. Considering where the highest possibility for human intervention, especially for management override, exists in the financial statement preparation process is an important step in designing the auditing audit work for the forensic-type phase.

- *Non-standard Entries*

All or virtually all entities record non-standard entries. These entries can provide an avenue for management to override controls that could lead to fraudulent financial

⁴⁹ This is consistent with a basic premise of GAAS as explained, for example, in the section on “Correlation of Control Risk and Detection Risk” in SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, which states, “Consequently, regardless of the assessed level of control risk, the auditor should perform substantive tests for significant account balances and transaction classes.”

⁵⁰ The Panel recognizes that its observations would mostly influence the extent of testing in the forensic-type phase. The types of individual accounts or classes of transactions selected for testing likely would influence the nature of the tests. The Panel’s observations on the timing of testing, for the most part, are discussed in the description of the forensic-type phase.

reporting. Consequently, auditors need to design tests in the forensic-type phase to detect non-standard entries and examine their propriety. This aspect of the forensic-type phase affects not only the extent of testing, but also its timing, because such entries can be recorded at various times during the year.

- *Considering Internal Control*

Internal control functions at many levels. Controls can range from high-level oversight by management, to detailed review and reconciliation activities of employees, to numerous procedural steps and protocols carried out by individuals, to sophisticated controls embedded in computer systems. Understanding the way that internal control functions at varying levels is important to how the auditor addresses the forensic-type phase.

Controls at the individual account-balance or class-of-transactions level that have been subjected to controls testing by the auditor and have been judged to be operating effectively tend to influence the nature of and reduce the extent of tests in the forensic-type phase.⁵¹ Auditors need to be especially alert to the possibility of management override, however, because management ordinarily possesses a deeper understanding of controls than does the auditor.

Auditors generally recognize that some financial statement accounts are partly or wholly a product of routine processing of transactions through well-controlled systems driven by sophisticated computer technology. Some of these routine processes may be highly integrated with the financial reporting process and are not readily susceptible to management override. Other systems process only some transactions routinely, while other transactions are processed after significant human intervention.

Management can influence the timing of the execution of some transactions, as well as when they are recorded in the accounts. This highlights the importance of tests of transaction “cut-offs,” especially at the end of quarterly or annual periods.

- *Accounts Subject to Management Judgments*

Certain aspects of a financial statement account, for example, the valuation assertion embedded in an inventory account, generally are more susceptible to management override. Consequently, accounts (or the assertions embedded in them) that require significant management judgments are generally more likely candidates for testing in the forensic-type phase. The complexity and subjectivity of the accounting principles that apply and the potential for management to influence their selection and manner of application also should influence the nature and extent of the tests.⁵²

⁵¹Tests of controls directed toward the operating effectiveness of a control are discussed in paragraph 53 of the section in SAS No. 55 on “Consideration of Internal Control in Assessing Control Risk.” To support a control risk assessment significantly below the maximum level, auditors perform additional tests of controls, as discussed in the section in SAS No. 55 on “Further Reduction in the Assessed Level of Control Risk.”

⁵² These matters also should influence the selection of the accounts that should be subjected to retrospective audit procedures.

- *Management's Monitoring Activities to Prevent or Detect Fraud*

The entity's preventive and detection controls over fraud are important considerations in deciding on the nature and extent of testing in the forensic-type phase. Auditors need to consider, however, whether those controls deal with fraudulent financial reporting, as opposed to, for example, misappropriation of assets or illegal acts only indirectly related to the financial statements. Auditors also need to consider the likelihood that such controls actually would serve to inhibit management fraud, if management (at any level) were inclined to override them.

In that regard, an important consideration is whether management has reported to the audit committee on the entity's control environment and how that environment and the entity's policies and procedures (including management's monitoring activities) serve to prevent or detect financial statement fraud. Auditors' understanding of the audit committee's assessment of the strength of management's intolerance for improper behavior should influence the nature and extent of testing.

Auditors should be cautious, however, not to place excessive emphasis on management's high-level monitoring activities, including high-level monitoring of financial and non-financial data, as a reason for reducing the extent of testing in the forensic-type phase.

- *Materiality Issues*

In the section in Chapter 2 on "Establishing Auditing Standards," the Panel recommended that the ASB evaluate its guidance on materiality in the planning phase of the audit. That recommendation also applies to the forensic-type phase. The forensic-type phase seeks to implement a degree of "auditor-unpredictability," and it includes tests of accounts not ordinarily performed annually or tests of accounts traditionally or frequently deemed "low risk." Furthermore, the forensic-type-phase recommendations suggest some surprise tests and periodic coverage of non-corporate and non-U.S. locations. In the section in Chapter 2 on "Multi-location Audits," the Panel has made recommendations for improvements to standards in that area.⁵³

The Panel does not intend for auditors to become embroiled in minutia in implementing the forensic-type phase. On the other hand, the Panel expects that auditors will exercise creativity in developing their approaches to this phase. Consequently, auditors normally would select some accounts or classes of transactions for testing in the forensic-type phase that fall below normal levels of planning materiality, or select some locations not normally included in the scope of their work.

Notwithstanding the foregoing, in *all* audits the degree of audit effort in the forensic-type phase should be more than inconsequential.

⁵³ See note 15 to Chapter 2 regarding the Panel's study of AAERs.

CHAPTER 4 – AUDIT FIRMS

4.1 Approximately 15,000¹ entities file financial statements with the Securities and Exchange Commission (SEC); about 1,200 of those entities are foreign registrants.² Those financial statements are audited by international, national, regional and local accounting firms, most of which are members of the SEC Practice Section (SECPS) of the American Institute of Certified Public Accountants (AICPA).³ The Panel studied, among other things, the overall “tone at the top” in the firms, their hiring and employee retention policies, the professional development of auditors, the assignment of personnel to audits, the performance measures used by the firms to evaluate audit personnel, and time pressures on auditors.⁴ The Panel focused primarily, but not exclusively, on the eight largest firms.⁵

PROFESSIONAL LEADERSHIP – THE TONE AT THE TOP

4.2 The “tone at the top” of an audit firm is a major influence on its culture. It determines, for example, whether the culture is quality-oriented or sales-oriented, and whether top management extols the important role audits play in the capital markets or acts as if audits are little more than minimum-value commodities.

4.3 Audit personnel constantly receive messages from firm management on such topics as audit efficiency and effectiveness, client service, client relationships, profitability, marketing of services and development of personnel. Often these messages only indirectly imply that quality audit work is an integral part of quality client service. They often do not focus directly on audit quality in the context of a service provided to protect the interests of the investing public.

Findings

4.4 Focus group participants often indicated that not only clients, but also engagement partners and firm leaders, treat the audit negatively – as a commodity. Some respondents to the Panel’s survey and some engagement teams interviewed in the QPR process expressed a similar view, in some cases implying, by the more positive comments made about the firms’ other service lines and their perceived higher levels of growth and profitability, that the audit was viewed as a commodity. The emphasis on providing profit-enhancing ideas to the client’s management, so the

¹ Internal SEC staff estimates as of March 2000.

² 1999 annual report of the Securities and Exchange Commission, *SEC Annual Report 99*, p. 76 (U.S. Government Printing Office).

³ The SECPS has approximately 1,300 member firms; however, only approximately 800 of them audit SEC registrants. There are approximately 50 U.S. accounting firms that audit U.S. domiciled registrants but are not SECPS members.

⁴ The Panel makes no recommendations on firms’ hiring and retention policies and the assignment of personnel, and accordingly they are not discussed in this chapter.

⁵ Appendix B provides information about the firms.

audit would appear to have value beyond meeting statutory requirements, also contributed to the perception that the audit itself had little value. All of the firms represent that they are placing significant emphasis on their audit practices. Furthermore, some firms have indicated that, following the divestiture of their consulting practices, they will place even more emphasis on their audit practices. The Panel views this as a positive development.

Recommendations

To audit firms:

4.5 The Panel recommends that audit firms:

- Emphasize to all audit personnel the importance of performing high-quality professional work. This message should be delivered frequently by the CEO, COO, leaders at the firm's regional and office levels, and the head of the assurance practice, as well as by the firm's top technical partners. It should stand out above all other messages.

The message should be a positive, constructive message that is refreshed frequently so it commands attention, rather than becoming a tired slogan that is ignored. For example, it might reference specific situations where client management, audit committees or others recognized and applauded audit quality. In addition, situations could be recognized in which individuals or engagement teams took difficult stands on earnings management issues, issues involving possible management fraud or illegal acts, or contentious accounting issues. Other messages might cover important developments in the profession that affect the quality of accounting and auditing.

- Address the importance of the role and responsibility of audit professionals, as well as the concepts of integrity and objectivity, independence, professional skepticism and accountability to the public. These concepts should be introduced on or near the day professionals, both experienced and inexperienced, are hired. They should be reinforced regularly and be integral to the firm's training efforts.
- Develop marketing and advertising messages targeted to users of audited financial statements, coordinated with similar AICPA messages, which promote the importance of audits.

To the SECPS Peer Review Committee:

4.6 The Panel recommends that the SECPS Peer Review Committee request that peer reviewers:

- Assess the timeliness, frequency and appropriateness of internal messages from firm leaders about audit quality

- Include their findings in this area in their reports to the SECPS Peer Review Committee

To the AICPA:

4.7 The Panel recommends that the AICPA develop messages targeted to both audit professionals and users of audited financial statements that promote the importance of audits.

PROFESSIONAL DEVELOPMENT

4.8 Audit firms have faced major challenges in recent years in maintaining the necessary level of professional competence on the part of their audit personnel. The challenges include increased business complexities and risks, the rapid pace of technological change, changes in audit methodologies, the globalization of business, significant regulatory developments, new and often complex accounting and auditing standards and a decreasing number of university graduates who intend to enter the accounting profession.

Findings

4.9 Participants in the focus groups, respondents to the Panel's survey, presenters at the Panel's public hearings, personnel in the offices visited in the QPRs and others expressed their views regarding both continuing professional education and collegiate education. In addition, the Panel reviewed the eight largest firms' instructor-led and self-study course catalogs and selected course content, coaching and mentoring programs, and average training hours per auditor by experience level.

Continuing Professional Education

4.10 Average continuing professional education (CPE) hours per audit professional, across all levels of experience in the large firms, are well above professional and regulatory requirements, and have changed little in recent years. Formal CPE is in addition to on-the-job training, which is the primary vehicle for the professional development of auditors. The firms also have invested heavily in new technology-driven, information-sharing systems, which include extensive databases of technical, industry and other resource materials. These systems serve as a means of delivering training programs and as important sources of professional self-development.

4.11 The firms support an impressive array of instructor-led and self-study programs directed at developing broad-based business professionals and skilled auditors. Professional development programs typically are standardized for less experienced personnel and focus on technical accounting knowledge and audit skills, industry knowledge, interpersonal skills and administration of work assignments. Programs for more experienced professionals generally are more tailored to the individual's needs and most often include technical topics, industry programs, and skills related to personnel development (including coaching and mentoring), relationship building and practice development. Formal training at all levels also includes using technology to deliver

internal communications, research resources and individual learning. The Panel supports the emphasis on coaching and mentoring and the use of high-quality, technology-based delivery tools as supplements to traditional instructor-led programs.

4.12 Participants in focus groups and other Panel activities indicated that partners and other supervisory personnel, and sometimes the firms themselves, do not always view professional development as a high priority. This negatively affects on-the-job learning, and at times interferes with attendance at scheduled formal training programs and the effective use of self-study programs. The participants also noted that auditors need improved knowledge and skills to respond to the increased audit demands called for by the Panel's recommendations in Chapters 2 and 3. The participants indicated that current professional and regulatory CPE requirements are focused on the attainment of a specified number of training hours and are, in general, less than effective in providing auditors with the necessary levels of skills and competence. The Panel believes that outcome measures, such as assessments of performance against agreed-upon knowledge and competency criteria, would be more effective in developing auditors' skills and improving audit quality.

4.13 The profession's approach to professional development has started to move toward self-directed, competency-based learning. Several firms have developed "competency models" that reflect the firms' skills and competency expectations for each experience level, which are then incorporated into their performance management processes. The AICPA, working cooperatively with the National Association of State Boards of Accountancy, has issued an exposure draft of a *Statement on Standards for Continuing Professional Education* that incorporates the core competency concept. The Panel supports these steps to improve the focus, relevance and effectiveness of CPE.

Collegiate Education

4.14 The Panel did not study the extent to which entry-level audit personnel bring to the firms the necessary knowledge and skills to respond to the increased audit demands called for by the Panel's recommendations in Chapters 2 and 3. As indicated above, however, improved knowledge and skills are required, whether they are brought to the firms by newly hired personnel or are obtained afterward by formal CPE or on-the-job training. Numerous participants in the focus groups stated that collegiate accounting programs do not always adequately prepare entry-level personnel for auditing.

4.15 Throughout the project, the Panel has listened to concerns about the decline in the number of accounting majors. Perceptions that other careers are more attractive along with negative perceptions or misperceptions about the work of accountants and auditors, compensation, workloads, family or lifestyle, and increased educational requirements⁶ are often included among the factors contributing to this decline.⁷ While the larger firms generally believe that they have

⁶ According to the AICPA website (August 2000), 48 of the 54 jurisdictions that issue CPA licenses have adopted the 150-hour education requirement as a prerequisite to sit for the Uniform CPA Examination. However, the requirement is not yet effective in 15 of the 48 jurisdictions.

⁷ A report commissioned by the AICPA and conducted by The Taylor Research & Consulting Group, Inc., *Student*

been able to hire sufficient numbers of qualified people to meet their needs, they too have expressed concerns about the future. These concerns led the Big 5 firms along with the American Accounting Association (AAA), AICPA, and Institute of Management Accountants (IMA) to sponsor a project to reconsider and transform accounting education. In August 2000, the sponsors published a monograph that discusses a number of issues and makes recommendations for improving accounting education.⁸ The Panel applauds this step and encourages firms (both large and small), the AAA, AICPA, IMA and other interested parties to work together to address this crucial challenge.

Recommendations

To audit firms:

4.16 The Panel recommends that audit firms:

- Support and adopt the competency-based learning concepts in the AICPA exposure draft, *Statement on Standards for Continuing Professional Education*, and use a core competency model that is similar in design to the AICPA model as a basis for career planning and self-assessing whether individual performance and competency goals are being achieved
- Make increased knowledge and skills a high priority for all experience levels, with a particular focus on meeting the increased audit demands called for by the Panel's recommendations in Chapters 2 and 3

To the SECPS Peer Review Committee:

4.17 The Panel recommends that the SECPS Peer Review Committee request that peer reviewers:

- Assess whether engagement teams have the requisite knowledge and skills for the particular engagements
- Make qualitative assessments of the audit firm's policies and performance related to professional development
- Include their findings in this area in their reports to the SECPS Peer Review Committee

& Academic Research Study Final Quantitative Report (July 2000), discusses a number of these issues.

⁸ W. Steve Albrecht and Robert J. Sack, "Accounting Education: Charting the Course through a Perilous Future," *Accounting Education Series*, Volume No. 16 (August 2000).

To the AICPA:

4.18 The Panel recommends that the AICPA assist firms in adopting the competency-based learning concepts in the AICPA exposure draft, *Statement on Standards for Continuing Professional Education*, and in using a core competency model that is similar in design to the AICPA model as a basis for career planning and self-assessing whether individual performance and competency goals are being achieved.

PERSONNEL MANAGEMENT

4.19 Audit firms devote significant time and resources to personnel management. Although each firm has unique policies and procedures, their evaluation criteria all generally encompass industry knowledge, client relationship building, practice development activities (including cross-marketing), and interpersonal, administrative and technical skills. Incentive compensation programs exist in most firms. Quantifiable incentive measures typically are related to practice development, revenue growth and practice profitability. Measures related to technical skills and the quality of professional work – which are considered in firms’ internal inspection programs and in peer reviews – typically are more subjective and consequently not consistently as influential in their incentive compensation programs.

Findings

4.20 The Panel found that generally there is an appropriate focus on technical skills and the quality of professional work, and a reasonable balance of these items with other criteria. Focus group and QPR participants expressed few concerns about the attention firms give to personnel evaluations and rewards or about their overall effectiveness. Participants at all levels spoke positively about the benefits of mentoring programs. Some audit managers believed that their firms sometimes overemphasize new business development in measuring performance. Other participants commented about the need for firms to develop innovative compensation plans that would add to the attractiveness of auditing as a profession.

Recommendations

To audit firms:

4.21 The Panel recommends that audit firms:

- Review performance measures for all experience levels, and ensure that performing high-quality audits is appropriately recognized as the highest priority in performance evaluations and in compensation, promotion and retention decisions for all personnel. The measures should focus on such matters as (1) the depth and substance of understanding of the client’s business and risks, (2) responsiveness to unexpected or unplanned conditions encountered in audits, (3) development of innovative audit approaches, (4) professional skepticism and persistence, and (5) knowledge of

accounting principles and practices.

- Work cooperatively with the SECPS in developing effective measures of audit quality and incorporate those measures into their internal inspection processes. (See the Panel's recommendations to the SEC Practice Section in the section "Enhancing Peer Reviews" in Chapter 6.)

To the SECPS Peer Review Committee:

4.22 The Panel recommends that the SECPS Peer Review Committee request that peer reviewers:

- Assess the role that performing high-quality professional work plays in performance reviews and in compensation, promotion and retention decisions at all levels of audit personnel
- Include their findings in this area in their reports to the SECPS Peer Review Committee

TIME PRESSURES ON AUDITORS

4.23 Time pressures on auditors have been a pervasive and long-standing issue within the profession. The Commission on Auditors' Responsibilities initially raised the issue of time and budget pressures as a factor in substandard audits.⁹ In addition to having an immediate potential effect on the quality of audit work, over time, these pressures may reflect negatively on job satisfaction, on the desirability of choosing a career in auditing and ultimately on the profession's ability to attract and retain high-quality personnel.

4.24 The Panel believes that time and fee budgets, unexpected turnover of engagement personnel, and sometimes unrealistic client-imposed or internally imposed deadlines can place significant pressures on engagement teams. These pressures can create an environment in which audit quality might be compromised if engagement team members, at any level, perceive that their individual performance is measured primarily by meeting time deadlines and budget estimates. These threats to audit quality frequently appear at or near the completion of the engagement in the form of client pressures on the engagement team to "finalize the audit" and hurry the issue-resolution process.

Findings

4.25 No focus group participant indicated any personal involvement in either self-imposed, firm-imposed or client-imposed time pressures that resulted in compromised audit quality, and this

⁹ Commission on Auditors' Responsibilities, *Report, Conclusions, and Recommendations*, 1978. This commission often is referred to as "the Cohen Commission."

generally was confirmed by the QPR process. Focus group participants, however, suggested that time pressures can and often do place stress on the audit process and have the potential to affect audit quality adversely. The study of SEC Accounting and Auditing Enforcement Releases indicated that, in a limited number of instances, succumbing to time pressures may have contributed to the auditors' failure to detect material misstatements.¹⁰ Conversely, in other situations the auditors' resistance to time pressures may have facilitated the detection of material misstatements.

4.26 The Panel recognizes that client deadlines and engagement budgets are a necessary part of the audit process. It also recognizes that many firms have controls built into their audit processes that are designed to help detect and correct quality issues arising from time pressures. Nonetheless, managing the potential risks from excessive time pressures on engagement teams must be a high priority. Performance measures need to be balanced and clearly and carefully communicated to all professionals to ensure that all personnel understand that quality work, not meeting time deadlines and budget estimates, is the ultimate priority.

