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Panel on Audit Effectiveness report and recommendations : August 31, 2000

American Institute of Certified Public Accountants. SEC Practice Section. Public Oversight Board. Panel on Audit Effectiveness

THE PANEL ON AUDIT EFFECTIVENESS

REPORT AND RECOMMENDATIONS

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The Panel on Audit Effectiveness

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PUBLIC OVERSIGHT BOARD

PANEL ON AUDIT EFFECTIVENESS

Date: August 31, 2000

To: The Public Oversight Board and Other Interested Parties

From: Shaun F. O'Malley
Chair, Panel on Audit Effectiveness

Subject: Report and Recommendations

Almost two years ago, at the request of the chairman of the Securities and Exchange Commission (SEC), the Public Oversight Board (POB) appointed a Panel of eight members, charging it to thoroughly examine the current audit model. The Panel and its staff have completed a comprehensive review and evaluation of the way independent audits are performed and assessed the effects of recent trends in auditing on the public interest.

I would like to emphasize that, while many specific recommendations are made for improvements in the conduct of audits and the governance of the profession, our report demonstrates that both the profession and the quality of its audits are fundamentally sound.

The Panel believes the recommendations in this report will result in more effective audits that improve the reliability of financial statements, enhance their credibility, contribute to investors' confidence in the profession and improve the efficiency of the capital markets. Implementation will require the efforts, support and cooperation of the profession, various standard-setting and oversight bodies, and the SEC. The very existence of the Panel has helped to stimulate desirable changes, and the Panel is gratified to note that various bodies and firms have already adopted, or are currently in the process of adopting, a number of its recommendations.

The Panel's recommendations are addressed to many constituencies: standard setters, audit firms, the SEC Practice Section (SECPS), audit committees, the SEC and others.

Among the Panel's major recommendations are:

- Auditors should perform some "forensic-type" procedures on every audit to enhance the prospects of detecting material financial statement fraud.

- The Auditing Standards Board should make auditing and quality control standards more specific and definitive; in certain specified areas, audit firms should review and, where appropriate, enhance their audit methodologies, guidance and training materials; and peer reviewers should "close the loop" by reviewing those materials and their implementation on audit engagements and then reporting their findings.

- Audit firms should put more emphasis on the performance of high-quality audits in communications from top management, performance evaluations, training, and compensation and promotion decisions.

- The POB, AICPA, SECPS and SEC should agree on a unified system of governance for the profession under a strengthened, independent POB that would oversee standard setting (for auditing, independence and quality control), monitoring, discipline and special reviews.

- A majority of the members of the Independence Standards Board (ISB) should be from outside the profession, and the SEC should encourage and support the ISB in carrying out its mission.

- The SECPS should strengthen the peer review process, including requiring annual reviews for the largest firms, and the POB should increase its oversight of those reviews.

- The SECPS should strengthen its disciplinary process.

- Audit committees should pre-approve non-audit services that exceed a threshold amount and should consider certain specified factors when doing so. The ISB should identify the factors.

- The International Federation of Accountants should establish an international self-regulatory system for the international auditing profession.

The Panel believes that its recommendations are supported by its findings and are necessary to enhance the effectiveness of audits of financial statements. To elevate the entire profession to the high levels of quality some have already achieved, the Panel included in its recommendations certain excellent practices it observed. Finally, the Panel believes that its recommendations will provide a solid foundation for standard setters and firms to react to investors' demands for timely assurances from auditors on other financial and non-financial data in the "new economy."

The results of the Panel's review of specific audits were generally good, and the Panel is satisfied that the audit risk model is appropriate, although it needs to be enhanced, updated, and implemented more consistently.

The Panel members were unable to agree whether to support or reject an exclusionary rule that would prohibit an audit firm, except in very limited circumstances, from providing non-audit and non-tax services to its public audit clients. Chapter 5 contains statements of the opposing views. The SEC's rule-making initiatives should provide an opportunity for public discussion and resolution of this issue.