Recommendations

To audit firms:

4.27 The Panel recommends that audit firms:

- Expand the client acceptance and continuance assessment processes to include inquiries about possible time pressures on specific engagements that could create an environment in which audit quality might be compromised
- Provide guidance and training on actions that engagement partners and other supervisory personnel should consider in managing time pressures
- Incorporate appropriate measures of partners' and other supervisory personnel's abilities to manage time pressures in upward evaluations or other similar feedback processes
- Reaffirm periodically with partners and managers the importance of establishing realistic time budgets and work loads

To the SECPS Peer Review Committee:

4.28 The Panel recommends that the SECPS Peer Review Committee request that peer reviewers:

- Assess the extent of time pressures on audit engagements and the firm's success in managing those pressures

¹⁰ See Appendix F.

- Include their findings in this area in their reports to the SECPS Peer Review Committee

SMALLER FIRM CONSIDERATIONS

Findings

4.29 The Panel staff met with several partners from smaller firms, each of whom had extensive experience performing peer reviews of firms of similar size. Discussions with these and others indicated that smaller firms generally have a strong commitment to quality audit work. The focus group members also thought that the professionalism of people working in these firms is very high.

4.30 Some concerns were expressed, however, about the limited resources available in smaller firms for consultation on technical accounting and auditing issues, difficulties in obtaining concurring partners with the appropriate technical and industry skills, and difficulties in assessing engagement risk (client acceptance and continuance), especially when considering whether to accept a new audit client that previously had been served by a large firm.

4.31 The findings and related recommendations in each of the preceding subsections generally apply to smaller firms as well as the large firms.

Recommendations

To the AICPA:

4.32 The Panel recommends that the AICPA:

- Provide greater audit-related assistance to smaller firms, particularly technical and industry accounting and auditing support and consultation
- Consider additional means by which smaller firms can meet the SECPS concurring partner requirement
- Develop software and other tools to assist smaller firms in assessing engagement risk (client acceptance and continuance)

CHAPTER 5 – AUDITOR INDEPENDENCE

5.1 Independence is fundamental to the reliability of auditors' reports. Those reports would not be credible, and investors and creditors would have little confidence in them, if auditors were not independent in both fact and appearance. To be credible, an auditor's opinion must be based on an objective and disinterested assessment of whether the financial statements are presented fairly in conformity with generally accepted accounting principles. As expressed by Council of the American Institute of Certified Public Accountants (AICPA) in a statement adopted in 1947:

Independence, both historically and philosophically, is the foundation of the public accounting profession and upon its maintenance depends the profession's strength and its stature.¹

5.2 In an important chronicle of the accounting profession, John L. Carey described independence as a state of mind and a matter of character.² In the early part of the twentieth century, the concepts of integrity, honesty and objectivity were so familiar and ingrained that it was not considered necessary to have formal independence rules. The profession felt that written rules merely would have stated the obvious.

5.3 In 1932, AICPA Council considered prohibitions against auditors serving as officers or directors of clients, and rejected them as unnecessary. However, the proposal indicated the first concerns over a need to preserve the *appearance* of maintaining objectivity, as well as being independent in fact. After the Securities Act of 1933 was enacted, the Federal Trade Commission³ issued regulations stating that it would not *consider* auditors to be independent if they served as officers or directors of, or had any direct or indirect interests in, public audit clients.⁴ The concern was that these client relations might subconsciously impair the auditor's objectivity. This in effect introduced the *appearance* as well as the fact of independence as an independence concept. Carey later noted that no one would accuse an auditor who owned a few shares in a client company of losing integrity, but "what would other people think – what would the public think?"⁵ In 1941 the AICPA adopted similar prohibitions applicable to all clients, not just public companies.

5.4 The combination of well-developed accounting standards and independent audits has helped make the U.S. capital markets a national asset. Because the auditor's objectivity is critical to investor confidence, regulators and others become concerned when they detect any actions that may impair, or appear to impair, independence.

¹ John L. Carey, *The Rise of the Accounting Profession: To Responsibility and Authority, 1937-1969* (New York, 1970), p. 182.

² Carey, p. 175 (see note 1).

³ The Federal Trade Commission administered the federal securities laws until the SEC was established in 1934.

⁴ In 1936 the SEC changed the bar against "any" financial interest to a "substantial" interest, allowing an auditor to hold an interest in a public audit client of up to 1% of the accountant's personal worth. It was not until 1950 that the SEC removed the word "substantial" and once again barred *any* financial interest by the auditor in a public client.

⁵ Carey, p. 180 (see note 1).

5.5 The Panel examined certain auditor independence issues.⁶ It observed the extent to which an objective, independent view was brought to bear on difficult, complex audit judgments and decisions encountered during the Quasi Peer Reviews (QPRs). In addition, the Panel sought to assess the potential for impaired independence, both in fact and in appearance, resulting from providing non-audit services to public audit clients and from former audit firm personnel being employed as client management.

NON-AUDIT SERVICES

5.6 The potential effect of non-audit services on auditor objectivity has long been an area of concern. That concern has been compounded in recent years by significant increases in the scope and amounts of non-audit services provided by audit firms.

Prior Considerations of Non-Audit Services and Other Background Information

5.7 The potential impact on independence of an auditor's providing non-audit services to an audit client has been studied by a wide variety of observers. These include the U.S. Congress, the Securities and Exchange Commission (SEC), the Public Oversight Board (POB), the AICPA and academics. Appendix D to this report contains a brief chronicle and summary description of these studies, spanning a period of over 40 years.

5.8 The Panel is not aware of any instances of non-audit services having caused or contributed to an audit failure or the actual loss of auditor independence. However, as the POB noted in its study on scope of services, "Specific evidence of loss of independence through MAS [management advisory services], a so-called smoking gun, is not likely to be available even if there is such a loss."⁷ Many have expressed concerns that these services – and pressures to sell them – may cause an auditor consciously or subconsciously to subordinate his or her judgment to a client's desires. Also, as non-audit services have grown, concern has been expressed that managements of audit firms may have tended to focus more on them than on auditing.

5.9 An early recognition of the expanding scope of services offered by auditors was found in a statement adopted by AICPA Council in 1947. The services described in that statement were tax advice, accounting assistance, advice to businesses in the installation of accounting and cost systems, budgeting and internal control. However, independence concerns were not raised at that time.

5.10 The 1947 AICPA statement suggested that many non-audit services had their roots in the audit practice. They evolved from requests by audit clients for additional services that their auditors seemed best suited or capable of providing, as well as from the special skills needed to

⁶ The Panel notes that the Independence Standards Board (ISB) is developing a conceptual framework for independence applicable to audits of public entities that would serve as the foundation for the development of principles-based independence standards. The first step in the process was the ISB's issuance in February 2000 of a Discussion Memorandum, *A Conceptual Framework for Auditor Independence*.

⁷ *Public Oversight Board Report – Scope of Services by CPA Firms* (AICPA, 1979).

audit new and complex business transactions. Today, effective audits depend more than ever on specialists. For example, specialists used in audits include:

- Technology and systems specialists
- Actuaries, to help evaluate risk management controls, insurance companies' reserves, and pension and other benefit accruals
- Treasury specialists, to help evaluate controls over cash management, financing, currency and derivatives
- Tax specialists, to help evaluate tax liabilities and deferred tax assets
- Valuation specialists, to help evaluate the reasonableness of valuations of financial instruments, stock issued for assets or services, and allocations of the purchase price of acquired businesses

5.11 The evolution of specialty skills into consulting practices was a logical extension of services as firms began hiring specialists for audit support. Expanding the scope of the specialists' activities helped firms attract and retain people with skills that were increasingly important to effective auditing. Providing services beyond the audit was profitable; it also led to increased overall knowledge of the client's business.

5.12 Audit firms' management consulting practices have expanded far beyond the skills required for audit support and the traditional areas related to financial planning and controls.⁸ For example, some firms now offer certain investment banking and legal services, outsourcing of a variety of corporate functions, strategic business planning and business process reengineering advice. Independence questions can arise when these services are marketed to audit clients.

⁸ References to consulting services usually exclude special assurance services. Recently firms have tended to carve out as special assurance practices certain services that require audit skills – for example, transaction-based services such as due diligence studies in connection with proposed business combinations, litigation support and internal audit outsourcing.

5.13 The revenue mix of the Big 5 firms has shifted toward consulting services. The growth of consulting services is illustrated by the following table, showing those firms' mix of practice as a percentage of gross fees⁹:

	<u>1990</u>		<u>1999</u>	
	<u>All clients</u>	<u>SEC audit clients</u>	<u>All clients</u>	<u>SEC audit clients</u>
Accounting and auditing	53%	71%	34%	48%
Tax	27	17	22	20
Consulting	<u>20</u>	<u>12</u>	<u>44</u>	<u>32</u>
Total	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>

This indicates that, for SEC audit clients, the ratio of accounting and auditing revenues to consulting revenues dropped from approximately 6 to 1 in 1990 to 1.5 to 1 in 1999.

5.14 For 1999, 75% of the Big 5 firms' SEC audit clients received no consulting services from their auditors, down from 80% in 1990. Four percent of those firms' SEC audit clients had consulting fees that exceeded audit fees, up from one percent in 1990.

5.15 Similarly, the growth of consulting in the next three largest firms is shown below¹⁰:

	<u>1990</u>		<u>1999</u>	
	<u>All clients</u>	<u>SEC audit clients</u>	<u>All clients</u>	<u>SEC audit clients</u>
Accounting and auditing	56%	81%	44%	74%
Tax	33	16	28	16
Consulting	<u>11</u>	<u>3</u>	<u>28</u>	<u>10</u>
Total	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>

5.16 For 1999, 79% of those firms' SEC audit clients received no consulting services from their auditors, approximately the same as in 1990. Less than one percent of those firms' SEC audit clients had consulting fees that exceeded audit fees in either 1999 or 1990.

⁹ Compiled from annual reports submitted by the firms to the SECPS. Although consulting has grown significantly, accounting, auditing and tax also have continued to grow and prosper. In fact, in 1999 the growth of the Big 5 firms' accounting and auditing practices was slightly higher than that of their consulting practices ("Special Supplement: Annual Survey of National Accounting Firms – 2000," *Public Accounting Report*, March 31, 2000).

¹⁰ Compiled from annual reports submitted by the firms to the SECPS.

The Panel's Process

5.17 The Panel sought to obtain information about the effects of non-audit services on the independence of auditors. In the QPR process, 37 engagements were identified in which services other than audit and tax had been provided. (This represented 29% of the QPR population, and is similar to the average of 25% of all the Big 5 firms' SEC clients for 1999, as indicated above.) Supplemental questionnaires were completed in these instances, and in some cases the reviewers interviewed the firm personnel who performed the non-audit services.

5.18 The QPR reviewers did not identify any instances in which providing non-audit services had a negative effect on audit effectiveness. On about a quarter of the engagements in which non-audit services had been provided, the QPR reviewers concluded that those services had a positive impact on the effectiveness of the audit. On the balance of the reviewed engagements, the reviewers either were neutral regarding the effects of non-audit services on audit effectiveness or concluded that the services had no impact on audit effectiveness.

5.19 Of the 37 engagements, 15 involved (a) systems or processes used by the client to prepare its financial statements (or management reports directly integrated with its financial statements) or (b) financial statement amounts that were involved in, or derived as part of, the non-audit services. In all 15 of these engagements, the reviewers agreed that the engagement team's audit procedures were sufficient to bring an objective view to the area, provided sufficient competent evidential matter regarding the systems, processes or amounts, and were documented adequately. In addition, the reviewers agreed that the engagement team and/or the firm took appropriate steps to ensure that the non-audit services would not impair the firm's independence and that the auditors' independence was not adversely affected by the non-audit services.

5.20 Also, respondents to the Panel's survey were asked for their views on the matter, and participants at the Panel's public hearings expressed views on the issue. The Panel found that many people continue to be concerned – some very concerned – that the performance of non-audit services could impair independence, or that there is at least an appearance of the potential for impairment. Almost two-thirds of the respondents to the Panel's survey from outside the profession who addressed non-audit services expressed such concerns.

5.21 Respondents to a recent survey commissioned by the ISB indicated the following:

- They believed that the evolution of audit firms into the consulting fields was logical.
- Many felt that the provision of most consulting services was not likely to create a real problem of audit independence.
- However, almost all agreed that the potential for appearance problems was quite significant.¹¹

¹¹ Earncliffe Research & Communications, *Report to the United States Independence Standards Board: Research into Perceptions of Auditor Independence and Objectivity*, November 1999. Those interviewed in the survey included public company CEOs, CFOs and audit committee chairs, as well as buy- and sell-side analysts, audit partners and regulators.

Panel Considerations

5.22 The Panel discussed at length the subject of non-audit services and their potential impact on auditor independence. It also debated whether it should consider recommending a ban on some or all non-audit services to public audit clients. During its deliberations the Panel became aware that:

- Many of the major firms have announced that they have split off, or intend to split off, some or all of their consulting practices from their audit and tax practices. The expected results would include the reduction or elimination of potential conflicts of interest and renewed emphasis on core audit services.
- In May 2000 the Chairman of the SEC stated that he had asked the SEC staff to prepare a rule-making initiative related to the expanded non-audit services offered to public company audit clients.¹² He noted that the initiative would address fundamental public policy questions, including whether there should be limits on the types of services that an auditor can render to a public audit client, how firms should be structured to ensure independence, and whether firms should be permitted to affiliate with entities that provide services to the firms' audit clients that the firms themselves would not be allowed to provide to those clients. The Chairman added that any proposal resulting from the initiative would be supplemented by public hearings to solicit the broadest possible input.
- On June 30, 2000, the SEC issued those proposals.¹³ While not proposing to ban all non-audit services, the proposals identify many non-audit services that would be considered inconsistent with independence under four basic principles articulated in the proposal.¹⁴ The proposals cover certain aspects of the following services, some aspects of which are already precluded under SEC, AICPA and SECPS membership rules¹⁵:
 - Bookkeeping and similar services
 - Financial information systems design and implementation
 - Appraisal or valuation services
 - Actuarial services (to determine policy reserves and related accounts)

¹² Chairman Arthur Levitt, *Renewing the Covenant with Investors*, address at New York University Center for Law and Business, May 10, 2000.

¹³ *Revision of the Commission's Auditor Independence Requirements* (Release Nos. 33-7870; 34-42994; 35-27193; IC-24549; IA-1884; File No. S7-13-00). In addition to the scope of services provided by audit firms, the proposals address investments by auditors and their family members in audit clients and employment relationships between auditors and their family members and audit clients.

¹⁴ Situations that the SEC believes reasonable investors would agree impair an auditor's independence are when an auditor (1) has a mutual or conflicting interest with the audit client; (2) audits the accountant's own work; (3) functions as management or an employee of the audit client; or (4) acts as an advocate for the audit client (*Revision of the Commission's Auditor Independence Requirements*, III.B).

¹⁵ *Revision of the Commission's Auditor Independence Requirements*, III.D.1(b). Although the proposals would not prohibit tax services, the SEC is considering whether providing tax opinions for the use of third parties in connection with business transactions between audit clients and the third parties should be precluded.

- Internal audit outsourcing
- Management functions
- Human resources
- Broker-dealer, investment adviser or investment banking services
- Legal services
- Expert services (expert opinions in legal, administrative, or regulatory filings or proceedings)

The proposals would require registrants to disclose certain fee and services information in their annual proxy statements.¹⁶ Registrants would disclose annual audit fees and the fee paid for each non-audit service, unless the non-audit service was less than \$50,000 or 10% of the audit fee, whichever was smaller. Also, registrants would indicate whether, before each disclosed service was rendered, the audit committee had approved the service and considered the possible effect of the service on the auditor's independence.

- The SEC has requested comments on its proposals and held the first of several public hearings on July 26, 2000, to solicit the views of the public on its proposals. Additional hearings will be conducted in September 2000.

5.23 During its discussions, the Panel agreed that:

- Independence is essential for promoting public confidence in the audit process, and must be monitored continuously.
- So long as auditors provide non-audit services to audit clients, there will be at least an issue with respect to the appearance of independence.
- There has been an explosive growth in non-audit services in recent years, to the point where many large firms' revenues from these services exceed their audit revenues.
- In their zeal to emphasize the array of services that CPAs offer, audit firms and the AICPA scarcely acknowledge auditing services in the public images that they portray. This serves to exacerbate the independence issue and to downplay the importance of auditing.

5.24 Considering the history of the issue of non-audit services and all the prior studies, the Panel asked itself the fundamental question: Is there a conflict here and, if so, how should it be addressed?

5.25 Panel members have two distinct viewpoints on this question, which are presented later in

¹⁶ The proposals also would require disclosure of the percentage of hours worked on the audit engagement by persons other than the auditor's full-time employees, if greater than 50%. This is intended to respond to recent moves by some firms to sell their practices to financial services companies and "lease back" professional auditors from those companies.

this chapter in the sections “Statement Supporting an Exclusionary Ban on Non-Audit Services” and “Statement Opposing an Exclusionary Ban on Non-Audit Services.” Some Panel members believe there should be an exclusionary rule that would prohibit an audit firm from providing non-audit or non-tax services, except in very limited circumstances, to its public audit clients. Under this view, there is a fundamental conflict of interest because, in reality, the audit firm is serving two different sets of clients: management, in the case of management consulting services, and the audit committee, the shareholders, and others who rely on the audited financial statements in deciding whether to invest, in the case of an audit.

5.26 Other Panel members believe that audit firms can provide both audit and non-audit services to the same public audit client, and with the proper safeguards and disclosures, can maintain independence and objectivity. They believe that nothing in the long history of the profession’s providing non-audit services has indicated otherwise. They believe it is incorrect to suggest that the interests of management must be at variance with those of the audit committee and the shareholders, or that the interests of management must be inimical to good financial reporting. The company and shareholders are the primary beneficiaries of consulting services that “benefit management.” Thus, in the absence of compelling evidence of a problem, these members believe that such an extreme measure is unwarranted and could well have a negative effect on audit effectiveness.

5.27 Accordingly, the Panel makes no recommendation regarding an exclusionary rule. However, the Panel did agree on the importance of the independence issue and that audit committees should not await the results of the SEC’s rule-making initiatives to become actively involved in monitoring proposed non-audit services.

5.28 The Panel’s recommendations are intended to assist the SEC in its rule-making initiatives while providing for an immediate plan of action, as described below, that should be implemented by the ISB, audit committees and management pending any SEC rules.

Recommendations

To the Independence Standards Board:

5.29 The Panel recommends that, whatever the outcome of the SEC’s rule-making initiatives, the ISB identify factors to be considered by auditors, audit committees and client management (a) when implementing Independence Standard No. 1¹⁷ and the SEC’s new audit committee disclosure requirements¹⁸ and (b) when determining whether a specific non-audit service is appropriate. In determining the appropriateness of a particular service, one guiding principle should be whether the service facilitates the performance of the audit, improves the client’s financial reporting process, or is otherwise in the public interest. The factors to consider might include:

- Whether the service is being performed principally for the audit committee

¹⁷ Independence Standard No. 1, *Independence Discussions with Audit Committees* (ISB, January 1999).

¹⁸ *Audit Committee Disclosure* (SEC Release No. 34-42266), December 22, 1999.