The Panel members believe that the POB must play a key role in the implementation of the recommendations in this report. The POB should support, encourage and monitor their timely implementation by those to whom the recommendations are addressed and should discuss the progress made in its Annual Report.

All who have had the privilege to be involved in this important effort are grateful to the POB for the opportunity to serve and for its support and encouragement throughout the process. The Panel thanks everyone who provided information and assistance in its endeavor. We look forward with confidence to an increasingly important future role for the auditing profession both in the United States and throughout the world.

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This Report is available at *www.pobauditpanel.org*

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4. **January 25, 2000, Report of the Peer Review Process Task Force – Executive Committee, SEC Practice Section of the AICPA**

5. **July 10/11, 2000, Public Hearings Timetable**

ACKNOWLEDGMENTS

The assistance and cooperation of many organizations and individuals were critical to the Panel and its staff in this project. First, we are grateful to the eight large firms that funded the study, participated in the Quasi Peer Reviews and furnished significant amounts of internal information and data to us:

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Ernst & Young LLP
Grant Thornton LLP
KPMG LLP
McGladrey & Pullen, LLP
PricewaterhouseCoopers LLP

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We owe special appreciation to the Public Oversight Board and its staff for providing us with office space and administrative support. We will not soon forget their continued hospitality and patience despite our having interrupted them for many months. Jerry D. Sullivan, the POB's Executive Director, deserves particular thanks for giving us his own office to use for the duration of the project.

We thank the many AICPA groups and staff – including the SEC Practice Section and its committees, the Auditing Standards Board, the Professional Ethics Executive Committee and the Academic and Career Development Team – who were so helpful and cooperative in making presentations and otherwise providing information to the Panel and its staff. Similarly, the Independence Standards Board and its staff were always available to help us.

The SEC was instrumental in our having been formed and has been totally supportive of our efforts throughout the project. We are grateful to the SEC staff for presentations made to and information shared with the Panel and its staff, particularly the extraordinary assistance in connection with our study of recent SEC Accounting and Auditing Enforcement Releases (AAERs).

We also thank Thomas R. Weirich, Professor of Accounting at the School of Accounting at Central Michigan University, who conducted the AAER research for the Panel; Henry R. Jaenicke, the C. D. Clarkson Professor of Accounting at Drexel University, who was an inspired editor of most of the report and helped draft some portions; and Cleve E. Corlett, retired Director of Public Affairs of the United States General Accounting Office, who also helped edit the document.

Special thanks go to all the individuals who participated in the Panel's focus groups and public hearings and who submitted thoughtful responses to the Panel's survey and Exposure Draft. The insights they offered were invaluable to the Panel's process. We also thank the Financial Executives Institute and the Institute of Internal Auditors for arranging for the participants at the focus groups of their members. And, Practitioners Publishing Company was very gracious in supplying us with copies of its audit publications that are used by many smaller firms.

Finally, we must single out David B. Pearson, our staff director who is a retired partner from Ernst & Young LLP and currently Professor for the Practice of Accountancy at Case Western Reserve University. David provided unstinting leadership throughout the project to both Panel members and staff. His tireless efforts were the glue that kept the project together. The Panel also gratefully acknowledges the efforts of the other retired partners who constituted the Panel staff: George P. Fritz (Coopers & Lybrand L.L.P.), Edmund R. Noonan (KPMG LLP) and Thomas M. Stemlar (Arthur Andersen LLP).

EXECUTIVE OVERVIEW

The Panel on Audit Effectiveness was charged with the responsibility to review and evaluate how independent audits of the financial statements of public companies are performed and to assess whether recent trends in audit practices serve the public interest. This report is the culmination of a lengthy and complex investigation in furtherance of that responsibility. The scope of the project was wide ranging, and the activities undertaken to carry it out were substantial. This Executive Overview summarizes the genesis of the project and its scope, the way it was approached to develop findings, and the Panel's recommendations based on those findings. It also sets forth a final observation of the Panel on the importance of the individual professional auditor who is the ultimate backstop in furthering audit quality.

GENESIS AND SCOPE OF THE PROJECT

The Public Oversight Board (POB) is an independent, private-sector body that monitors and reports on the self-regulatory programs and activities of the SEC Practice Section (SECPS) of the Division for CPA Firms of the American Institute of Certified Public Accountants (AICPA). The POB appointed the Panel in October 1998 at the request of Chairman Arthur Levitt of the Securities and Exchange Commission (SEC).

Over the past few years, the SEC has become increasingly concerned about the efficacy of the audit process and a wide range of issues involving the public accounting, or auditing, profession – the independent auditors who audit the financial statements of public companies. It has expressed those concerns in public and private forums, and, in turn, those concerns have been widely publicized in the press. Also, several major instances of misstated earnings have resulted in massive declines in the market capitalization of the affected companies; some SEC registrants have appeared to be overreaching in terms of permissible accounting treatments; and the environment in which the auditing profession functions has been changing dramatically.

The high market valuations of equity securities have created pressures on corporate management to achieve earnings or other performance targets, especially in response to the expectations of securities analysts. Missing those targets can result in significant declines in market capitalization and, consequently, reduced compensation for those managers whose incomes are dependent in large part on achieving earnings or stock-price targets. The unforgiving nature of the equity markets when companies fail to achieve projected earnings or other targets has created unprecedented pressures on corporate management to "make the numbers." In succumbing to those pressures, management's behavior can become suspect, leading to accusations falling under the broad rubric of "earnings management." And, as this report discusses in some detail, earnings management sometimes can lead to or constitute fraud.

When auditors express their opinion on the fair presentation in conformity with generally accepted accounting principles of a public company's financial statements, they do not guarantee that the financial statements are not misstated. Rather, auditors provide only *reasonable assurance* that the financial statements are free of *material* misstatement. Nevertheless, when previously issued audited financial statements turn out to be unreliable and must be restated in corrected form, the logical question is, "Where were the auditors?" Implicitly, the question not only asks about the efficacy of the audit process, but also raises doubts about the value of audits in ensuring the reliability of financial statements – a key element in the efficient functioning of the capital markets. A fundamental assumption underlying the Panel's project is its belief in the value of an audit and the public's need for effective audits.

The constantly changing environment in which audits are conducted presents challenges to audit firms and consequently to the quality of audits. Rapid technological advances in both the operating and financial systems of companies, for example, have forced audit firms to recruit, train and deploy large numbers of information technology specialists to support their audit efforts. Technological changes also have caused firms to reconsider their audit methods and techniques in an effort to harness technology to improve audit efficiency and effectiveness. The SEC and others have questioned, however, whether the increased efficiency may have been accompanied by reduced, not enhanced, effectiveness. In addition, the large audit firms' consulting practices have grown significantly in recent years, at least in part as a result of the technology explosion. This growth has led to concerns about the relative importance of the audit practice to firms, and about auditor independence when non-audit services are performed for audit clients.

The Panel was created in response to all of these concerns. The SEC requested the POB to sponsor a thorough and objective examination of auditing to explore the efficacy of the audit process. Examining the efficacy of the audit process is an insufficient basis for assessing audit effectiveness. Understanding the environment in which audit firms operate and the factors that drive their business is equally important. For those reasons, the Panel not only investigated how audits are conducted, but also studied several aspects of the management of audit firms, as well as whether non-audit services provided to audit clients pose a threat to auditor independence and whether the system of governance of the auditing profession is adequate or in need of change.

APPROACH TO THE PROJECT

The Panel's investigation encompassed a wide range of activities. Its principal effort was its Quasi Peer Review – in-depth reviews of the quality of a significant number of audits of financial statements of public company clients of the eight largest audit firms, as well as focus groups and other activities related to those reviews. Panel members attended most of those reviews, and the Panel staff planned and directed all of them. The Quasi Peer Review is a major source of the Panel's findings and recommendations for improving the conduct of audits.