- The effects of the service, if any, on audit effectiveness or on the quality and timeliness of the entity's financial reporting process
- Whether the service would be performed by specialists (e.g., technology specialists) who ordinarily also provide recurring audit support
- Whether the service would be performed by audit personnel and, if so, whether it will enhance their knowledge of the entity's business and operations
- Whether the role of those performing the service (e.g., a role where neutrality, impartiality and auditor skepticism are likely to be subverted) would be inconsistent with the auditor's role
- Whether the audit firm's personnel would be assuming a management role or creating a mutuality of interest with management
- Whether the auditors, in effect, would be "auditing their own numbers"
- Whether the project must be started and completed very quickly
- Whether the audit firm has unique expertise in the service
- The size of the fee(s) for the non-audit service(s)

The Panel recognizes that considerable judgment may be required in reaching a conclusion regarding the appropriateness of an audit firm's performing a specific non-audit service for a specific public audit client.

To audit committees:

5.30 The Panel recommends that audit committees pre-approve non-audit services that exceed a threshold determined by the committee. This recommendation is consistent with the recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees regarding auditors' services. The threshold should be at a level that ensures that significant services are pre-approved, but not so low that the committee assumes a management function.

When audit committees determine whether to approve specific non-audit services, the Panel recommends that they consider the same guiding principle and the factors suggested above for use by the ISB.

To the SEC and the Independence Standards Board:

5.31 The Panel recommends that the SEC and the ISB evaluate on a continuing basis the effectiveness of the disclosures made under Independence Standard No. 1 and the SEC's new audit committee disclosure requirements, as well as any new rules issued by the ISB or by the SEC pursuant to its rule-making initiatives.

STATEMENT SUPPORTING AN EXCLUSIONARY BAN ON NON-AUDIT SERVICES

5.32 Some members of the Panel believe that, with very limited exceptions, audit firms and their affiliates should be excluded by rule from marketing and furnishing management services to their audit clients that do not directly advance the interests of investors in objective and reliable financial reports on the stewardship of management. This position rests on the belief of these Panel members in (a) the central importance of independence to the profession of auditing in general, and to the effectiveness of the audit process in particular, and (b) the severe and growing challenges to independence that the audit profession faces in the current environment.

The Exclusionary Rule Described

5.33 For the reasons set forth below, we believe the Panel should recommend a rule (the “Non-Audit Services Rule”) that, with the very limited exceptions described below, bars the provision of non-audit services to an audit client by either (a) the audit firm itself or (b) any firm affiliated with the audit firm, whether by reason of a control relationship or strategic or other business alliance or other arrangement that gives the audit firm or its partners a financial stake in the provision of non-audit services to such audit client by such other firm.

5.34 The Non-Audit Services Rule should be adopted by the SEC, which in turn should in the first instance look to (a) the ISB for the purpose of issuing detailed rules of implementation, and (b) the Public Oversight Board for the purpose of assuring effective enforcement of the Non-Audit Services Rule and the detailed rules of implementation.

5.35 The Non-Audit Services Rule would have application only to SEC registrants. Of course, the profession would be free to adopt the same or similar rules for application more generally to all audits conducted in the United States.

5.36 The Rule would define the category of services (“Non-Audit Services”) to be barred as including everything other than the work involved in performing an audit and other work that is integral to the function of an audit. In general, the touchstone for deciding whether a service other than the straight-forward audit itself should be excluded from Non-Audit Services is whether the service is rendered principally to the client’s audit committee, acting on behalf of investors, to facilitate, or improve the quality of, the audit and the financial reporting process rather than being rendered principally to provide assistance to management in the performance of its duties. The range of services, skills and personnel thus permitted to be employed in furtherance of the financial reporting process is in no way limited. The Non-Audit Services Rule adopted by the SEC would provide general guidelines to the ISB in writing detailed rules of implementation, which the Panel expects would evolve over time as the nature of the audit and the services changed. We do not believe the Panel need resolve the many difficult definitional issues that the Rule will undoubtedly create. That would be the task of the ISB.

5.37 Without prejudging, we offer the following brief observations on two types of non-audit services. Tax work, although typically performed for management, is also frequently performed for, and subject to close scrutiny by, the audit committee and has traditionally been thought of as tightly related to audit work. Given the history, we believe tax work that does not involve advocacy should probably be treated as outside the barred category of Non-Audit Services. So too should attest work rendered as auditor in connection with SEC registrations or other SEC filings.

5.38 We believe the SEC's Non-Audit Services Rule should contain a carefully circumscribed exception to permit Non-Audit Services to be rendered by the audit firm to its client where special circumstances justify so doing. Use of the exception would require the following:

- (a) Before any such Non-Audit Service is rendered to the audit client, a finding by the client's audit committee (which must consist only of independent directors) that special circumstances make it obvious that the best interests of the company and its shareholders will be served by retaining its audit firm or affiliate to render such Non-Audit Service and that no other vendor of such service can serve those interests as well;
- (b) Forthwith upon the making of such finding by the audit committee, submission of a written copy thereof to the SEC and the POB; and
- (c) In the company's next proxy statement for the election of directors, disclosure of such finding by the audit committee and the amount paid and expected to be paid to the audit firm or affiliate for such service.

Reasons Why the Exclusionary Rule Has Become Necessary to Protect Independence, both Now and Especially in the Future

5.39 There are a number of important and convincing arguments in favor of an exclusionary rule. In contrast, no other solution is likely to achieve the goal of protecting independence from the growing temptations and pressures that exist. A brief outline of the most important arguments appears below.

1. Of fundamental importance in understanding the conflict of interest that arises from the provision of non-audit services to audit clients is the fact that in so doing the audit firm is really serving two different sets of clients: management in the case of management consulting services ("MCS"), and the audit committee, the shareholders and all those who rely on the audited financials and the firm's opinion in deciding whether to invest, in the case of the audit. The firm is a fiduciary in respect to each of these client groups, duty-bound to serve with undivided loyalty. It is obvious that in serving these different clients the firm is subject to conflicts of interest that tear at the fragile fabric of loyalty owed to one client or the other. And it is equally obvious that the existence of dual loyalties creates a serious

appearance problem, regardless of whether, in particular cases, the fabric actually tears apart or not.

2. Our concerns with providing non-audit services to audit clients derive only in part from the well developed notions that (a) an auditor, directly or indirectly through others in the firm or affiliates, ought not to be put in the position of reviewing its own work, a concern clustered by the Independence Standards Board¹⁹ around the term “self-review” and (b) an auditor, directly or indirectly, ought not to be put in the position of playing a management role through, for example, the exercise of managerial responsibilities or participation in management decisions. The essence of the concerns is the potential for impairment of independence, both in appearance and in fact, that emanates from the wearing of more than one fiduciary “hat” in the services provided, creating, willy-nilly, a dual set of loyalties. It is for this reason that our concern, and the solution advanced above, extend beyond non-audit services of the types encompassed by (a) and (b) of this paragraph 2.
3. Given the conflict of interest, it is not realistic to expect the firm itself to decide on its own independence. Even if the firm is correct in concluding that the existence of non-audit business with a particular audit client will not impair its independence, the conflict of interest inherent in the firm attempting to address this issue for itself, given its sharp self-interest in an outcome permitting the conduct of non-audit business, creates in the minds of objective observers a serious loss of credibility.
4. Nor is it feasible to expect independence to be assured by approval of the audit committee, because it is impossible to identify when the problem exists, and to challenge the auditor’s judgment on the matter is to challenge its integrity, something audit committees are highly unlikely to do. Independence is a state of mind, necessary to maintain the skepticism and objectivity that are hallmarks of the accounting profession. Being subjective and invisible, it is not something an audit committee can apply any known litmus test to determine. Moreover, the credibility problem would remain whenever there are substantial levels of non-audit services being provided. This problem has long been seen as of profound importance to the public maintenance of confidence in the audit function.
5. In a real sense the audit committee will remain blind to the existence of an independence problem unless the auditor acknowledges its existence. Regardless of the independence of the audit committee, and its willingness to cut back or eliminate entirely the non-audit services that have given rise to conflicting interests, the committee is wholly dependent on the auditor to identify whether a problem exists and how serious it may be. Such

¹⁹ See, e.g., Discussion Memorandum of Independence Standards Board, September 1999, “Appraisal and Valuation Services” and Discussion Memorandum of Independence Standards Board, December 1999, “Legal Services.”

dependency is a very weak reed on which to base a solution that looks to the audit committee to assure independence, case by case, through a “facts and circumstances” test.

6. No one has suggested that the audit committee can be a substitute for clear rules where the problem of conflicts is most serious. Thus, for example there is no suggestion that the audit committee be charged with discretion to assess independence despite the existence of financial interests by the audit firm in its audit client. Stock or other financial interests in one’s audit client have long been viewed as creating too clear a conflict of interest to become the subject of discretion. The need for an exclusionary rule on non-audit services is rooted in the same ground: prospective revenues from the provision of non-audit services, extending into the future, create precisely the kind of financial stake that produces a conflict of interest capable of impairing independence.
7. An exclusionary rule is relatively easy to administer. It does not preclude an audit firm from engaging directly or through affiliates in non-audit services. All business entities other than its audit clients are available for business. Thus, the Non-Audit Services Rule affirms the freedom of audit firms to engage widely in non-audit services and to attract and hold top-flight experts in IT and other non-audit services who must be available to assist in audit work from time to time. As the Panel’s data show, consulting staff and practice have burgeoned in recent years, even though 75% of the Big 5 firms’ SEC clients receive no consulting services from their auditors.

The SEC made the same observation in somewhat analogous circumstances in 1989. In rejecting an application by Arthur Andersen to enter into an MCS venture with a client on the basis of Andersen’s claim of immateriality, the SEC said: “the petition argues that the staff interpretation is anticompetitive in that it denies the accountant an opportunity to compete by providing services in combination with its audit clients. The accountant is precluded only from entering into a direct business relationship with an existing audit client. The accountant is thus free to enter into the relationship with any party unless the direct business relationship is in effect during the period when the accountant is conducting an audit of that party.”

In this same opinion the SEC rejected the argument that an exclusionary rule is contrary to the public interest in denying potential clients their choice of service providers, an argument likely to be advanced against the suggested rule as well. Thus: “the petition also asserts that the staff interpretation is injurious to the public interest because the public is deprived of the efficient delivery of the prime/subcontractor’s technical non-attest services. The public interest with which the Commission is

concerned, however, is the assurance of the integrity of financial statements filed with it. As discussed above, it is this objective which requires independence....” Moreover, the Non-Audit Services Rule allows the ban to be lifted when special circumstances make it compelling to do so.

8. As the Panel’s report indicates under “Personnel Management” in Chapter 4, the system of compensation within the audit firms may not presently give adequate weight to performing the audit function with high levels of skill and professionalism. This fact may well adversely impact audit effectiveness. Success in marketing an audit firm’s consulting services is a significant factor in the compensation system. The skills that make one successful in marketing non-audit services to management are not generally consistent with the professional demands on an auditor to be persistently skeptical, cautious and questioning in regard to management’s financial representations. As long as the marketing of non-audit services by auditors to their audit clients is encouraged, expected and rewarded, there will exist a tension counterproductive to audit excellence. An exclusionary rule will eliminate both this tension and its harmful effects.
9. Some have considered addressing the problem of conflicts by banning this or that non-audit service that is thought to be especially troublesome. Legal and valuation services, for example. Our underlying objection to this case by case approach is that it would produce the sort of finely tuned evasion and concomitant enforcement proceedings that always follow from efforts to define narrowly what is a prohibited practice. (The essentially futile rules and re-rules of the FASB to determine when the lease of an asset must be shown on the balance sheet as a liability are a classic case in point.) Consider the recent announcement by one of the Big 5 firms that it will be acquiring a high-profile lobbying concern, one that would, in the words of one of its principals, enable the audit firm to help clients “get a law enacted . . . and work with the actual statutory language.” Are the halls of Congress so different from those of the courthouse that these would be permitted, “non-legal” services, as the acquiring audit firm apparently contemplates? This approach also puts the burden on those seeking to ban a particular non-audit service. We believe it is essential to start with an exclusionary rule for all non-audit services, and then to create limited exceptions where the risk of impairing independence is slight.
10. An exclusionary rule would be effective in rewarding those audit firms most sensitive to the independence issue and most scrupulous in seeking to avoid a real problem or the appearance of a problem. Exhortation and even disclosure, by itself, often encourage those willing to sail close to the line, or even cross over it. This result has the real and perverse impact of hurting the competitive position of the most sensitive and scrupulous audit

firms, and in time encourages even those firms to drop their guard, and exploit the laxness in standards as well.

11. An exclusionary rule is a low cost premium on an important insurance policy for the whole profession, against governmental intervention to deny audit firms the right to do any non-audit work. The rule would go far toward eliminating the possibility of a major audit failure being linked to the influence of non-audit service business on the audit firm's diligence and skepticism, an event that would provide a basis, and possibly the momentum, for some radical solution like a total ban.
12. Independence is given important meaning in many analogous situations where potential conflicts, while not always certain to impair independence, nonetheless are prohibited in the interest of avoiding the problem entirely. Some observers would describe this strictness as an effort simply to preserve the appearance of independence. We agree, but only in the sense that it is solely by looking to what is observable directly that we can set the bar for the fact of independence, which is inherently indeterminate. Appearances matter, in sum, because the visible conflicts of interest are all that we have to go on. The rules forbidding audit partners from owning stock in the clients they audit and the rules tightly restricting the eligibility of corporate directors to serve on audit committees are but two examples of rules based not on the proven, but rather the presumed, dangers of conflicting interests.

For example, the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees determined that, for a director to be independent for purposes of meeting the membership requirements of the audit committee, he or she must not accept compensation from the corporation for any service other than service as a director and committee member. The Blue Ribbon Committee noted that "...common sense dictates that a director without any financial, family or other material personal ties to management is more likely to be able to evaluate objectively the propriety of management's accounting, internal control and reporting practices." The parallel to the auditor is both exact and compelling. Compensation for any service other than the audit would impair the auditor's independence.

13. Another useful analog is found in the NYC Bar Association report on law practice within the audit firm. This Statement of Position on Multidisciplinary Practice, appearing in *The Record*, September/October 1999, emphasized the incompatibility of the auditor's independence with the lawyer's duties of confidentiality. As a result, the Executive Committee of the NYC Bar Association stated its belief that "those roles are always intrinsically incompatible, and that any regime permitting MDPs should make clear that the same MDP may not provide both legal and audit services to the same clients." As early as 1962, looking at the

same issue from the auditing side, the SEC decided that the independence of an audit firm was tainted when a partner in the firm rendered legal services to the audit firm's client.²⁰

14. The provision of non-audit services is and can consistently be a profitable business without the door-opener of already serving a prospective client as its auditor. See, for example, Andersen Consulting. As noted in paragraph 7 above, notwithstanding the rapid growth in management consulting services, and the dominant share of firm revenues they now command, the provision of non-audit services to most audit clients remains relatively small. Adoption of the exclusionary rule now would not have as large an impact on firm profits as many in the profession seem to fear. If the rule is put off, however, its likely impact on the firms when ultimately adopted will surely increase. Continued rapid growth in management consulting work is likely to mean an increase in the provision of such work for audit clients.
15. Audit services, standing alone, have been, are often today, and can consistently be a profitable profession in the future. As a statutorily mandated function capable of being performed only by licensed professionals who are organized chiefly in a handful of very large firms, there is ample pricing power to assure profitability. In our hearings, the audit firms claimed their auditing work was profitable, standing alone. Other commentators seemed to dispute this claim, believing the firms too often use auditing as a loss leader for marketing non-audit services. In either case, the rule we recommend will make it unnecessary to treat auditing as any kind of loss leader, because there will be no other services to be cross-marketed. The incentive to compete on price will be sharply reduced. Thus, charges for auditing will be adequate to attract and hold the quality professionals necessary to perform quality audits. Overall the quality of audits should go up. To quote *The Economist* (1/15/00): "Of course, if accountants are barred from selling other services to their audit clients, then the cost of audits may well go up. But companies should be happy that they are not having their arms twisted into buying other sorts of advice from their auditors' colleagues. Auditors too would be freed from the insidious pressure of selling or reviewing colleagues' work. And for shareholders, surely the price of truly independent audits is one worth paying."
16. Whatever its merits in 1978 when ASR 250²¹ was adopted, disclosure of non-audit services will not suffice today or for the future. In 1978 disclosure was widely seen as an indirect way to deter too much non-audit work for audit clients. The use of disclosure to shape substantive behavior

²⁰ *American Finance Company, Inc.*, 40 SEC 1043 (1962).

²¹ *Disclosure of Relationships with Independent Public Accountants* (SEC Accounting Series Release No. 250), June 29, 1978.

has a long and often successful history at the SEC. In repealing ASR 250 in 1982, the SEC noted a lack of “utility to investors.” The question of usefulness to investors is equally true today. How are shareholders expected to deal with the disclosure? For most, this or that piece of consulting work might not seem material, but independence is not for shareholders to choose, one by one. It is a public choice issue, much like clean streets; there is independence for all the shareholders or for none. More importantly, the scale of management consulting work and the pressures to cross-sell that we have described are of such growing magnitude that the less intrusive, and indirect, solutions of an earlier day are no longer adequate. The problem is structural, across our financial markets as a whole, and must be dealt with in those terms.

Using disclosure to assure independence in fact and appearance is a lot like pushing the string rather than pulling it. To some extent, with some clients, it may act as a brake on the growth of non-audit services sold to audit clients. Again, however, it will often serve to harm the most sensitive and scrupulous, while rewarding those willing to push the limits, despite transparency. We conclude, for all these reasons, that a direct rule of exclusion is far superior to the indirect route of disclosure.

17. There are arguments from the perspective of both the service provider and the service user that favor combining audit and non-audit services for the same client. In marketing terms, there is an attractive link between auditing and management consulting. The one provides continuing access and credibility for the other. Auditing provides a matchless opportunity to uncover the competitive opportunities and risks of the client, which the management consulting group is then prepared to address. No other profession has the same ability, year in, year out, to work with large, public clients, on a worldwide basis, division by division. No other profession has the same privileged opportunity to reach regularly into the very sinews of the client, on a basis of complete candor and access. Indeed, for the profession of auditing, the law requires it. But this legally compelled access carries with it responsibilities importantly affected with the public interest. In these terms, management consulting is a business, not different from a host of others, and as the AICPA Professional Standards state, “differ[ing] fundamentally from the CPA’s function of attesting” services. The paramount importance of independence to auditing means that to the extent cross-marketing, however efficient it might be to the audit firm, impairs independence, whether in fact or in appearance, the right to cross-market must give way. For those in the profession who value the audit function, this should be an easy trade-off to make.
18. Audit firms also argue on behalf of their clients that they are simply giving corporate management greater choice. But independence is not about management choice. Corporate management is the client for management

consulting services, but for the audit the clients are shareholders (and the audit committee as surrogate), creditors and the investing public, all of whom need an objective, reliable report on management's stewardship. If offering corporate management a choice of using its audit firm to supply a full range of other services threatens to impair this oversight function, on which the credibility of our markets depends, then the denial of that choice is simply a cost – a minor one at that – of preserving investor confidence in our financial system. Indeed, the proposed rule is the least intrusive method we could imagine for achieving this essential goal.

STATEMENT OPPOSING AN EXCLUSIONARY BAN ON NON-AUDIT SERVICES

Introduction

5.40 Those members of the Panel who oppose a so-called exclusionary rule believe strongly in the absolute need for auditors' independence, objectivity and integrity. However, they believe that audit firms can provide both audit and non-audit services to the same public audit client and maintain independence, objectivity and integrity. Nothing in the long history of the profession's providing non-audit services has indicated otherwise. These Panel members have confidence that audit committees, management and auditors are fully capable of exercising their responsibilities and making rational, appropriate judgments. Thus, there is no need to default to extreme measures that, while well intended, may produce negative unintended consequences.