The Panel also undertook many other activities. It held meetings with representatives of the SEC and various private-sector bodies involved in the governance of the profession, such as the AICPA; SECPS Executive, Peer Review and Quality Control Inquiry committees; Auditing Standards Board (ASB); Independence Standards Board (ISB); and POB. The Panel conducted a survey and held public hearings. It also conducted focus groups with financial executives and internal auditors from public companies, audit personnel at all levels from the eight largest firms and partners from smaller accounting firms. In addition, the Panel conducted research, with the assistance of the SEC staff, into the circumstances that led to recent SEC Accounting and Auditing Enforcement Releases involving the five largest firms or their clients; studied the profession's current governance structure and analyzed alternatives to that structure; analyzed the academic, professional and regulatory literature on the effects of non-audit services on auditor independence; and studied recent international initiatives to strengthen audit effectiveness on a global basis.

The findings resulting from all of these activities are included throughout this report.

Finally, the Panel considered the benefits and costs of its recommendations. The Panel believes that the benefits to the public and the other participants in the financial reporting process from implementing its recommendations and thereby enhancing audit effectiveness and reducing the cost of capital will justify the additional costs, producing a net benefit over time.

RECOMMENDATIONS

Because they are premised upon the many findings discussed and analyzed throughout this report, the Panel's recommendations are numerous. However, the Panel's principal recommendations in the following areas are summarized in this Executive Overview:

- Conduct of audits, including the auditor's responsibility for the detection of fraud (including earnings management when it constitutes fraud)
- Leadership and practices of audit firms
- Effects on auditor independence of non-audit services provided to audit clients
- Governance of the auditing profession
- Strengthening the auditing profession internationally

Conduct of Audits

Overall, findings from the in-depth reviews of audits were favorable and did not support the view that audits are being conducted in an ineffective manner. The Panel is satisfied that the model underpinning financial statement audits generally is appropriate, although in need of enhancing and updating. Furthermore, the Panel accepts the premise that, in protecting the public interest, reasonable, not absolute, assurance that financial statements are not materially misstated is a sufficiently high standard of responsibility for auditors. The Panel's perspective, however, is that, even in the face of strengthened auditing standards in recent years, audit firms may have reduced the scope of their audits and level of testing, at least in part as a result of redesigning their audit methodologies. The Panel is concerned that the auditing profession has not kept pace with a rapidly changing environment, and that the profession needs to address vigorously the issue of fraudulent financial reporting, including fraud in the form of illegitimate earnings management. The Panel also observes that, while auditors 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.

The Panel's principal recommendation in this area is that auditing standards should create a "forensic-type" fieldwork phase on all audits. This work would be based on the possibility of dishonesty and collusion, overriding of controls and falsification of documents. Auditors would be required, during this phase, in some cases on a surprise basis, to perform substantive tests directed at the possibility of fraud. The recommendation also calls for auditors to examine non-standard entries, and to analyze certain opening financial statement balances to assess, with the benefit of hindsight, how certain accounting estimates and judgments or other matters were resolved. The intent of this recommendation is twofold: to enhance the likelihood that auditors will be able to detect material fraud, and to establish implicitly a deterrent to fraud by posing a greater threat to its successful concealment.

The Panel's recommendations for improving the conduct of audits reflect three major themes:

- Definitive auditing standards form the starting point for promoting quality audits.

- Audit firms need comprehensive and vigorous audit methodologies, based on the standards, to drive the behavior of their auditors to a higher plane.

- The peer review process is a critical element in "closing the loop" to provide assurance to the public that audit performance measures up to high standards and continues to improve.

Consequently, virtually all of the recommendations are addressed to the three major constituencies that are capable of significantly improving the conduct of audits. They are the ASB, the firms that audit the financial statements of public entities and the SEC Practice Section of the AICPA. The Panel also has made certain recommendations to other constituencies, including recommendations to audit committees designed to strengthen corporate governance.

The individual recommendations fall in a number of areas, including assessing inherent and control risks, analytical procedures, auditing revenue, auditing estimates and judgments, considering materiality and waived adjustments, and communicating with audit committees. In a number of instances they call for a deeper understanding by auditors of business processes, risks and controls, including the client's use of information technology. The recommendations also call for increased information technology skills and for more effective participation in audits by information technology specialists. A number of recommendations call for auditing standards to be more specific and definitive and thereby serve to guide auditors in exercising their professional judgment more consistently and effectively.