5.41 These members believe that the conclusion of the POB in its study on scope of services by CPA firms²² is still valid. In that study the POB considered and rejected any broad prohibition against non-audit services as a "draconian measure" that, among other things, would deprive audit clients of services that they obviously deem valuable. The POB noted that "otherwise lawful and productive activity" should not be prohibited unless "clearly in the public interest and no other measures are available."

5.42 Why is the POB's view still valid? First, the Panel has identified no new issues related to consulting services. Although the appearance problem has been spotlighted by the steady growth of consulting services over more than 40 years, there is little, if any, difference in the nature of the issue regardless of the comparative mix of the firms' revenues. These Panel members also note that the cause of much of the recent concern – the continued growth of non-audit services – may in large measure be reversed by the divestiture or planned divestiture of consulting practices by many firms.

5.43 Most importantly, these Panel members are persuaded by the lack of any specific link between audit failures and the rendering of non-audit services, which is consistent with the facts at the time of the POB's study. This is not a momentary phenomenon; for about a century, CPAs have been providing valuable non-audit services without these services being linked to audit failures.²³ These Panel members are reluctant to change the rules in the absence of any compelling evidence of a problem.

5.44 These members believe that many non-audit services are, indeed, both in the public interest and beneficial to audit effectiveness. As one of many examples, a company may seek the

²² See note 7.

²³ In addition to a lack of evidence of a causal relationship between audit failures and non-audit services, the Panel's QPR findings indicated that auditors' independence was not impaired when non-audit services were provided (see paragraphs 5.17-5.19). This is wholly consistent with the results of the regular peer review process. In that process certain engagements where the client also engaged the audit firm for management consulting services are selected, and the peer reviewer must evaluate the effects, if any, on independence. The SECPS staff reported that 67 such engagements were selected during the 1999 peer reviews, and consistent with prior years, no instances were found in which independence or objectivity appeared to have been impaired.

assistance of its auditors to correct control weaknesses identified during the audit. The public interest is served by the controls (and the company's financial reporting process) having been strengthened through the auditors' knowledge of the company and its operations, and audit effectiveness is enhanced through the auditors' increased understanding of the company's systems. Similarly, a pre-acquisition review of a potential target company by the acquirer's auditors provides timely identification of accounting and operations issues to the acquirer, facilitates the combining of two previously unrelated accounting and financial reporting systems, and enables the auditors to plan a more effective audit of the newly combined enterprise.

5.45 Thus, these members question how the public interest is served if auditors are expected to identify problems but have to decline if asked to help solve them. A client should not have to make continual choices about whether it wants a firm solely as its auditors or solely as a provider of other services, and a client should not have to dismiss a firm as its auditors to obtain other necessary services from that firm. Also, these members fear that companies that most need to improve their controls may opt not to do so because of the potential added costs and efforts of identifying and using firms other than their auditors.

5.46 Those who support an exclusionary ban assert that an audit firm has divided loyalties when it provides non-audit services to audit clients because it serves "different clients" in doing so, that is, management in the case of non-audit services, and the board and shareholders in the case of audits. The Panel members opposing such a ban believe that it is incorrect to suggest that the interests of management must be at variance with those of the audit committee or shareholders, or that the interests of management must be inimical to good financial reporting. The company and shareholders are the primary beneficiaries of consulting services that "benefit management."

5.47 In addition to the public interest criterion, the POB believed that a ban could be justified only if no other measures were available. Since the time of the POB study, many additional measures have been instituted, including the establishment of the ISB, enhanced peer reviews, significant strengthening of the role and scope of audit committees, and the combined effects of Independence Standard No. 1 and the SEC's recent proxy statement disclosure requirements for audit committees (described more fully later in this Statement). These Panel members question the efficacy of proposing a whole new rule at the same time other rules to address the issue are being implemented. These rules have been publicly supported by the Chief Accountant of the SEC, who stated that they should "bring independence issues to audit committees' attention and stimulate their participation in identifying and resolving independence issues."²⁴

5.48 Clients voluntarily purchase these services. These Panel members believe that client management, boards and audit committees are in the best position to assess the terms and conditions of these voluntary contracts, which include independence considerations. They view any notions that audit committees have not made or cannot make reasoned judgments about independence matters as unfairly impugning the abilities and integrity of these committees.

5.49 Indeed, a ban might appear to make life simpler for those who would prefer not to accept

²⁴ Report on SEC auditor independence initiatives, Chief Accountant Lynn Turner, January 19, 2000, in a memorandum to SEC Chairman Levitt responding to correspondence from Congressman John D. Dingell.

what these Panel members see as a normal business responsibility. However, given the lack of identified independence impairments, making matters simpler for audit committees would hardly justify depriving clients of needed services. Thus, these Panel members see a proposed ban as potentially punitive to clients, shareholders and auditors. They believe that audit committees should be afforded an opportunity to do their job, and that the current audit committee and disclosure initiatives should be given a chance to work. They note also that, even if a ban were imposed, audit committees would still have to make judgments, albeit less frequently, regarding whether certain services were included in the scope of banned services.

5.50 Other factors supporting this view include:

- Audit firms increasingly need specialists (e.g., information technology and treasury) to provide critical audit support. The QPR results reinforced that access to these resources will only become more vital in the future. Attracting and retaining these resources, and motivating them to provide direct audit support, may well be hampered significantly if they were to be prohibited from providing non-audit services to public audit clients. Further, these professionals maintain and build their skills by providing non-audit services. Thus, another unintended consequence of a prohibition could be to reduce audit effectiveness.
- The ISB and the SEC recently have taken actions to bring independence matters to audit committees and stimulate their participation in identifying and resolving any potential independence issues.²⁵ These actions are consistent with the recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees. They should result in significant additional consideration being given to auditor independence, particularly since the SEC's rule requires audit committees to report on these activities in companies' proxy statements.
- There are demonstrated benefits of non-audit services both to audit effectiveness and to clients, as the POB pointed out in its study on scope of services, to cite one example.²⁶ As noted in this chapter under "Non-Audit Services – Panel Process," the QPR findings indicated that non-audit services had either a positive effect or no effect on audit effectiveness, but no negative effects.
- When timing of a project is critical and requires the rapid deployment of skilled personnel, a company should not be denied access to the services of its audit firm. This is particularly true when the company believes that the firm, because of its knowledge of the company, is best capable of providing the services and of doing so on a timely basis. This is a frequently occurring, very practical consideration that

²⁵ Independence Standard No. 1, *Independence Discussions with Audit Committees* (ISB, January 1999); *Audit Committee Disclosure* (SEC Release No. 34-42266), December 22, 1999. Also, in SECPS Practice Alert 99-1, *Guidance for Independence Discussions with Audit Committees*, the SECPS issued guidance designed to assist firms in evaluating and enhancing their policies and procedures for identifying and communicating to audit committees those judgmental matters that may reasonably be thought to bear on the auditor's independence.

²⁶ See note 7.

ought not be overlooked.

- Prior to the SEC's issuance of its auditor independence proposals in June 2000, the ISB had been actively considering the independence ramifications of certain specific non-audit services. These Panel members continue to believe that the ISB is the proper body to evaluate, with due process, the need for any proscriptions on these services.

5.51 Those with this view also point to the POB's having observed in its study on scope of services that there would be occasional trade-offs between avoidance of all conflicts and audit effectiveness:

Integrity is an element of character, and objectivity relates to the ability of an auditor to maintain impartiality of attitude and avoid conflicts of interest. All conflicts of interest are not avoidable and some conflicts of interest produce countervailing benefits. Such conflicts are accepted, consistent with the concept of independence, because of practical necessity and the realization of important benefits, coupled with the fact that auditor integrity and various legal incentives provide adequate public protection. This helps explain public acceptance of the fact that auditors can be "independent" even though the client selects them and pays their fee. It also helps explain why there has been public acceptance of accounting firms furnishing a variety of tax advisory services to audit clients. Recognizing, therefore, that independence in an absolute sense cannot be achieved, when evaluating whether certain services should be prohibited, it is necessary to consider the potential benefits derived from the service and balance them against the possible or apparent impairment to the auditor's objectivity.²⁷

5.52 Opposition to an exclusionary rule does not mean that, after careful study, debate and due process, the SEC or ISB should not proscribe certain types of services in some or all circumstances. Indeed, these Panel members believe that the ISB is the appropriate organization to review the independence ramifications of various specific non-audit services, with the full support of the SEC. However, the standard setter that deals with non-audit services should consider carefully the aforementioned arguments against an exclusionary ban, especially those concerning the potential effects on audit effectiveness and the public interest that could result from prohibiting the services, as well as the factors that follow regarding specialists who provide recurring audit support and audit personnel who provide other services.

Non-audit Services Provided by Specialists Who Also Provide Recurring Audit Support

5.53 These Panel members strongly believe that services that ordinarily are performed by specialists who also provide recurring audit support should not be prohibited. They urge the SEC or the ISB to consider the following:

- Non-audit services by *technology* specialists who also provide *recurring audit support* – Throughout its process the Panel has seen an ever-increasing need for

²⁷ See note 7.

technology skills. Auditors must have access to skills that are as current and sophisticated as the increasingly complex systems and processes they must audit. Technology specialists help the engagement team understand computerized systems and processes, evaluate and test controls, and devise and execute sophisticated computer-assisted audit techniques. Thus, the assessment of the potential benefits of proscribing any services provided by these technology specialists must be balanced against the potentially adverse effects on firms' abilities to use their expertise in support of critical audit support services and to attract and retain them.

- Non-audit services by *others* who also provide *recurring audit support* such as actuaries, treasury specialists and valuation specialists – Similar consideration should be given to evaluating the potential benefits and adverse effects of proscribing any non-audit services these specialists provide to public audit clients.

5.54 Audit firms believe that they cannot attract and retain those with specialty skills if they will be limited to providing audit support. These specialists generally are not CPAs and their primary professional interest is not auditing. They likely will not consider working for an audit firm if they are limited to working only on audits and cannot build their skills and gain job satisfaction by performing other services.

5.55 These Panel members believe, based on discussions with these specialists and others, that these specialists likely would resist audit support assignments if they were prohibited from providing other services to these clients. Further, if they are assigned to provide audit support on such restricted engagements, they would be less likely to demonstrate the same vigor and creativity that they would on an engagement where they could provide other services. This neither enhances audit effectiveness nor serves the public interest. Thus, one question to ask when considering a ban on specific non-audit services is: Do those who ordinarily provide the services also provide recurring audit support services?

Other Services Provided by Audit Personnel

5.56 In addition to asking specialists to provide non-audit services, clients may ask the members of the audit engagement team or other audit personnel of the firm to perform a wide variety of special projects. For example, a client may request that an auditor perform a due diligence review of a potential acquisition. The knowledge gained in such a project enhances the auditor's understanding of the target's business and systems, which is critical to planning and performing an effective audit. Also, audit personnel enhance their inventory of skills in these special projects, which broadens their business knowledge and audit capabilities.

5.57 Again, in evaluating other services that auditors typically perform, practical considerations are essential. The most effective audits will be performed by the most competent auditors. But attracting and retaining those people requires providing them with work that is interesting and intellectually challenging. The more their professional experiences expand their business acumen, the better auditors they become and the more likely they will be satisfied with their jobs.

Other Considerations

5.58 In arriving at this position, these Panel members are mindful that, in its study on scope of services,²⁸ the POB admonished the profession to exercise restraint and judgment before entering into new areas of service. These members believe that that advice continues to be appropriate and seems particularly timely as many of the major firms are about to undergo significant restructurings and have an opportunity to reemphasize their core audit services. One could argue that, despite the profession's enviable track record in having performed both audit and non-audit services, the current outcry over non-audit services would not be so shrill had the profession better heeded the POB's advice. These members urge the profession to give serious consideration to this advice.

5.59 Also, these members believe that the SEC's rule-making initiatives can be a constructive exercise to analyze the fundamental policy questions raised by Chairman Levitt. They expect a complete, fair and non-biased airing through means such as the comment process on the SEC's independence proposals released in June 2000 and related public hearings.²⁹ They believe that the SEC is capable of reaching a reasoned conclusion after gathering all the relevant evidence and hearing from all sides. However, these members urge the SEC to be wary of proposals whose principal thrust appears to be more punitive than practical and that have the real potential to damage audit effectiveness. They hope that, consistent with the concept of self-regulation under a strengthened POB, the SEC will exercise restraint in its rule-making authority by delegating to the ISB the determination of any services that audit firms may not provide to their audit clients.

²⁸ See note 7.

²⁹ *Revision of the Commission's Auditor Independence Requirements* (see note 13).

FORMER FIRM PERSONNEL IN CLIENT MANAGEMENT

Introduction

5.60 The partners and professional staff of an audit firm have always represented an attractive pool of potential employees for industry, clients and non-clients alike. In fact, most personnel who join audit firms eventually move to a job in industry. Industry views public accounting as a unique training ground because it offers a broad variety of industry and client experiences, as well as the development of specialty skills. Further, dealing directly with auditors gives clients the ability to assess the abilities of individuals far better than any process of interviewing prospective employees.

5.61 From the standpoint of the auditor, once he or she accepts a position in industry, it is likely to be at a higher level in the company than he or she would have attained at the same point in his or her career without the public accounting experience. One of the attractions of the profession has always been the opportunity it provides individuals for professional and financial success, either by remaining in the profession or by accepting an attractive offer outside the profession. In fact, AICPA members in business and industry outnumber those in public accounting.³⁰

5.62 There are concerns about threats to independence when clients hire firm personnel. For example, did the individuals exercise appropriate audit skepticism prior to departure? Would the departing auditor's knowledge of the audit allow him or her to circumvent it as a member of the client? Will the former auditor be able to exercise undue influence over the audit team? Further, there have been instances where the former engagement partner or manager joined the client in a high-level position and was alleged to have become involved subsequently in a fraud scheme.

5.63 The degree of concern depends primarily on the stature of the auditor in the firm, the former auditor's new position with the client, and whether the former auditor had been involved in the audit of the client. For example, a client's hiring the audit engagement partner to become its CFO would generate more concerns than the client's hiring a staff member (who is not assigned to the audit) onto its corporate staff.

5.64 AICPA Ethics Ruling No. 77 on Independence, Integrity and Objectivity, *Individual Considering or Accepting Employment With a Client*, requires that, while considering an employment offer from a client, an auditor remove himself or herself from the engagement. Also, the firm should consider whether any procedures performed by a former partner or staff should be reperformed or additional procedures performed. Several firms have policies and procedures to assist firm personnel in complying with this ruling, and to provide guidance on additional or reperformed procedures.

³⁰ Members in business and industry represented 46.2% of the AICPA's membership in 1999, up from 39.9% 10 years earlier. Members in public accounting were 39.5%, down from 45.8% in 1989 (AICPA, *1998-1999 Annual Report*). Moreover, only a fraction of those in public accounting participate in audits of public companies.

5.65 AICPA Ethics Interpretation 101-2, *Former Practitioners and Firm Independence*, describes the required severing of financial and other firm ties with a former partner in order for the firm to maintain its independence.

5.66 The Panel sought to assess the potential for threats to independence when clients hire former audit firm personnel. In the QPR, 16 engagements were selected in which a former partner or manager of the firm had accepted a position in client management³¹ within the past three years. The reviewers were asked to complete a supplemental questionnaire to evaluate any effects on independence. Also, survey respondents and participants in some focus groups were asked for their views on audit personnel taking jobs with clients.

Findings

5.67 In all but one of the 16 QPR engagements, the reviewers agreed that the engagement team and the firm had put appropriate safeguards into place or had taken appropriate steps to make sure the audits were effective. In one instance the reviewer believed that additional steps should have been considered, although the reviewer did not believe that the effectiveness of the audit had been impaired.

5.68 Focus group participants and respondents to the survey generally did not view this as an area of major concern. Several noted that a client's hiring audit personnel is a benefit to the client and very important to attracting good people to the profession. Some believed that safeguards are necessary and a few suggested a "cooling off" period after employment, during which contact with the former audit firm would be restricted.

5.69 In July 2000 the ISB issued Independence Standard No. 3, *Employment with Audit Clients*. The Panel observes that the ISB has captured the concerns and has described safeguards that firms should implement when their professionals consider joining or have joined audit clients. The standard also specifies the circumstances in which capital and retirement balances owed to the departing professional should be liquidated or settled to preserve the firm's independence.³² The Panel believes that the ISB has dealt with the issue appropriately.

5.70 Also, under "Communicating with Audit Committees" in Chapter 2, the Panel recommends that audit committees require that the auditor and management advise the committee of (a) plans to hire any of the audit firm's personnel into high-level positions, and (b) the actions, if any, the auditor and management intend to take to ensure that the auditor maintains independence.

³¹ Chairperson, CEO, CFO or Controller.

³² The SEC's June 2000 independence proposals (see note 13) also include similar steps that would have to be taken to disassociate an auditor from the firm to maintain independence. Under the proposal, the former auditor must not (a) influence the firm's operations or financial policies, (b) have a capital balance in the firm, or (c) have a financial arrangement with the firm, other than a fully funded, fixed-payment retirement account.

CHAPTER 6 – GOVERNANCE OF THE AUDITING PROFESSION

6.1 This chapter describes the auditing profession’s current governance system,¹ the limitations of that system and the Panel’s recommendations for strengthening it. The chapter also discusses briefly the current relationship between the profession and the SEC.

OVERVIEW OF CURRENT GOVERNANCE

6.2 Auditors are subject to a system of controls that, taken as a whole, constitutes the regulation of the profession. The principal elements of that regulation are the Securities and Exchange Commission (SEC), state boards of accountancy, the American Institute of Certified Public Accountants (AICPA), the SEC Practice Section (SECPS) of the AICPA, the Independence Standards Board (ISB) and the Public Oversight Board (POB) – a combination of public regulation and self-regulation.

Public Regulation

6.3 The state boards of accountancy and the SEC, with their statutory responsibilities to protect the public, both play important roles in regulating the profession.

6.4 The profession has significant interaction with the SEC through the Office of the Chief Accountant (OCA) and the Division of Corporation Finance. The OCA is the principal advisor to the Commission on accounting and auditing matters. It works closely with domestic and international private-sector accounting and auditing standard-setting bodies and consults with registrants, auditors and other SEC staff regarding the application of accounting standards and financial statement disclosure requirements. The Division of Corporation Finance oversees the disclosure of important information to the investing public and routinely reviews the disclosure documents filed by public companies with the SEC.

6.5 One of the powers and responsibilities delegated to the SEC is disciplining independent auditors of publicly held companies, among others. The Division of Enforcement investigates possible violations of the securities laws and recommends SEC action when it deems appropriate, either in a federal court or before an administrative law judge, and negotiates settlements on behalf of the SEC. All such investigations are conducted privately. The SEC has exercised its disciplinary power over the years, using prosecutorial discretion in deciding which cases to pursue. In addition, the Panel understands from a presentation by the heads of the Division of Enforcement and the OCA that for a variety of reasons, including limited resources, the SEC ordinarily pursues cases against accountants only if alleged reckless conduct is involved. The number of enforcement actions varies from year to year, depending on the SEC’s allocation of

¹ See Appendix C for a more detailed description of the current governance system.

resources among the many competing demands for enforcement efforts and on the number of cases in which the SEC believes the accountants were reckless.

6.6 Although the profession enjoys a national image through the AICPA, CPA licenses are granted by the individual states (typically by the state board of accountancy), and the state boards are the only agencies that can revoke them.² States also register or license audit firms to practice within their jurisdictions.

Self-Regulation

6.7 A profession may be subject to varying degrees of self-regulation, for example, a statutory self-regulatory organization (SRO), like the National Association of Securities Dealers (NASD) or the New York Stock Exchange (NYSE), or a voluntary system of self-regulation, like the auditing profession. The auditing profession's self-regulatory system includes the bodies that set professional standards as well as those that monitor and discipline CPAs and audit firms. The profession's self-regulatory system supplements public regulation in some areas, for example, discipline, where it extends beyond the realm of the law and public regulation, while in other areas, such as standard setting, it largely takes the place of public regulation.

Standard Setting

6.8 Professional standards for auditors include technical, ethical and quality control standards as well as standards for continuing professional education.³ Those standards are set by the AICPA's Auditing Standards Board (ASB), the AICPA's Professional Ethics Executive Committee (PEEC) and the ISB. The ASB promulgates generally accepted auditing standards and quality control standards, while the PEEC is responsible for changes to and interpretations of the AICPA's Code of Professional Conduct. The ISB was established in 1997 by the SEC and AICPA to establish standards on auditor independence with respect to audits of public entities.⁴

Monitoring and Discipline

6.9 The audit firms and the AICPA and its components carry out practice monitoring and discipline.

6.10 Audit firms establish, maintain and enforce quality control policies and procedures that are

² The Uniform CPA Examination, which is prepared and graded by the AICPA and must be passed before a CPA license can be obtained in any state, is an important contributor to the national image.

³ Professional standards also include accounting standards that are promulgated by the Financial Accounting Standards Board (FASB), the Governmental Accounting Standards Board (GASB) and the Accounting Standards Executive Committee (AcSEC) of the AICPA. While this report includes recommendations to the FASB about accounting standards, it does not discuss or make recommendations related to the governance and structure of accounting standard-setting bodies.

⁴ Independence standards for all AICPA members are established by the PEEC. Auditors of public entities must meet independence standards established by the PEEC, the ISB, the SEC and their state society and board of accountancy. The PEEC will treat any pronouncement passed by the ISB as authoritative for audits of public entities unless and until the PEEC announces that it will not view that pronouncement as authoritative.

designed to provide each firm with reasonable assurance that it complies with professional standards, maintains its technical capabilities, applies the appropriate expertise on all audits and meets the SECPS membership requirements. Effective self-regulation by individual audit firms is an essential part of the profession's overall self-regulatory system.

6.11 The AICPA bodies involved in the monitoring and disciplining of auditors include the Professional Ethics Division, the Joint Trial Board and the SECPS. The Professional Ethics Division and the Joint Trial Board enforce technical and ethical standards by investigating and adjudicating disciplinary charges against auditors. Unlike the SEC and state boards of accountancy, the Professional Ethics Division and the Joint Trial Board do not have subpoena power, their disciplinary authority extends only to a CPA's membership rights in the AICPA or a state society of CPAs, and their disciplinary proceedings are deferred while litigation or regulatory proceedings are in process.

6.12 The SECPS was created to improve the quality of audit firms' practice before the SEC by establishing requirements for member firms and a program for monitoring compliance with those requirements and professional standards. SECPS members must undergo peer reviews of their accounting and auditing practice every three years, or at such additional times as determined by the SECPS Executive Committee, which governs the SECPS's activities. The SECPS Peer Review Committee (PRC) establishes the *Standards for Performing and Reporting on Peer Reviews*, oversees the SECPS peer review program, accepts peer review reports and determines the appropriateness of firms' actions in response to those reports. The peer review process is overseen by the POB. In addition, certain peer review working papers and the related reports (masked to protect the confidentiality of individual registrants) are made available for review and oversight by the staff of the SEC's OCA.

6.13 The Quality Control Inquiry Committee (QCIC) of the SECPS conducts an investigation when allegations of an audit failure are made against a member firm with respect to an audit of an SEC registrant. The purpose of the investigation is to determine whether there are deficiencies in the firm's system of quality control, in its compliance with that system or in professional standards. QCIC also serves a disciplinary function in that it may require remedial action if it finds deficiencies in a firm's system or in the firm's compliance with it. Member firms are required to report to QCIC, within 30 days of being served, all matters of alleged audit failures arising from litigation, regulatory investigations and criminal indictments. The QCIC process begins almost immediately after a matter is reported; it is not deferred while legal or regulatory proceedings are in process. The QCIC process is overseen by the POB as well as by the SEC. The POB participates in all aspects of QCIC's analysis, investigation and closing of each matter, while the SEC reviews QCIC's closed case summaries and the POB's oversight files.

6.14 The POB oversees and reports on the activities of the SECPS. Its objective is to safeguard, and act as an advocate of, the public interest. The POB consists of five members, primarily non-accountants, with a broad spectrum of business, professional, regulatory and legislative experience. Besides overseeing the peer review and QCIC processes, the POB may commission special reviews by *ad hoc* bodies created to investigate and report on issues involving

the quality of practice. Examples of special reviews include reports by the Advisory Panel on Auditor Independence⁵ and the Panel on Audit Effectiveness.

Limitations of the Current Governance System

6.15 While the auditing profession's system of voluntary self-regulation is extensive, it suffers from certain limitations, some of which are inherent in any voluntary system. Those limitations, which are discussed in this chapter, include:

- Lack of sufficient public representation on the various self-regulatory bodies
- Lack of unified leadership of the various self-regulatory bodies
- Constraints on effective communications with the SEC and among the various entities in the current system
- Differing interests and divergent views of the AICPA's priorities on the part of its diverse members
- A disciplinary system that is perceived to be slow and ineffective

6.16 As SEC Chairman Arthur Levitt asked in his remarks to the Panel at its public hearings, "...has the accounting profession become so big and complex that perhaps we need a full-time SRO? Are the alphabet of regulatory bodies, the POB, the AICPA's PEEC, the SECPS, the ASB and the ISB, really workable?"

6.17 These limitations have resulted in a less effective governance structure and erosion of confidence in the independent auditor. The Panel's recommendations are intended to strengthen the profession's voluntary self-regulatory system by minimizing the limitations while enabling the public and the profession to benefit from the strengths of a voluntary system.

PROPOSED SYSTEM OF GOVERNANCE

6.18 The Panel believes that many of the limitations of the current self-regulatory system can be mitigated by building on the POB's experience and reputation and giving it increased authority. The recommendations in this chapter are designed to provide for a strengthened, unifying oversight body to help ensure that the governance system works more effectively and that the public is the system's primary beneficiary.

⁵ *Strengthening the Professionalism of the Independent Auditor*, Report to the Public Oversight Board of the SEC Practice Section, September 1994.

6.19 To be effective, the profession's self-regulatory system should include establishing professional standards, monitoring and measuring performance, ensuring accountability for improper acts and substandard performance through an effective disciplinary system, and identifying and addressing emerging issues and changes in the environment and the profession on a timely basis. In the Panel's proposed self-regulatory system, as in the existing system, the Auditing Standards Board, the Independence Standards Board and the Professional Ethics Executive Committee will perform the standard-setting function; the SECPS Peer Review Committee will perform the monitoring function; the Quality Control Inquiry Committee, the Professional Ethics Executive Committee and the Joint Trial Board will perform the disciplinary function; and the aforementioned bodies and special review panels convened by the POB and others will address major emerging issues and changes in the environment and the profession.

6.20 To command the public's respect, the POB, which will oversee the system, should:

- Have a majority of public members whose primary responsibility is to serve the public
- Maintain independence from both the profession and regulatory authorities
- Develop an environment of mutual respect and confidence with regulatory authorities
- Report periodically to the public regarding its activities

6.21 During its 23-year history, the POB has been a clear voice for enhancing quality in auditing and financial reporting, strengthening the professionalism of the independent auditor and safeguarding the public. The Panel believes that the POB should continue in that capacity, but with an expanded oversight and leadership role in a more unified governance system. To do so, the POB will need a charter, now being developed, that commits the firms, SECPS, AICPA and SEC to the POB's expanded role and to the new system of self-regulation.

6.22 For the POB to succeed in this new expanded role, the present system of governance needs to be revised. The revised system is described in the following recommendations and depicted in the chart following paragraph 6.36.

Recommendations

To the Public Oversight Board, the AICPA, the SEC Practice Section and the SEC:

6.23 The Panel recommends that the auditing profession's system of governance be unified under a strengthened, independent POB that oversees the profession's activities with respect to standard setting, monitoring, discipline and special reviews. Accordingly, the POB should oversee the ASB, the ISB, the SECPS Executive Committee, QCIC, the SECPS Peer Review Committee, the Professional Issues Task Force (PITF), the SEC Regulations Committee and the standard-setting activities of the PEEC that relate to audits of public companies. The POB should serve as the oversight body to whom the SEC, the state boards of accountancy, the auditing profession

and the public should look for leadership. This leadership position is intended to enhance communications among the profession's self-regulatory bodies in order to facilitate the profession's continuous improvement efforts and identify and resolve important issues on a timely basis.

6.24 The Panel recommends that the POB, AICPA, SECPS and SEC work together to create and implement a formal charter for the POB that would include the responsibilities and powers enumerated in this report. The POB, AICPA, SECPS, SEC and major firms should agree to the charter and cooperate in facilitating its implementation.

6.25 The Panel believes the charter should cover the following matters:

- ***The POB's sole authority to determine its budget and financial and other resources, and the profession's obligation to provide those resources.*** The Panel strongly believes that such "no-strings-attached funding" is absolutely essential if the POB is to be effective and independent of the profession and if the profession's self-regulatory system is to be viable. The profession must not be able to control or cut off the POB's financial resources and thereby cause irreparable harm to the profession's self-regulatory system by destroying the POB's independence and others' confidence in it. The POB's annual statement of expenditures should be audited and included in the POB's Annual Report to evidence its financial accountability.
- ***The POB's authority to oversee the activities of the ASB, the ISB, the SECPS Executive Committee, QCIC, the SECPS Peer Review Committee, the PITF, the SEC Regulations Committee and the standard-setting activities of the PEEC that relate to audits of public companies.*** The POB should approve all appointments to the ASB, SECPS Executive Committee and ISB's Independence Issues Committee (IIC), as well as the ISB members who represent the public accounting profession. Annually the POB should evaluate whether the resources that the AICPA and the SECPS provide to the ASB and the SECPS are sufficient for those bodies to meet their mandates. In addition, the POB should oversee the AICPA's evaluation, compensation, hiring and promotion decisions with respect to its employees who constitute the ASB and SECPS staffs.
- ***Term limits for POB members.*** POB members should be limited to two five-year terms, with staggered terms to ensure continuity.
- ***A nominating committee responsible for identifying and nominating new POB members.*** The nominating committee should be appointed by the POB from names suggested by public and private institutions that are most concerned with the quality of audits and financial reporting.
- ***An advisory council to advise the POB on issues related to projects on its agenda, new agenda items, project priorities and related matters.*** The POB should appoint the council members, whose service should be limited to two three-year terms. The

council should comprise nine to fifteen people selected from the constituencies that are concerned with audit quality and financial reporting matters, thus ensuring the broadest spectrum of participants in the self-regulation of the auditing profession. Council members should serve on a voluntary, part-time basis and be available to meet with the POB at regularly scheduled intervals (e.g., two to four times a year).

- ***A coordinating task force of the chairs of each body within the POB's oversight.*** This task force would be responsible for sharing information related to each body's activities. It should meet periodically (e.g., two to four times a year) to ensure effective communications among the bodies subject to POB oversight. For example, the task force would provide a formal means for QCIC and the PRC to communicate to the ASB, ISB and PEEC their findings and the resulting implications for changes in standards.
- ***The POB's authority to commission special reviews related to significant professional matters that affect the public's confidence in the profession.*** One such matter is the perceived lack of candid and timely public reporting of why and how highly publicized audit failures and frauds occurred, together with an analysis of the effectiveness of generally accepted auditing standards in such circumstances and the actions that have been taken or will be taken to ensure that such problems do not recur.

6.26 The Panel recommends that the POB, SEC, AICPA, SECPS and major firms promptly agree to a charter for the POB. The Panel understands that there are two matters in the August 22, 2000, draft charter that are still under negotiation: (1) the POB's role in the appointment of the chairs of the ASB and the SECPS Executive Committee, and (2) the procedures for amending the charter. Upon the successful conclusion of these negotiations, the Panel believes the charter will result in a major step forward in the governance of the profession. The draft charter includes a provision for the POB to conduct an annual "outreach" meeting with representatives from the constituencies that are concerned with audit quality and financial reporting matters. While this may alleviate the need for a nominating committee and advisory council, the Panel recommends that this issue be addressed in three years as part of the POB's review of the effectiveness of the self-regulatory oversight process as contemplated in the draft charter.

To the Public Oversight Board and the SEC:

6.27 The Panel recommends that the POB and SEC acknowledge the need to maintain a continuing dialogue that will foster a cooperative relationship, protect and enhance mutual respect and confidence, and increase the public's respect for the profession and its role in the capital markets.

To the Public Oversight Board and State Boards of Accountancy:

6.28 The Panel recommends that the POB and state boards of accountancy, perhaps through the National Association of State Boards of Accountancy, determine how best to facilitate meaningful continuing dialogue between the POB and state boards.

To the Public Oversight Board:

6.29 The Panel recommends that the POB:

- Enhance its resources, including augmenting its staff with additional qualified technical professionals, in order to implement the POB's expanded oversight role. Among other matters, the augmented staff would assist the POB in overseeing the peer reviews of the largest firms. The POB should identify such professionals as soon as possible.
- Review its charter periodically to ensure its continuing adequacy in the light of changing circumstances and, if appropriate, work with the AICPA, SECPS and SEC to amend it
- Review periodically the effectiveness of the ASB, the ISB, the SECPS and other groups that it oversees and include its findings and conclusions in its Annual Report
- Summarize in its Annual Report the status of all AICPA Ethics Division investigations of audits of SEC registrants when the civil litigation and public regulatory investigations have been concluded (see the fourth recommendation to the AICPA below)
- Increase its public communications to expand the public's awareness of the POB, its activities and its value to the capital markets

To the Public Oversight Board and the SEC Practice Section:

6.30 The Panel recommends that the SECPS and POB staffs compile data from their oversight of peer reviews and QCIC investigations that will enhance the diagnostic value of the peer review and QCIC findings to standard setters and audit firms. The data should be communicated to the profession and, when appropriate, to the public in the POB's Annual Report. The data might include the following:

- Disciplinary measures taken by member firms resulting from substandard performance
- The audit firms' fraud risk assessments and related responses, if any, on audits where fraud is subsequently discovered
- Data related to emerging issues that identify needed modifications to professional

standards or best practices guidance

- Data on non-audit services provided to the audit clients encompassed by peer reviews and QCIC investigations

To the AICPA:

6.31 The Panel recommends that:

- The constituencies (both practitioners and non-practitioners) represented on the ASB remain unchanged; however, at least a majority of the members should be from CPA firms that provide attest services to SEC clients
- The AICPA provide the resources necessary for the ASB to meet its mandates
- The AICPA provide the resources necessary for the SECPS to meet its staffing needs, including providing QCIC with the resources needed to enable it to act quickly in investigating alleged audit failures and thereby preserve the candid dialogue with SECPS member firms that presently adds to the effectiveness of the QCIC process
- The Ethics Division take all necessary actions to ensure timely processing of investigations involving audits of SEC registrants when the civil litigation and public regulatory investigations have been concluded. The Ethics Division should establish reasonable time frames for these matters and report the status of all such matters to the POB semiannually.
- The ASB, SECPS and PEEC staffs remain employees of the AICPA

To the SEC Practice Section:

6.32 The Panel recommends that:

- The SECPS Executive Committee retain its responsibility for approving members of the PRC, the QCIC, the SEC Regulations Committee and the PITF
- The preceding four groups continue to report to the Executive Committee
- The SECPS continue to fund the ISB

To the SECPS Quality Control Inquiry Committee:

6.33 The Panel recommends that QCIC establish a panel of industry specialists and experts whose members would be drawn from the practicing profession and industry and who would be available to QCIC members and the POB and SECPS staffs for consultation on various matters, such as industry issues and the application of accounting standards.

To Member Firms of the SECPS Represented on the SECPS Executive Committee:

6.34 The Panel recommends that each member firm ensure that its representative on the SECPS Executive Committee has sufficient authority and responsibility to commit the firm to the protection of the public interest when this conflicts with a more favorable business position, and ensure that the public interest remains the paramount objective in the representative's decision making and voting.

To the Independence Standards Board:

6.35 The Panel recommends that:

- The ISB reconstitute its membership to include four members representing the public and three members representing the public accounting profession (currently the membership is four and four)
- The public members retain responsibility for the selection of their replacements, with the POB being consulted on the selections
- Two of the members representing the public accounting profession be selected by the SECPS Executive Committee from member firms, with the third member continuing to be the AICPA president or his or her designee
- The ISB retain sole authority to determine its budget and other resources
- The ISB retain its staff and the responsibility for their hiring, supervision and compensation

To the SEC:

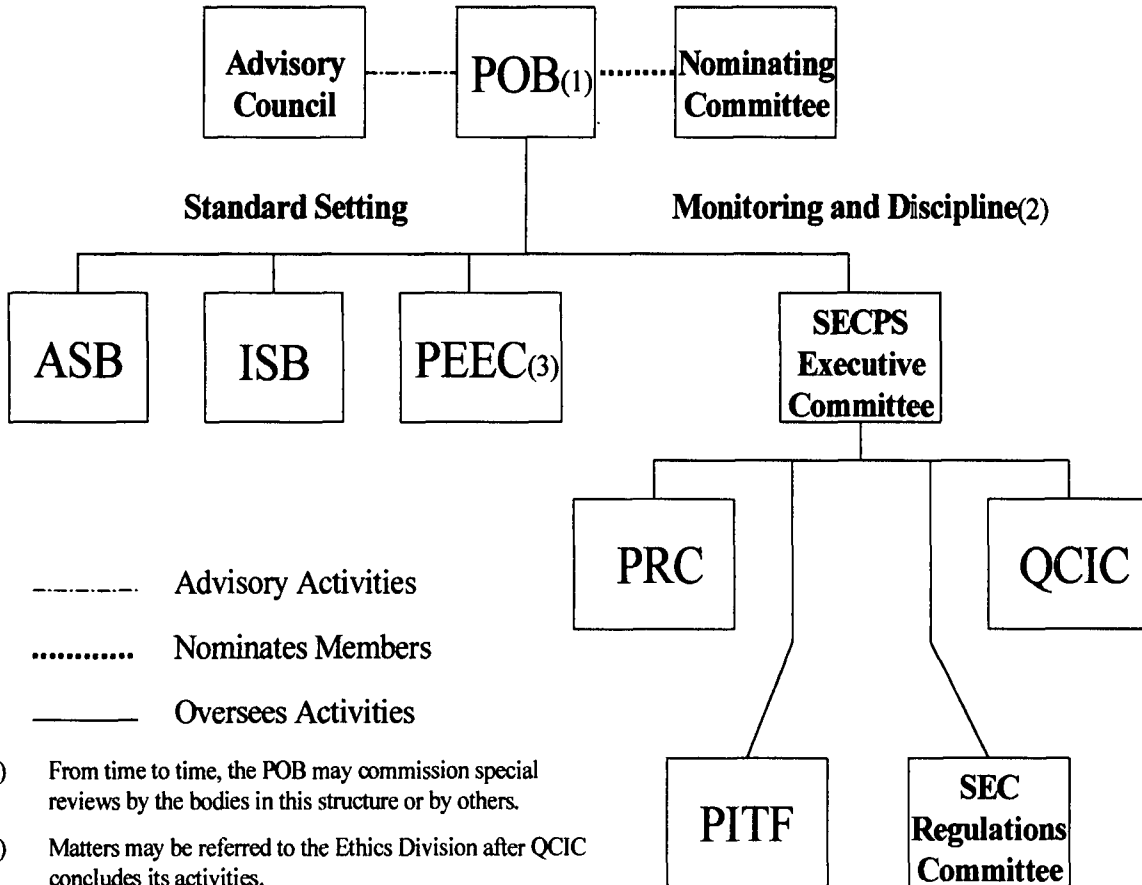
6.36 The Panel recommends that the SEC, as the statutory overseer of the quality of audits of SEC registrants:

- Encourage and support the ISB in carrying out its mission, recognizing that the SEC retains ultimate authority over auditor independence with respect to SEC registrants
- Support the IIC and work with the ISB to clarify the IIC's role
- Assist in implementing the POB's activities contemplated by the charter
- Support the POB's authority as enumerated in its charter to enable the POB to serve as an independent, effective, unifying leader of the profession's voluntary self-regulatory process

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PROPOSED GOVERNANCE STRUCTURE

SEC



----- Advisory Activities

..... Nominates Members

———— Oversees Activities

- (1) From time to time, the POB may commission special reviews by the bodies in this structure or by others.
- (2) Matters may be referred to the Ethics Division after QCIC concludes its activities.
- (3) Standard-setting activities that relate to audits of public companies

ENHANCING PEER REVIEWS

6.37 From the inception of the SECPS, its peer review program has been the cornerstone of its self-regulatory activities. During its formative and developing years, the SECPS enjoyed success and public respect, due in no small part to the effectiveness of its peer review program. Its structure and operating rules evolved as experience was gained in implementing previously untried concepts and procedures. No program can maintain its vitality and relevance, however, without identifying, addressing and resolving challenges that are certain to arise.