The Panel believes that each of its recommendations is individually important, but also that they need to be viewed in their totality. Recommendations addressed to only one constituency are less likely to lead to major changes in how audits are conducted; action by all constituencies is necessary to assure the public that the recommendations will achieve their objectives. The Panel calls upon the POB and the ASB to work together in establishing priorities for implementing its recommendations and setting future agendas.

Leadership and Practices of Audit Firms

The Panel's recommendations to audit firms call for action in four areas: professional leadership, professional development, personnel management and time pressures on auditors. Certain recommendations also are made to assist smaller firms.

The first set of recommendations concerns professional leadership and "the tone at the top." The Panel calls on audit firms to reaffirm, within their organizations and to the outside world, the importance of their audit practices and to stimulate their auditors to proudly hold high the banner of objectivity, independence, professional skepticism and accountability to the public by performing quality audit work. These messages should be conveyed by all of the firms' top leaders, consistently and continuously.

Similarly, the Panel calls on the AICPA to actively and publicly promote the importance of audits.

The Panel recommends that audit firms ensure that the performance of high-quality audits is recognized as the highest priority in their professional development activities, performance evaluations, and promotion, retention and compensation decisions. The Panel also calls on firms to place more emphasis on managing time pressures that might compromise audit quality.

Lastly, the Panel recommends that the AICPA provide greater audit-related technical and industry support to smaller firms and assist them in their practices by providing practical tools for their client acceptance and continuance decisions.

Auditor Independence – Non-audit Services

This report highlights, in two statements of views discussing the subject, the importance of and wide-ranging perspectives about the issue of non-audit services provided to public audit clients. Members of the Panel were of two minds on this issue: One view supports (with limited exceptions) an exclusionary ban on those services; the other opposes such a ban. The Panel did not fully support either view. However, it foresees considerable public debate as the SEC pursues its rule-making initiatives to address the subject.

Beyond this debate, the Panel recommends that, whatever the outcome of the SEC's rule-making initiatives, the ISB develop guidance to help auditors, audit committees and management comply with (a) recent ISB requirements for auditors to disclose independence matters to audit committees and (b) new SEC disclosure rules for audit committees of public companies. That guidance should include factors to consider in determining whether specific non-audit services are appropriate. The Panel has identified and suggested several such factors. One guiding principle for determining the appropriateness of particular services is whether the services facilitate the performance of the audit, improve the client's financial reporting processes or are otherwise in the public interest.

The Panel also recommends that audit committees, when evaluating non-audit services, immediately begin considering the factors suggested by the Panel and that they preapprove significant non-audit services exceeding threshold levels that they have established.

In addition, the Panel recommends that the SEC and ISB evaluate, on a continuing basis, the effectiveness of the disclosures made by public companies under the SEC's new rules, and the disclosures made by auditors to audit committees under the ISB's requirements. This recommendation also applies to any future requirements or rules issued by the ISB or by the SEC pursuant to its rule-making initiatives.

Governance of the Auditing Profession

The Panel proposes significant changes to the profession's self-governance system. The Panel believes the profession's system of governance should be unified under a strengthened, independent POB that would oversee the profession's activities with respect to standard setting (other than accounting standards), monitoring, discipline and special reviews.

The Panel recommends that the POB, AICPA, SECPS and SEC work together to develop a formal charter for the POB that will strengthen the POB's oversight of the auditing profession and ensure the POB's independence and viability. The preceding groups as well as the major firms should agree on this charter. Important new elements of self-governance recommended by the Panel include: (1) the POB's oversight of the ASB, ISB and the standard-setting activities of the Professional Ethics Executive Committee that relate to audits of public companies, (2) a nominating committee to identify and nominate new POB members, and (3) term limits for POB members. The charter is being developed currently.