6.38 To its credit, the SECPS generally has addressed and met those challenges. Its Executive Committee formed a Peer Review Process Task Force (the Task Force) in March 1999 to determine ways of improving the effectiveness of peer reviews conducted under the SECPS peer review program. A Panel staff member participated in the deliberations of the Task Force, which issued its report in January 2000.⁶ The Panel acknowledges the efforts and contributions of the Task Force. The objective of continuous improvement should be a major driver of the peer review process. For this reason, the SECPS periodically should consider reconvening the Task Force.

6.39 Many of the Task Force's recommendations resulted from experiences gained during the Quasi Peer Reviews. The Task Force's principal recommendations are:

- Provide for differences between the reviews of the largest firms and other firms, in recognition of the greater public interest in the largest firms' audit practices
- Perform some portion of the review of the largest firms each year and furnish an annual report to the PRC and the POB. (A triennial report would continue to be available to the public.)
- Integrate the reviews more thoroughly with the firms' internal inspection programs
- Place more emphasis on important issues that currently are facing the profession, the industry and the entity whose audit is being reviewed
- Put more emphasis on the qualitative aspects of the functional areas (elements of quality control) and engagements reviewed, and less on the routine, objective compliance aspects
- Conduct focus groups of seniors and managers within the offices reviewed and increase the emphasis on interviewing members of the engagement teams whose audits are being reviewed
- Expand the peer review report to provide more information about the scope and results of the review performed

⁶ The Task Force's report is included in Exhibit 4.

- Use the peer reviews to identify best practices and matters for the attention of standard setters regarding important issues facing the profession, and then disseminate this information
- Enhance the training and quality of team captains and reviewers by establishing a standing task force that would oversee the peer review training programs
- Enhance the evaluation of peer review team captains by establishing a formalized system of evaluations
- Increase the frequency with which peer review guidance materials (checklists, etc.) are revised so they address important new issues as soon as the issues are identified, and provide easier access to these materials via the Internet

Recommendations

To the SEC Practice Section:

6.40 The Panel recommends that the SECPS substantially improve the peer review process by implementing all of the Task Force’s recommendations and the following additional recommendations. Implementing the recommendations will require changes to the SECPS *Standards for Performing and Reporting on Peer Reviews*. The SECPS should:

- Make clear to peer review team captains and reviewers that the POB, not the firm being reviewed, is the primary client. Peer reviews are performed to enhance the public’s confidence in independent auditors; the POB, as the public’s representative, should be viewed as the principal stakeholder in this process.
- Emphasize the types of issues described in this report that affect audit quality, including the more judgmental and less objective issues, such as the “tone at the top.” As noted elsewhere in this report, continuous quality improvement stems from a culture that is created and nurtured by senior management. While cultural and environmental matters are difficult to measure, their presence is evident and will affect the effectiveness of a firm’s audits and quality control system.
- Require additional qualitative evaluations of the information obtained during peer reviews. For example, with respect to the selected engagements, the reviews should include assessing whether management’s representations and responses to inquiries were adequately corroborated. In addition, the reviews should include assessing the adequacy of the training materials distributed and available to all professionals.
- Include in a peer review the business aspects of the reviewed firm’s practice that are closely related to the firm’s professional practice

- Increase the emphasis on which professionals perform various aspects of the audit, including who makes the risk assessments, and whether they have the necessary knowledge and skills. Other areas that should be emphasized include:
 - Engagement risk assessment (client acceptance and continuance)
 - Knowledge and understanding of the client’s industry and business
 - Inherent risk assessment
 - Control risk assessment
 - Linkage of risk assessments to tests of controls and substantive audit procedures
 - Sufficiency and competency of evidence obtained
 - Appropriateness and effectiveness of analytical procedures
 - Timeliness of the risk assessments, resolution of issues, supervisory reviews and other work

- Develop specific performance measures, to be included in the peer review report, that relate to the quality of the firm’s practice/effectiveness of audits. (See the Panel’s recommendations to audit firms in the section “Personnel Management” in Chapter 4.)

- Require a review of the peer-reviewed firm’s (the firm) review of selected financial reports/filings of foreign registrants that are audited by the firm’s foreign-associated firms and for which the firm reviews the filings in accordance with the membership requirements of the SECPS. The peer review should include interviewing the “filing reviewers.”

To the Public Oversight Board:

6.41 The Panel recommends that the POB, by using its augmented staff (see paragraph 6.29), expand its oversight throughout the peer reviews of the largest firms on a “real-time” basis. The expanded role should include, at a minimum:

- Reviewing the qualifications of the peer review firm and the review team captain
- Attending important meetings, focus groups and interviews with firm personnel
- Reviewing the draft peer review reports before they are provided to others
- Overseeing the following:
 - The planning of the review
 - The review of the internal inspection program
 - The practice office and National office reviews
 - The debriefing of engagement reviewers at the conclusion of the reviews
 - The resolution of issues that arise during the reviews

To the SEC Practice Section and the Auditing Standards Board:

6.42 The Panel recommends that the ASB, in collaboration with the Peer Review Committee and QCIC, review the quality control standards and make them more specific and definitive for firms with public clients, especially for the largest firms. The Panel also recommends that the three groups establish a mechanism for ongoing monitoring of the standards to keep them current. (See the Panel’s recommendations to the ASB on *Auditing Standards and Quality Control Standards Generally* in the section in Chapter 2 on “Establishing Auditing Standards.”)

To the SEC:

6.43 The Panel recommends that the SEC mandate that all firms that audit SEC registrants be enrolled in a peer review or similar monitoring program that includes public oversight. With respect to foreign-based audit firms, the requirement should extend to the peer review or similar monitoring programs or processes in their foreign locations. (See the Panel’s recommendations to the International Federation of Accountants on *Quality Assurance over Auditing* in Chapter 7.)

ENHANCING THE DISCIPLINARY PROCESS

Current Disciplinary System

6.44 Self-regulation includes identifying violations of professional standards, establishing appropriate consequences for those violations, and enforcing the standards through disciplinary measures in a fair, consistent and timely manner. The profession’s current system for investigating violations and disciplining the violators includes two vehicles: the AICPA’s Ethics Division (with respect to allegations of improprieties against individual members)⁷ and QCIC (with respect to allegations of improprieties against member firms related to audits of SEC clients). While the profession’s current disciplinary system is not totally satisfactory, the profession has made a significant effort to make it as workable as practicable given its inherent limitations.

6.45 Typically, the profession’s disciplinary process involving audits of SEC clients begins after the filing of civil litigation or the public issuance of findings by a public regulatory body (e.g., an Accounting and Auditing Enforcement Release [AAER] issued by the SEC). Civil litigation generally names the firm as a defendant, while an AAER may name one or more individuals or the firm. Upon learning of these events, QCIC and the Ethics Division open their respective case files.⁸ In accordance with a Memorandum of Understanding between QCIC and the Ethics Division, the Ethics Division defers its activities until QCIC has concluded its investigation and reported its findings to the Ethics Division.

⁷ The Ethics Division is responsible for investigating allegations against all AICPA members; however, the Panel’s focus is on allegations that involve audits of SEC clients.

⁸ A SECPS member firm must report such events to QCIC within 30 days of being served with the original complaint or the publication of findings.

6.46 The QCIC investigation focuses primarily on the effectiveness of the member firm's system of quality control and whether the audit engagement team complied with the system. The QCIC investigation generally results in a determination of whether the allegations concerning substandard performance *might* have merit. This determination is reflected in QCIC's ratings and recommendations.

6.47 QCIC assigns a rating of 1 to 4 to each concluded case.⁹ The Ethics Division has agreed to close its case file on those cases rated a 1 or 2. For those cases rated a 3, the Ethics Division forms a panel to review the QCIC files and case summaries to determine whether it should commence an investigation or close its file. With respect to those cases rated a 4, the Ethics Division will commence an investigation.

6.48 Ethics Division investigations and findings are not privileged and are subject to subpoena. Therefore, as a matter of fairness, the Ethics Division historically has granted individual members the right to request a deferral of an ethics investigation while civil litigation or a criminal investigation related to the subject matter is in process. As a voluntary membership organization, the AICPA believes its members would be unwilling to participate in an investigation while civil litigation or a criminal prosecution is in process. QCIC's files also are subject to subpoena.¹⁰

6.49 The most powerful disciplinary measure available to the Ethics Division is the authority to expel an individual member from the AICPA and to publish this action (which includes the individual's name, city and state, and violations of the Code of Professional Conduct) in *The CPA Letter*, an AICPA publication for its members. Public regulatory bodies that have more drastic disciplinary powers (e.g., the SEC and state boards of accountancy) monitor these notices.

Discussion

6.50 State boards of accountancy can revoke a practitioner's or a firm's license. Because of limited budgets and the lack of effective means to investigate allegations and impose discipline, some boards have not been effective in disciplining substandard conduct. Similarly, competing demands on the SEC's resources and its own prosecutorial priorities limit its enforcement activities.

6.51 The profession's disciplinary system also suffers from a number of limitations. The Ethics Division has limited investigative powers; it cannot issue subpoenas or compel testimony; it must rely on the cooperation of the individual being investigated; and it cannot talk to the plaintiff or the client company involved. As previously noted, its proceedings are not timely since, as a matter of fairness to the accused, all litigation must be concluded before an investigation can begin. The Division's disciplinary proceedings are confidential, and thus the public cannot determine what went wrong when a sanction is imposed, and in some cases whether a sanction was imposed.

⁹ See Appendix C for a detailed description of the QCIC process, including the rating system.

¹⁰ One federal district court recently upheld a plaintiff's subpoena of a QCIC case file (*In the Matter of Mercury Finance Company of Illinois*, No. M8-85, S.D.N.Y. Dec. 21, 1999), while another federal district court refused to order production of QCIC materials (*In re Health Management, Inc.*, CV 96-0889, slip op. [E.D.N.Y. Sept. 25, 1999]).

Finally, the Division is able to impose only limited sanctions, such as suspension or expulsion from the AICPA. The QCIC process suffers from many of the same limitations, although generally its investigations are quite timely. The corrective actions it imposes on firms are not made public.

6.52 The preceding limitations, especially the Ethics Division's deferral, help to create public frustration with the current system. They create a belief that the profession is not dealing with audit failures on a timely basis, since the judicial and public regulatory processes may, and often do, encompass many years. Thus, ethics investigations typically commence and conclude long after the public's memory of the matter has faded. The SEC staff recently has expressed concerns regarding these delays and their effects on the public's confidence in, and respect for, the profession's self-regulatory system.

6.53 Market discipline may be as effective or more effective than more formal disciplinary processes in dealing with substandard auditing. For example, reputation-damaging publicity surrounding civil litigation, together with the potential for significant monetary damage awards, provides a powerful deterrent to substandard performance. Thus, enlightened self-interest has led firms to emphasize the importance of quality control and to discipline professionals who depart significantly from firm and professional standards. Firm-imposed disciplinary measures typically are not deferred while civil litigation is in process, nor are they made public.

6.54 The Panel has concluded that the profession's self-regulatory system needs protection through the right of privilege over its disciplinary activities if it is to resolve disciplinary matters on a timely basis – protection that is obtainable only through legislation. The Panel would support such legislation if it would ensure more timely resolution of alleged audit failures. There is no assurance, however, that such legislation is attainable now or in the foreseeable future.¹¹

Recommendations

6.55 The Panel believes the profession's current disciplinary process can be improved to provide greater protection to the public without legislation and without any diminution of the current fair treatment of firms and individuals. These improvements would require changes in the SECPS membership requirements and in the QCIC process. The Panel's recommendations to strengthen the profession's disciplinary process, many of which are based on the efforts of a joint AICPA/Big 5 firms task force, follow.

To audit firms, the SEC Practice Section, the AICPA and the Public Oversight Board:

6.56 The Panel recommends the following procedures when civil litigation or a criminal or public regulatory investigation contains allegations of an audit failure:

1. Firms should continue to report cases in accordance with QCIC's current requirement, but the AICPA should devote more resources to QCIC to speed up

¹¹ In 1995 the accounting profession supported federal legislation (Senate Bill 240) that would have established a Public Auditing Self-Disciplinary Board with certain protections against civil discovery of certain investigatory materials by third parties. The proposed legislation was not enacted.

the process.

2. A firm should, as soon as reasonably possible after the commencement of the litigation against the firm, conduct an internal review of the subject engagement to evaluate the performance of the senior engagement personnel. In addition, in its meeting with the QCIC committee member and staff and the POB staff, the firm would respond to a standard question regarding whether the firm had conducted such a review. A person who is knowledgeable, or one who has become knowledgeable, about the circumstances of the engagement should be present at the meeting to discuss the engagement.
3. QCIC should conduct its usual inquiries. If QCIC assigns a 3 rating and there is a subsequent Ethics Division investigation, or assigns a 4 rating, the Ethics Division would open a case file.¹² The Ethics Division would then inform the firm that its consideration of the matter was being deferred in accordance with the Ethics Division's policy, pending the termination/completion of the litigation or public regulatory investigation, or the end of the threat of litigation.
4. Upon notification by the Ethics Division regarding its deferral, and in order to protect the public, the firm would select one of the following three options, if it had not already done so, to apply to the engagement partner¹³ during the period of the deferral, if the partner was still with the firm:
 - A. Terminate or retire the partner
 - B. Remove the partner from all public company audit engagements until the Ethics Division's process is completed
 - C. Perform an additional second partner review of all public company audit engagements completed by the partner in the 12 months prior to the deferral. The firm would report the results of such review to both QCIC and the POB.

Subject the partner to additional oversight on all public company audit engagements for at least one year by requiring that the concurring partner review be performed by an experienced senior technical partner appointed by the firm's managing partner/CEO. In addition to the required concurring

¹² See Appendix C for a description of the QCIC rating system.

¹³ There may be instances in which these options should apply to other members of the engagement team in addition to, or instead of, the engagement partner.

partner review procedures,¹⁴ this review must include, at a minimum, timely involvement in:

- Significant planning activities
- Determination of risk assessments and the design of tests of controls and substantive audit procedures

Thereafter subject the partner to those additional oversight procedures that the firm's managing partner/CEO determines are necessary to protect the public, based on the firm's evaluation of the partner's performance

5. The processes implemented by SECPS member firms when they choose Option C should be subject to peer review and oversight by the POB. At least one engagement to which Option C is being applied should be a mandatory selection in the firm's peer review and annual inspection program. If the POB disagrees with a member firm's selection or method of applying Option C, it should promptly make its views known to the firm, SECPS committee representatives and the SEC through its normal communication channels, and to the public through its Annual Report and other publications.
6. The POB should report on these activities in its Annual Report on an aggregate, no-name basis, including matters that are concluded through the retirement of the partner, Ethics Division decisions or settlement of litigation.
7. SECPS member firms should apply one of the foregoing options to a professional that joins a member firm while subject to one of the options at his or her former firm.
8. If the Ethics Division becomes aware of a matter (e.g., through a complaint letter or newspaper report) involving the financial reporting of an SEC registrant in which the SECPS member firm has not been made a party, and the Division otherwise would open an investigation, it instead should refer the matter to QCIC for further action, and the firm should be notified of such referral.

¹⁴ The SECPS membership requirements provide that the concurring partner's responsibility is fulfilled by performing the following procedures:

- Discussing significant accounting, auditing and financial reporting matters with the audit engagement partner;
- Discussing the audit engagement team's identification and audit of high-risk transactions and account balances;
- Reviewing documentation of the resolution of significant accounting, auditing and financial reporting matters, including documentation of consultation with firm personnel or resources external to the firm's organization (such as standard setters, regulators, other accounting firms, the AICPA and state societies);
- Reviewing a summary of unadjusted audit differences;
- Reading the financial statements and auditors' report; and
- Confirming with the audit engagement partner that there are no significant unresolved matters.

9. QCIC frequently may not have sufficient information to proceed in connection with matters in which the firm has not been made a party. In such cases, QCIC should close the matter without prejudice, and the Ethics Division should not open a case on the matter. However, QCIC would retain the right to reopen the matter if it obtained additional information. If the matter ends without the firm having been made a party, it would remain closed. If the firm becomes a party at a later date, the QCIC reporting requirement should be reduced to 15 days for the matter.
10. Once an Ethics Division deferral is lifted, the Ethics Division should expedite its investigation of the matter. The AICPA should allocate additional resources to both QCIC and the Ethics Division to enable both bodies to perform their responsibilities promptly and effectively.

6.57 The Panel recommends that the POB and SECPS review the results of implementing these recommendations over a two- to three-year period to determine their effectiveness. If the POB determines that these recommendations have not satisfactorily protected the public, the Panel recommends that the POB, in cooperation with the SEC, then seek legislation to achieve the protections necessary to make the disciplinary process more effective.

To the Public Oversight Board:

6.58 The Panel recommends that the POB, concurrent with its oversight of the disciplinary process outlined above, leverage the knowledge it gains to determine whether changes in professional standards or further guidance is needed and communicate these findings to the appropriate standard setters or authoritative bodies.

To the SEC:

6.59 The Panel recommends that the SEC allocate additional resources to its enforcement activities directed at allegations of failed audits. The Panel recognizes that a finite budget imposes limitations on the SEC's ability to apply its investigative resources wherever needed. A larger budget allocation to enforcement efforts directed at allegations of failed audits would have salutary effects on the accounting profession, and reassure the investing public that the main "cop on the beat" recognizes the critical importance of audits and the deterrent effects of vigorous enforcement.

6.60 Because the Panel believes the study of the AAERs described in Appendix F was very useful and provided valuable information to supplement the evidence obtained from other activities, the Panel recommends that the SEC:

- Periodically, such as annually or biennially, undertake a similar study and disseminate the results
- Document information on the auditors' work in every enforcement investigation involving materially misstated financial statements, not just those in which the auditor

is named in an AAER. (In making this recommendation, the Panel recognizes that the SEC staff routinely examines the auditors' involvement in each case.) The SEC staff may wish to employ the Panel's questionnaire as a guide in identifying the types of information to be documented.¹⁵

THE RELATIONSHIP BETWEEN THE PROFESSION AND THE SEC

6.61 The federal securities laws require that the financial statements of public companies be audited by independent auditors. Congress gave the SEC the broad authority to establish accounting standards used by public companies as part of its mandate to administer and enforce the provisions of the federal securities laws. However, the SEC has relied principally on accounting standards established in the private sector, currently by the FASB. Similarly, the SEC has the statutory authority to modify or supplement auditing standards, but it has looked to the ASB as the principal source of auditing standards.

6.62 Since the enactment of the federal securities laws, the unique relationship between the profession as auditor and standard setter, on the one hand, and the SEC as regulator, on the other, has been one of the key features of the success of the American capital markets. The Panel believes that the relationship has helped engender extraordinary credibility in those markets and that continuing a healthy working relationship is critical to maintaining that credibility.

6.63 While one would expect occasional tensions, the current relationship between the profession and the SEC seems under unusual stress. The Panel views this situation as counterproductive to continued improvement in financial reporting – a shared goal of both the profession and the SEC.

6.64 As in any relationship under stress, each participant typically has contributed to the pressure points. Thus, there is undoubtedly merit to the concerns of each party. The Panel believes that this important relationship must be restored to its historic level of candor, trust and respect. A revitalized relationship can facilitate progress in improving audit effectiveness and can enable the participants to work in harmony for the public interest.

6.65 The Panel has recommended a strengthened POB as an effective oversight body to whom the SEC, the state boards of accountancy, the auditing profession and the public can look for leadership. The Panel believes that the POB can play an important role in ensuring a strong, healthy working relationship between the profession and the SEC.

¹⁵ The questionnaire was designed to gather the data discussed in Appendix F. The questionnaire has been provided to the SEC staff.

CHAPTER 7 – INTERNATIONAL

INTRODUCTION

7.1 The scope of the Panel’s project included seeking information on issues of audit effectiveness from a global perspective. Several speakers at its October 1999 public hearings and a number of respondents to the survey urged the Panel to consider the effects of globalization. The QPR assessed the work of U.S. engagement teams on audits on which significant auditing work was performed outside of the United States by foreign affiliates of the U.S. audit firm.¹ The Panel also addressed issues of global significance in a number of interviews and other settings. However, the Panel makes no claim of having made a comprehensive review of audit effectiveness on a global basis.

THE GLOBAL ENVIRONMENT

7.2 The business environment continues to reflect the extensive globalization of companies and the markets they serve. Increased cross-border access to the capital markets has helped fuel the international expansion of many businesses. Securities offerings that years ago would have been limited to a company’s home country now are routinely extended to multiple jurisdictions. The securities of many companies are traded on exchanges located throughout the world or on sophisticated trading networks that transcend national borders.

7.3 The number of foreign companies that have registered securities in the United States has almost tripled since 1990. In 1999, there were over 1,200 foreign companies from 57 countries reporting in the United States, 10% of which entered the U.S. markets in 1999.² In 1990, there were 434 such companies. (Foreign companies that file financial statements with the Securities and Exchange Commission [SEC] are referred to in this chapter as “foreign registrants.”) The securities of many U.S. companies registered with the SEC are traded outside of the United States, and the financial statements of those companies may be filed with non-U.S. regulators. The financial statements of many U.S. companies and foreign companies are available to investors or creditors in numerous countries, irrespective of the jurisdiction that regulates such companies.

INTERNATIONAL ORGANIZATION OF THE ACCOUNTING PROFESSION

7.4 The organization of the accounting profession on an international scale has many facets. Audit firms operate in diverse legal environments, as do their clients. The large audit firms portray themselves as global entities, but in reality their legal organizations vary by jurisdiction.

¹ See “Multi-location Audits” in Chapter 2.

² 1999 annual report of the Securities and Exchange Commission, *SEC Annual Report 99*, p. 76 (U.S. Government Printing Office).

Government regulation of the auditing profession also varies by jurisdiction, as do the profession's self-regulatory structures.

7.5 The standards that affect the profession differ from country to country. Some countries have highly developed standards or rules for accounting, auditing, independence and quality controls over audit firms' practices. Other countries, generally those that are less developed, have not promulgated their own standards.

7.6 There are a number of international organizations that play key roles in the international setting in which the accounting profession is involved. However, in this chapter only the following organizations are discussed:

- IFAC – the International Federation of Accountants. IFAC is an organization of 143 national and regional organizations representing the accountancy profession in 104 countries. The American Institute of Certified Public Accountants (AICPA) is a member of IFAC.
- IASC – the International Accounting Standards Committee. IASC issues international accounting standards.³ These accounting standards are analogous to U.S. generally accepted accounting principles (GAAP) promulgated by the Financial Accounting Standards Board (FASB).⁴
- IAPC – the International Auditing Practices Committee. IAPC establishes international auditing standards.⁵ These auditing standards are analogous to U.S. generally accepted auditing standards (GAAS) promulgated by the Auditing Standards Board (ASB).⁶
- IOSCO – the International Organization of Securities Commissions. This is a global organization of individual country securities regulators. The SEC is a member of IOSCO.
- IFAD – the International Forum for Accountancy Development. This is a group comprising the World Bank, IFAC, large accounting firms, the International Monetary Fund and regulators, among others. Its objectives are discussed later in this chapter.

THE GOAL OF TRANSPARENCY

7.7 Transparency simply means “openness.” It is a concept that calls for full and fair

³ These international accounting standards are referred to as “IASs.” The FASB staff periodically publishes non-authoritative reports on the similarities and differences between IAS and U.S. GAAP.

⁴ In this chapter, the terms GAAP or GAAS are preceded by “U.S.,” “national” or “international” to indicate the body that promulgates these standards.

⁵ These international auditing standards are referred to as “ISAs” or “international GAAS” (see note 4).

⁶ See note 4.

disclosure of information to the constituencies who need that information. An effective and efficient global capital market depends on financial information that is reliable and comparable, regardless of country of origin. For example, the recent Asian crisis raised questions about the effectiveness of accounting and auditing in the affected countries. Critics have cited incomplete financial information, inappropriate or inadequate accounting standards and the inconsistent application of the standards that did exist as factors contributing to the seriousness of the crisis or to the delays in responding to it. Consequently, it has become evident that achieving the goal of “transparency” in the disclosure of information across borders is critical to the orderly development of the global capital markets.

7.8 Transparency is hindered in some areas of the world by a lack of requisite accounting and auditing standards, corporate governance practices and regulation, among other issues. Achieving transparency requires the cooperative efforts of all participants in the capital-raising and financial-reporting processes, including national governments, regulators, the international business community, international lenders and other financial institutions, accounting and auditing standard setters and audit firms.

ACCOUNTING STANDARDS AND REGULATION

Accounting Standards

7.9 Critical to the reliability and comparability of financial information (and therefore its “transparency”) is the establishment of a set of accounting principles and practices that can be accepted internationally. Accounting standards vary significantly from country to country, and in some jurisdictions the standards or rules constituting national GAAP are not oriented to the needs of investors.⁷ Instead they may be driven by tax or other regulatory needs. On the other hand, IASs promulgated by the IASC endeavor to serve the needs of investors.⁸

Regulation

7.10 In the United States the SEC permits foreign registrants to present financial statements prepared in accordance with their home country GAAP (i.e., their national GAAP) or in accordance with standards issued by the IASC.⁹ In either case, foreign registrants are required to quantify and reconcile material differences between their national GAAP or IASs and U.S. GAAP and disclose such differences in financial statements filed with the SEC. The SEC requires that these disclosures be audited.

7.11 In a major effort to seek acceptance of IASs as the benchmark “international” accounting standards, IASC and IOSCO (including the SEC) have been working to develop accounting

⁷ See note 4.

⁸ See note 3.

⁹ In February 2000 the SEC issued for public comment a concept release regarding the use of IAS (Release Nos. 33-7801, 34-42430; International Series No. 1215). The release seeks to identify what important concerns would be raised by acceptance of IAS and asks for comments on whether the SEC should modify its requirement for all financial statements to be reconciled to U.S. GAAP. The release also questions whether having the host country specify the treatment for a topic not addressed by the core standards is workable.

standards for cross-border offerings and listings. In 1995, the IASC announced a program to complete a core set of standards that IOSCO identified as being a reasonably complete set of accounting standards. IOSCO recognized that the initial core set of standards would not address all issues, such as those related to specialized industries or areas where improvements could be made but were nevertheless not critical to the initial core set of standards. IOSCO also recognized that individual jurisdictions might specify required accounting treatments of matters not addressed satisfactorily in IASs.

7.12 By the end of 1999, the IASC had completed the last major component of its core standards project, and both IOSCO and the SEC were engaged in a detailed assessment of the standards. In May 2000, IOSCO recommended that its members permit the use of IAS to prepare financial statements for cross-border filings and listings. However, IOSCO recognized that some of its members might require reconciliation for certain items.

7.13 Because many of the IASC's standards deal with complex issues in considerable detail, they will represent a significant change for some companies that adopt them. Transnational harmonization (or complete convergence) of accounting standards is still evolving and likely will continue for some time.

7.14 In 1998, IOSCO endorsed a set of disclosure standards for the *non-financial statement* portions of a disclosure document. These standards cover fundamental disclosure topics such as the description of the securities issuer's business. The SEC recently revised its foreign private issuer integrated disclosure system to incorporate fully those international disclosure standards, effective September 30, 2000. At that time, except for financial statements, disclosures in offering documents should be substantially equivalent, regardless of the jurisdiction involved.

International Accounting Standards Committee

Structure

7.15 In December 1999, the current IASC Board adopted a proposal to make several significant structural changes so that it can better meet the needs for accounting standards acceptable in most areas of the world.¹⁰ A key change is that the current part-time board will be replaced by a new autonomous board of 14 individuals, 12 of whom will be full-time. The most important board membership qualification is technical expertise. The new board is expected to commence its activities in 2001.

7.16 In applying IASs, questions may arise regarding the appropriate accounting for transactions that are not specifically covered by the standards. The IASC has (and will continue to have under its revised structure) a Standing Interpretations Committee (SIC), which is a vehicle for issuing timely guidance on international GAAP issues, similar to the EITF.¹¹ If an

¹⁰ The new structure adopted by the current IASC Board provides for a group of 19 trustees having diverse geographical and functional backgrounds. The trustees will appoint members of the new IASC Board, the Standing Interpretations Committee and a new Standards Advisory Council. In May 2000, the IASC Nominating Committee made up of seven members headed by SEC Chairman Arthur Levitt announced the selection of the initial trustees, including as their Chairman, Mr. Paul A. Volcker, former chairman of the U.S. Federal Reserve Board.

¹¹ EITF refers to the Emerging Issues Task Force of the Financial Accounting Standards Board.

issue is not addressed by the SIC, preparers may look to their national GAAP for analogous guidance, or regulators may impose other alternatives.¹² This has the effect of permitting a variety of alternatives in the absence of specific guidance. Thus, SIC has a significant challenge in establishing the priorities for dealing with issues that are not addressed by the core set of standards.

Convergence of Accounting Standards

7.17 Many factors may influence how and to what extent standard setters and regulatory authorities are willing to converge on a single set of global accounting standards. However, regardless of whether individual countries adopt the IASC's standards, retain their own standards or select other standards, market pressures likely will encourage convergence over time.¹³ Countries that elect to participate in the convergence of accounting standards may do so in different ways. For example, some countries may:

- Adopt IASs nationally
- Permit, but not require, compliance with IASs as an alternative to national standards
- Not allow certain options permitted by IASs or require additional disclosures
- Adopt IASs piecemeal

7.18 The IASC realizes that identifying and dealing with departures from its standards by preparers (i.e., the enforcement of its standards) will be an important element of the ultimate acceptance of its standards. The leadership efforts of the major accounting firms and IFAD may prove helpful in this regard.

AUDITING IN THE INTERNATIONAL ARENA

International Auditing Standards

7.19 Since the late 1970s, IFAC has led the effort to establish global auditing standards. IFAC formed the International Auditing Practices Committee to establish international auditing standards (international GAAS). IFAC determines membership on IAPC based on candidates' qualifications and with an eye on geographical representation, among other factors. The AICPA

¹² Where the measurement principles of U.S. GAAP and IAS are the same, but U.S. GAAP have interpretive guidance, the SEC staff may expect registrants to use that additional guidance in implementing IAS. For example, in determining when the equity method of accounting should be applied under IAS 28, *Accounting for Investments in Associates*, the SEC staff has stated that indications of significant influence should include those cited in U.S. GAAP in FASB Interpretation No. 35, *Criteria for Applying the Equity Method of Accounting for Investments in Common Stock*.

¹³ The Panel recognizes that convergence solely to promote uniformity might not result in the highest-quality accounting standards, and it believes that policy makers, standard setters and investors need to be cognizant of this fact.

has been represented on IAPC since its inception, and its representative has chaired IAPC several times. The immediate past chair of the IAPC was the AICPA's representative.

7.20 Historically, IAPC has been constrained by limited staff and research resources and the wide geographical dispersion of its members. IFAC's member organizations approved a significant dues increase in 1999 that was allocated to IAPC's activities. Since then, a new technical director and additional technical managers have been hired.

7.21 IAPC reviews its agenda and discusses important projects with a consultative advisory group of public interest organizations. This process has been in effect since 1994. The consultative group members include IOSCO, the European Commission and the Basel Committee on Banking Supervision.

7.22 IFAC's member organizations endeavor to implement IAPC standards in their own environments, albeit country-specific auditing standards generally govern the work of auditors in their own country. For example, in the United States U.S. GAAS established by the ASB govern the work of auditors, notwithstanding the AICPA's membership in IFAC.

7.23 IAPC has endeavored to establish a comprehensive core set of auditing standards. It made significant progress toward that end when it issued a codified core set of international auditing standards in 1994. To date 34 countries have adopted IAPC's international auditing standards, and another 35 countries have based their national standards on the international standards with no significant differences between their national standards and the ISAs.¹⁴ In addition, the European Commission is studying whether the European Union should adopt ISA.

7.24 Similar to efforts to gain regulatory acceptance of international accounting standards, IOSCO and IAPC are in discussions with respect to IOSCO's endorsing IAPC's standards. The process for endorsing the international auditing standards is expected to proceed once IOSCO has completed all of its work on international accounting standards.

7.25 The SEC requires that the financial statements of foreign registrants be audited in accordance with U.S. GAAS and that auditors comply with U.S. standards for auditor independence.¹⁵ The SEC accepts an auditor's report prepared in accordance with the requirements of the auditor's national GAAS or international auditing standards issued by IAPC provided that the report includes a statement that the audit also was conducted in accordance with U.S. GAAS.¹⁶ The SEC recently indicated that qualifying language in auditors' reports such as "substantially similar" or "similar in all material respects" to U.S. GAAS is no longer acceptable.

7.26 The breadth and quality of auditing standards vary from country to country. Regulators'

¹⁴ As reported by IFAC.

¹⁵ For example, see General Instruction E(c) to Form 20-F, an SEC form used for registration and annual reporting by foreign issuers under the Securities Exchange Act of 1934.

¹⁶ The ISAs (see note 5) are similar in concept to U.S. Statements on Auditing Standards (SASs). The staff of the AICPA periodically publishes a non-authoritative analysis of the ISAs, identifying portions of the ISAs that require procedures and documentation beyond those required by U.S. GAAS or that may be in conflict with U.S. auditing standards.

requirements also vary from one jurisdiction to the next. Consequently, one set of “international” standards that could serve as minimum benchmarks for auditors regardless of domicile would be especially useful when an entity’s financial statements are used by investors outside of the country where the entity is domiciled. Consistency in the quality of assurances provided by audits would enhance the efficiency of cross-border financing and help promote a global marketplace for capital.

Other Aspects of Audit Effectiveness Internationally

7.27 As in the United States, other elements of the “system” play a major role in ensuring the reliability of information. Aside from government regulation, the accountancy profession’s efforts at self-governance are an essential part of that system. IFAC endeavors to be a catalyst in promoting practice monitoring and appropriate professional standards, such as quality control standards and ethics standards (including auditor independence). Similarly, IFAC endeavors to promote higher educational standards for the accountancy profession, since the educational systems and consequently the level of technical skills and competencies differ among countries. IFAC has made substantial progress over the years in these endeavors. However, it has been constrained by jurisdictional issues, the stage of development of the profession in specific countries, and its limited financial and other resources.

Recent Changes to SECPS Membership Requirements

7.28 In recognition of the increase in the number of foreign registrants that file audited financial statements with the SEC, in November 1999 the SEC Practice Section (SECPS) of the AICPA changed its membership requirements for member firms associated with foreign firms that audit financial statements of foreign registrants. The changes apply to the foreign offices of international firms as well as any firm outside the United States that is a member of, correspondent with, or similarly associated with an international firm or international association of firms with which the SECPS member is associated.

7.29 The first change, sometimes referred to as the “gatekeeper” provision, requires a limited review of most foreign registrants’ filings by a filing reviewer, that is, a person or persons knowledgeable about U.S. GAAP and U.S. GAAS, as well as about the U.S. independence rules and SEC regulations. The required procedures include discussions with the engagement partner and documenting the results of the procedures performed. Prior to this change, many of the large firms already had such a process, but some firms limited it primarily to initial public offerings and certain other registration statements.

7.30 The second change calls for enhanced inspection procedures, for example, a review of a sample of foreign registrants’ audits that were performed by foreign associated firms. The qualifications of an inspection reviewer are similar to those of a filing reviewer. Prior to this change, many of the large firms already performed internal inspections of foreign offices, but not always on a recurring basis or specifically directed at foreign registrants.

7.31 The “gatekeeper” provision is aimed at the audits of foreign registrants. The inspection procedures, however, also embrace audits of foreign affiliates of U.S. registrants. Thus, a firm’s

global audit practice of both domestic and foreign SEC registrants will now be subject to internal inspection.

7.32 The Panel believes that these changes are appropriate and will serve to improve both financial reporting by foreign registrants and audit quality.

IMPLEMENTATION OF INTERNATIONAL STANDARDS

7.33 Establishing accounting standards internationally appears to the Panel to be progressing at a reasonable pace. But, lagging behind standard setting is the proper application of the standards by the financial reporting community. In its concept release on the use of IAS, the SEC noted that:

...while the accounting standards used must be high quality, they also must be supported by an infrastructure that ensures that the standards are rigorously interpreted and applied, and that issues and problematic practices are identified and resolved in a timely fashion. Elements of this infrastructure include:

- effective, independent and high quality accounting and auditing standard setters;
- high quality auditing standards;
- audit firms with effective quality controls worldwide;
- profession-wide quality assurance; and
- active regulatory oversight.¹⁷

7.34 The former Vice President and Controller of the World Bank observed:

[IASC and IFAC] are . . . excellent standard setters but without an effective compliance mechanism, commitment or responsibility. On the one hand they can be seen as useful debating clubs, setting state of the art standards, which, if complied with, could dramatically change the face of the economic earth through transparency; but again, having no teeth to make it happen, other than by benevolently agreed regulatory osmosis. When you keep issuing top class standards, but 80% of your membership does not comply with your own club rules and know full well that nothing in the world can make them do it when they sit in judgment on the next one, you have a problem: tremendous professional satisfaction in a pool of missed opportunities....¹⁸

¹⁷ See note 9.