As a result of this recommendation, the POB would oversee the ASB, the ISB, the SECPS Executive Committee (including its main committees, the SECPS Peer Review Committee and the SECPS Quality Control Inquiry Committee) and the standard-setting activities of the Professional Ethics Executive Committee that relate to audits of public companies. This expansion of authority should enable the POB to serve as the body to whom the SEC, state boards of accountancy, the auditing profession and the public can look for leadership.

The Panel recommends that the SECPS strengthen the peer review process by providing for more frequent reviews of the largest firms, increased POB oversight of the reviews and greater emphasis on the qualitative aspects of the reviews. The Panel calls upon the SEC to mandate a peer review or similar monitoring program subject to public oversight for all firms (not just SECPS member firms) that audit SEC registrants, including a peer review or similar monitoring program for foreign-based audit firms in their foreign locations. In addition, the Panel recommends enhancements to the profession's disciplinary process. The Panel also envisions a more coordinated and substantive approach for providing feedback and guidance to the profession as a result of the enhanced peer review and disciplinary processes, as well as from special reviews commissioned by the POB.

The Panel recommends that the ISB reconstitute its membership to include four members representing the public and three representing the auditing profession (currently the membership is four and four). The Panel believes that adopting this recommendation will provide a more appropriate balance between the interests of the public and the profession.

The Panel recommends that the SEC respect the POB's authority, as specified by its new charter, to carry out the profession's self-regulatory activities. In this connection, the Panel also recommends that the SEC encourage and support the ISB in carrying out its independence mission.

International Perspectives

The Panel also focused on the audit firms and international organizations that play key roles in the global setting. Accordingly, it reviewed recent international developments in accounting and auditing standards, regulation and the governance of the profession. It makes no claim of having made a comprehensive analysis of audit effectiveness on a global basis. The Panel is aware, however, of current efforts to strengthen self-regulation of the auditing profession globally. Because it devoted considerable attention to the governance of the auditing profession in the United States, the Panel concluded that it was advisable to make similar recommendations to the International Federation of Accountants relating to the global self-regulatory structure of the auditing profession and to audit firms that operate internationally.

The Panel's principal recommendation to the International Federation of Accountants is that the self-regulatory structure of the international auditing profession meet certain important criteria. The main elements of such a structure would include public interest oversight, including oversight over standard setting in auditing, quality control, and ethics and independence; monitoring; investigations; discipline; and public reporting.

The Panel also recommends that audit firms implement uniform audit methodologies worldwide, following international auditing standards as the base minimum, and subject all audit practice units to periodic inspection procedures. It believes that the leadership and support of the large international audit firms is critical to the success of a number of international initiatives now underway and to the effectiveness of a global self-regulatory structure.

Finally, the Panel recommends a formal collaborative effort between the ASB and the International Auditing Practices Committee to harmonize auditing standards and achieve their global acceptance.

THE PROFESSIONAL AUDITOR

This report contains many recommendations to enhance audit effectiveness that are addressed to a variety of constituencies. The Panel recognizes that, in the final analysis, the most important determinants of audit effectiveness are the personal attributes and skills of the individual auditor. The personal attributes of individuals provide structure and definition for their role in society and establish the foundation for what constitutes a true professional. For the individual auditor, these attributes are independence in fact and in appearance, adherence to strong ethical standards, a great sense of personal integrity and the will to act objectively even in the face of intense pressures. Most importantly, individual auditors, as members of a respected profession, should assign their highest priority to protecting the public interest.

A commitment to the public interest and the possession of personal professional attributes and skills are not in conflict with a sense of service to clients – public companies, their shareholders and the investing public. The clients of audit firms require the skills and competencies offered by the auditing professionals in those firms – indeed, clients value those skills and competencies. Auditors need not apologize for feeling pride and satisfaction in providing audit services to clients. At the same time, auditors must possess the discipline, fortitude and ability to stand up to management or to an audit committee or board of directors. They need to be able to say, "No, that's not right!"

Critical to such discipline is firm management giving clear and consistent messages that it not only expects auditors to do the right thing, but also will support them, fully and unequivocally, when "no" is the right answer – even when that means losing a client.