¹⁸ Jules W. Muis, *Governance, Institutions, Disclosure and Transparency*, an address to the Association of Chartered Certified Accountants, September 1999.

7.35 Of course, as observed earlier in this chapter, achieving transparency requires an enormous effort by all the participants in the capital-raising and financial-reporting processes. This effort entails more than merely moral support from the participants in the processes. Unfortunately, in some cases, the participants themselves may pose the greatest hindrance for transparent reporting. Clearly, strong leadership initiatives are needed.

LEADERSHIP ROLE OF THE MAJOR AUDIT FIRMS

7.36 The major international audit firms have a unique role and franchise in the promotion of uniform accounting standards, financial statement transparency and consistent audit quality around the world. Through their international affiliations and organizational infrastructures, they can promote consistent levels of practice. A widely held view is that their active leadership is critical to achieving the goals of consistent, high-quality financial reporting and auditing throughout the world.

7.37 For example, when the IASs are silent about the appropriate accounting for particular transactions, preparers and regulators may default to their national GAAP or other practices for guidance. Given their international networks, the major international audit firms should be able to put into place policies that will help identify such transactions and promote consistent treatment of similar items in similar circumstances. Furthermore, the firms' active support of the SIC should aid this process by identifying areas of uncertain or differing practice and helping the SIC resolve the conflicts.

7.38 The major firms often have exerted significant influence in the international arena, and they are increasing that influence through cooperative efforts. For example, the Big 5 audit firms decided early in 2000 to identify in their audit reports the basis of GAAP and GAAS employed (i.e., the national or international standards used). Subsequently, in May 2000, the ASB issued a proposal to require a reference in the auditor's report to the country of origin of the accounting principles used to prepare the financial statements and the auditing standards that the auditor followed.¹⁹

INTERNATIONAL FORUM FOR ACCOUNTANCY DEVELOPMENT

7.39 IFAD was formed in 1999 as an initiative of the World Bank and IFAC. Its objectives are to:

- Promote a strong accounting profession throughout the world, especially in developing countries
- Enhance the understanding by developing countries' governments of the value to them of transparent financial reporting

¹⁹ ASB Exposure Draft, *Omnibus Statement on Auditing Standards – 2000*.

- Help harness funds and expertise to build accounting capacity in developing and transitional countries
- Assist in defining expectations about how the accounting profession should carry out its responsibilities to support the public interest in these countries
- Promote the use of IASs as the minimum benchmark for national accounting standards

7.40 IFAD held its first two meetings in 1999 and has held one meeting in 2000 to date. In response to concerns about inconsistent reporting and auditing practices, the seven largest international audit firms proposed an approach to raising and enforcing standards across the world, which IFAD adopted. Implementation will require significant long-term efforts, and the firms have committed themselves to provide a leadership role in that endeavor.

7.41 The approach includes joint efforts by all participants to develop country-by-country action plans to achieve a rational framework of financial reporting. This framework would encompass upgrading not only accounting and auditing standards, but also corporate governance, the accounting and auditing profession, regulation and education. Pilot projects related to the action plans are to be initiated in several countries in 2000. Where any actions are solely or primarily within the control of the major firms, they have agreed to adopt interim measures until long-term solutions can be implemented.

7.42 The Panel applauds IFAD and the major audit firms for this undertaking. IFAD's mission is daunting and will require extraordinary patience, perseverance and statesmanship. The Panel encourages the major audit firms and IFAD's other members to continue their leadership efforts.

STRENGTHENING SYSTEMIC ASSURANCES GLOBALLY

7.43 The Panel is aware of recent proposals to strengthen the influence of IFAC that include a number of ideas for enhancing global self-regulation of the auditing profession. The important goals of this initiative are to involve the large audit firms as catalysts for improving audit quality, further increase the resources available to IAPC and establish the supporting mechanisms for quality review and monitoring.

7.44 The proposals call for IFAC to sponsor a new group of audit firms with transnational clients to work closely with IFAC in developing and encouraging implementation of international accounting and auditing standards. Membership in this IFAC-sponsored group of firms would require, among other things, intra-firm practice reviews and periodic peer reviews. The proposals also include creating an oversight body to oversee all of IFAC's audit-related activities, embracing not only auditing standards, quality review and monitoring, but also ethics (including independence) and education.

7.45 At the time of this report, the Panel has not seen the final proposals that are under

consideration by IFAC. However, given its extensive deliberations on the self-regulatory aspects of the auditing profession in the United States, the Panel believes that its views concerning the global aspects of self-regulation of the auditing profession may be useful to IFAC and other constituencies with an interest in auditing globally. In making its recommendations to IFAC, the Panel is cognizant of the difficulties involved in timely implementation, but believes those difficulties can be overcome if a commitment to do so is made by key interested parties, including audit firms, IFAC, standard setters, preparers of financial statements and regulators.

RECOMMENDATIONS

To the International Federation of Accountants:

7.46 The Panel recommends to IFAC that the global self-regulatory structure of the international auditing profession meet the following criteria:

Public Interest Oversight

- The global self-regulatory structure should have as its centerpiece a global oversight body to monitor and report on the activities of individual country self-regulatory organizations (or the member organizations of IFAC that expressly serve that purpose). The charter of this oversight body should establish clearly that its primary goal is to serve the public interest.²⁰ Membership in this body should be established through a mechanism that ensures its independence and viability. (The Panel's recommendations to the U.S. Public Oversight Board [POB], included in Chapter 6, may be helpful to IFAC in this regard, recognizing that a global structure would not operate in exactly the same manner as the POB.)

The global oversight body should ensure that IFAC imposes on its member organizations clear and unequivocal minimum guidelines for the self-regulation of the auditing profession in each country subscribing to its oversight. Timetables for achieving goals should be established on a by-country basis.

International Auditing Practices Committee

- The global oversight body should be consulted on the membership appointments and agenda of IAPC and evaluate the efficacy of the ISAs and the progress made in achieving their global acceptance. It should ensure that IAPC's standards are comprehensive and sufficiently specific and rigorous so that they serve as appropriate benchmarks to judge the work of auditors. (See "Establishing Auditing Standards" in Chapter 2 for the Panel's recommendations to the ASB.)

²⁰ The public interest, in the context of a global oversight function, includes that of cross-border investors and creditors who obtain assurance from the work of auditors on financial and other information that they use in making investment decisions. It also may include the interests of all users of accounting and auditing services.

- IAPC’s deliberations should be open to the public and the basis for and outcome of its actions published.²¹ Dissenting views of its members should be published to promote the goal of transparency, encourage development of the highest-quality standards and assist in their proper interpretation.

Quality Assurance over Auditing

- A key element of quality assurance by individual self-regulatory organizations should be external reviews of the quality controls of audit firms over their accounting and auditing practices. Minimum global standards for quality control over the audit function should serve as the benchmark for these reviews. (See “Recent Changes to SECPS Membership Requirements” above.) IAPC (or an equivalent technical body) should establish these quality controls standards with due process. The global oversight body should evaluate these standards and the progress of the individual self-regulatory organizations in promoting external reviews and reporting on their results.²² (See the Panel’s recommendation to the SEC in the section “Enhancing Peer Reviews” in Chapter 6.)

Ethics and Independence

- The oversight body should evaluate the adequacy of IFAC’s ethics standards, including independence standards (for firms and individual auditors), in serving the interests of public investors, creditors and other users of financial statements.

Education

- The oversight body should assess IFAC’s process for evaluating the education and training of auditors on a by-country basis and its initiatives for establishing high-level, minimum educational standards for the auditing profession. This process should include monitoring the progress of the profession in each country toward achieving established goals.

By-Country Monitoring, Investigations and Discipline

- The global oversight body should establish a framework for monitoring the accountancy profession to guide the individual country self-regulatory organizations (or equivalent bodies, if not formally designated as self-regulatory organizations).²³

Key elements that the global oversight body should ask each country’s self-regulatory

²¹ IAPC’s meetings take place in various locations throughout the world. IOSCO is invited as an observer in these meetings.

²² The Panel is aware that some elements of “external review” already are called for by IFAC’s International Professional Practice Statement No. 1, *Assuring the Quality of Professional Services*. This recommendation speaks to the role of the global oversight body.

²³ IFAC has set up a Compliance Committee with some functions similar to those described as key elements in this recommendation. This recommendation speaks to the role of the global oversight body.

organization to address include: (1) accounting standards adopted and in use and the status of efforts toward convergence with IASC standards, (2) auditing standards adopted and in use and the status of efforts to apply IAPC standards, (3) ethics (including independence) standards adopted and in use and the status of efforts to adopt international standards as a minimum, (4) educational levels and skills and the status of efforts to achieve goals, (5) quality reviews (including peer reviews) and the status of efforts to achieve goals, (6) monitoring of practice quality by investigating allegations of audit deficiencies or failures and the status of efforts to achieve goals, (7) disciplinary activities and the status of efforts to achieve goals, and (8) the regulatory environment over global financing and changes occurring in that environment.

Membership Requirements of IFAC-sponsored Group of Audit Firms²⁴

- Membership requirements of the proposed group of audit firms that will work with IFAC to raise international standards should include periodic reports by those firms to the global oversight body about their structure and operations.²⁵

Monitoring the Global Auditing Profession

- A system for monitoring the global auditing profession should be established by IFAC that provides for reporting to the global oversight body by the individual self-regulatory organizations. This monitoring activity should address the key elements described above for individual countries.

Reporting to the Public

- There should be comprehensive annual reports to the public by the global oversight body on its activities, including the results of its monitoring of the quality assurance functions for the auditing profession on a by-country basis.²⁶ Such reporting should describe the nature of the self-regulatory processes followed in each country and the results of reporting by each country's individual self-regulatory organization. These reports should address the progress being made by each country toward achieving goals in the areas of standards, quality assurance, ethics and independence, education, monitoring and investigations, and discipline. The global oversight body's goal should be to bring "transparency" to how the global auditing profession functions and

²⁴ The proposed group of audit firms currently is referred to as "The Forum of Firms."

²⁵ For example, World Bank officials have suggested disclosure statements by the various institutions involved in capital flows, including countries, international standard setters and international accounting firms. One official of the World Bank has described possible elements of disclosures for firms as, among other things, the international structure of the firm; what the global use of the firm's name means to clients and others, when associated with financial statements; minimum standards followed; their financial strength; their risk profile; their effective control; and their independence rules (Muis; see note 18).

²⁶ If some or all of these processes are delegated to regional organizations, the results nonetheless should be reported on a by-country basis.

serves the interests of investors.²⁷

To audit firms:

7.47 While the changes in the SECPS membership rules described earlier in this chapter are important first steps, the Panel believes that additional steps are necessary to effect significant improvements in worldwide accounting and auditing quality. The Panel believes that the major firms share this view and that they are in varying stages of upgrading their international quality for the benefit of all users of audited financial statements, not just those who invest in companies whose securities are registered with the SEC.²⁸ Accordingly, the Panel recommends that audit firms²⁹:

- Implement uniform audit methodologies throughout the world that use international auditing standards as the base minimum³⁰
- Subject all audit practice units to periodic inspection procedures covering all audits, not just foreign registrants or affiliates of U.S. SEC registrants
- Assign personnel throughout the world to function as technical consultants in the application of international accounting and auditing standards. Firms should consider establishing intra-firm international “clearinghouses” to resolve differences in the application of international accounting and auditing standards and promote consistency of practice.

To the Auditing Standards Board and the International Auditing Practices Committee:

7.48 The Panel recommends that the ASB and IAPC initiate a formal collaborative effort to harmonize auditing standards and achieve their global acceptance. Others interested in auditing standard setting should be invited to participate in this effort.³¹

7.49 While the Panel encourages this initiative, it also believes that such an effort should be conducted in parallel with the ASB’s consideration of its other recommendations. (See the Panel’s recommendation to the POB and the ASB under “Establishing Auditing Standards” in Chapter 2.)

²⁷ The Panel recognizes that the global oversight body, not IFAC, would determine what to include in its reports. This recommendation gives the Panel’s view of the matters that it considers important and appropriate.

²⁸ Users in this context are those who use financial statements for financing and other needs on a transnational basis.

²⁹ The Panel understands that some audit firms already have made significant progress toward implementing these recommendations.

³⁰ The Panel understands that audits of the financial statements of foreign registrants are required to comply with U.S. GAAS. Nonetheless, it believes that it would be in the best interests of both the public and the audit firms if there were, regardless of jurisdiction, a uniform global “standard” for what constitutes “audit assurance.”

³¹ The Assurance Standards Board of the Canadian Institute of Chartered Accountants and the United Kingdom’s Auditing Practices Board are two auditing standard-setting bodies that addressed the Panel’s Exposure Draft. Two national accountancy organizations, the Institute of Chartered Accountants in England and Wales and the German Institut der Wirtschaftsprüfer, also addressed the Panel’s Exposure Draft. Other standard-setting bodies and IFAC member organizations may be interested in this initiative.

CHAPTER 8 – LOOKING AHEAD

8.1 The past decade has seen unprecedented changes in the global economy and capital markets. In making its recommendations, the Panel recognizes that many of these changes have profoundly affected the auditing profession, and they will continue to do so at an accelerating pace. The Panel's recommendations throughout this report seek not only to make today's audits more effective, but also to help the profession make continuous improvements in the years ahead. The Panel recognizes that implementing its recommendations requires a major effort by many constituencies. It believes that its recommendations can have a significant effect on the conduct of audits, the governance of the profession and the public's perceptions about the value of audits.

8.2 The Panel is aware that future developments may affect the conduct of audits in ways that it cannot now foresee. In interpreting its mission, the Panel focused on improving the effectiveness of audits of financial statements prepared in accordance with the current accounting model predicated on generally accepted accounting principles, or GAAP. However, the Panel recognizes that auditors will face many challenges in the years ahead and will have to adapt to an ever-evolving world.

8.3 The Panel foresees the following developments as having a major effect on how audits will be conducted in the future: the technology explosion, the demand for new and more timely information, finding and retaining the best people for the profession, and the globalization of business. The Panel's vision about each of these is briefly discussed in the balance of this chapter.

TECHNOLOGY

8.4 Not a day goes by without more news about the revolutionary effects of technology on the world economy. Technological developments are changing business and financial reporting, and consequently how audits are conducted also is changing. And more changes are forthcoming.

8.5 Increasingly, auditors will find it necessary to understand fully the risks associated with new and advanced business information systems, and the controls that are needed to respond to those risks. Auditors also will find that they must expand their technological knowledge and skills, devise more effective audit approaches by taking advantage of technology and design different types of audit tests to respond to new business processes. Highly skilled technology specialists will become even more essential members of audit engagement teams.

8.6 Attracting and retaining qualified technology specialists in the numbers required for audit support has long been a challenge to the profession, one that will become even more critical in the high technology environment of the future. Technology specialists will need to work with auditors as a team. However, auditors cannot cede addressing all technology matters to technology specialists, and in turn technology specialists will require a better understanding of auditing.

THE INFORMATION DEMAND

8.7 The demand for new or timelier information is on the rise. Technology-driven information systems are capable of capturing, organizing and disseminating information in “real time.” Investors can quickly access information and consequently have expanded their demands for both financial and non-financial information. Some of that information is “traditional” historical financial data, and some of it is new. Information provided on a real-time basis to investors inevitably will raise the question of its reliability. And, at this point, the auditors likely will be expected to enter the picture and to provide some assurances about the reliability of the expanded array of information. But, because of the virtually real-time nature of the information, these assurances will involve both the reliability of the systems or processes that produce the information and the ultimate output of those systems or processes, the information itself.

8.8 At the same time, the historical-cost-based GAAP accounting model is seen by some as out-of-date and increasingly unresponsive to investors’ needs for information. They charge that the current model is oriented to tangible assets rather than the intangible assets that drive many of the values of today’s “new economy” service- and technology-based businesses. Some observers believe that the challenge for the auditing profession will be to develop new approaches to auditing to meet the demands for any new information and to adapt to changes in the accounting model. These new approaches may include some form of continuous auditing and require new tools and skills, with greater emphasis on the use of technology-driven analytical and diagnostic procedures.

THE BEST PEOPLE

8.9 Perhaps the biggest challenge facing the auditing profession today is the apparent decline in the attractiveness of auditing, particularly to college and university students. That decline has been influenced by increased educational requirements, issues of compensation, heavy workloads and issues of family or lifestyle. It also has been influenced by the perception that alternative career opportunities are more exciting, challenging and rewarding than auditing. Some of the same issues affect the ability of audit firms to retain professional personnel for the long term. All this comes at a time when some observers believe that the profession also faces the need to attract even more personnel with technology and other special skills to meet the challenges of, and the demands for, providing assurances on additional and new forms of financial and non-financial data.

8.10 The profession will need to restore the historic attractiveness of auditing as a profession and convince the “best” people that it offers excellent long-term career opportunities. To do so it will have to lift the public perception of the profession to a higher plane and convincingly demonstrate the worth of the profession. This is an effort that will require a partnership among audit firms, professional societies and the academic community.

GLOBALIZATION

8.11 Economic globalization is expected to continue at an accelerating rate. For the auditing profession, this means greater attention to the development of fully integrated international organizations with uniform audit policies and methodologies premised on high-quality standards. The challenges of globalization will require extraordinary leadership efforts by audit firms, especially the large firms, to overcome the many impediments to progress, such as weak country-specific regulations and corporate governance practices. The firms will need to be the first line of enforcement of uniform worldwide accounting and auditing standards.

8.12 An infrastructure for global self-regulation that provides for strong governance and oversight of the profession needs to be put in place. Importantly, this infrastructure will have to be sufficiently transparent that it is responsive to the public interest in both fact and perception. Audit firms will need to work closely and cooperatively with regulators, the key organizations involved in establishing international accounting and auditing standards, and those involved in overseeing the international auditing profession to achieve these goals.

FINAL THOUGHTS

8.13 Responding to change promises to be an ongoing challenge for audit firms, for those who establish standards, and for those who oversee the profession and monitor auditors' performance – essentially the bodies and organizations to whom the Panel's recommendations are addressed. The Public Oversight Board (POB), in particular, will face major challenges in meeting its expanded responsibilities – challenges that the Panel believes present a unique opportunity not only to improve audit effectiveness but also to elevate the image of the auditing profession. A fully cooperative effort by the profession, POB and SEC is essential to ensure both successful implementation of the Panel's recommendations and continuous improvement in audit quality.

8.14 In even a short five years from now, it is likely that the auditing profession will have undergone dramatic change. The Panel is hopeful that its recommendations will serve to promote some of that change in positive ways. The Panel is confident that a newly empowered POB will monitor the progress toward implementing the recommendations in this report and use its expanded influence to see that the profession addresses the challenges of the future. The POB also will act as the catalyst for a renewed spirit of cooperation between the profession and the SEC.

8.15 POB-sponsored special reviews of issues of audit efficacy or other matters affecting the profession are clearly within the scope of the POB's new charter. While another broad review of audit effectiveness of the nature of the Panel's project is not foreseeable, the POB should not hesitate to exercise its discretion in calling for further reviews if circumstances demonstrate the need to do so. At the end of the day, the public interest is paramount.