Each and every auditing professional contributes to the performance of an audit. No amount of guidance, admonitions to do good work, the right "tone at the top," or the threat of sanctions will produce a high-quality audit, unless every individual auditor embraces a high sense of personal responsibility and diligence. The Panel calls on all individual professional auditors to heed this message: Only quality audits serve the public interest, and the public is your most important client.

CHAPTER 1 – INTRODUCTION

1.1 At the request of Chairman Arthur Levitt of the Securities and Exchange Commission (SEC), the Public Oversight Board (POB) appointed the Panel on Audit Effectiveness in October 1998 to assess whether independent audits of the financial statements of public companies adequately serve and protect the interests of investors. The Panel reviewed and evaluated the way that audits are performed, and assessed recent trends in audit practices to determine whether they are in the public interest. It studied the audit policies, methodologies and other forms of guidance used primarily by the large audit firms, certain aspects of auditor independence and the auditing profession's self-regulatory structure. The Panel also focused on international developments affecting the auditing profession.

1.2 This chapter provides an introduction to independent audits of financial statements, the environment in which the auditing profession functions and the Panel's approach to the project. It also describes how the Panel's findings and recommendations in this report are organized by chapter. Finally, it discusses the Panel's consideration of the benefits and costs of its recommendations.

INDEPENDENT AUDITS OF FINANCIAL STATEMENTS

The Value of Audits

1.3 Public companies are required to file financial statements with the SEC that have been audited in accordance with generally accepted auditing standards (GAAS) promulgated by the Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA). Those standards require the auditor to obtain sufficient evidence to express an opinion on whether the entity's financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles (GAAP). The financial statements are the responsibility of the company's management; the auditor is responsible for expressing an opinion on those statements.

1.4 Financial statement audits are performed by certified public accountants in the private sector who must be independent of the entities whose financial statements they audit. Whether audits should be performed in the private sector or by government auditors was debated during the Senate hearings that preceded the Securities Act of 1933, and the resulting decision to rely on the private sector has not been challenged seriously in the intervening seven decades.

1.5 Audits improve the reliability of financial statements, make them more credible and increase shareholders' confidence in them. Auditors constitute the principal external check on the integrity of financial statements. As former SEC Commissioner Steven M. H. Wallman has noted, "Without accountants to ensure the quality and integrity of financial information, the markets for capital would be far less efficient, the cost of capital would be far higher, and our standard of living would be lower."[1] Accordingly, a fundamental assumption underlying the Panel's study and recommendations is its belief that, for many reasons, the value of audits and the public's need for effective audits remain undiminished and in fact may be greater than ever before.

Efficacy of the Audit Process

1.6 Over the past few years, several major instances of misstated earnings resulted in headlines reporting massive declines in market capitalization. If share prices decline when companies' results fail to meet expectations, they decline even more precipitously when the market learns that previously issued audited financial statements are unreliable. This revelation frequently leads to restatements of those financial statements, suggesting that the financial reporting system may not, in fact, promote the most efficient allocation of capital. Restatements also raise the question, "Where were the auditors?" suggesting that there may be something wrong with the very concept of audits performed by private-sector auditors who are largely self-regulated.

1.7 At the same time, the SEC and others have expressed concerns about registrants' overreaching in terms of permissible accounting treatments, as well as about alleged accounting abuses involving such matters as accounting for business combinations, revenue recognition and restructurings, along with alleged misuse of the materiality concept. This overreaching often is characterized as "earnings management."

1.8 As a consequence, the SEC requested the POB to sponsor a thorough and objective examination of auditing, from top to bottom, in order to explore the efficacy of the audit process. In large part, the Panel was created in response to those concerns.

THE ENVIRONMENT AND THE AUDITING PROFESSION

1.9 The past decade has been one of unprecedented change in the global economy and capital markets. Key aspects of the current business environment include a globalized, highly competitive, expanding economy; explosive growth in the development and use of technology; dramatic increases in "new economy" service- and technology-based businesses with predominantly intangible assets; unparalleled expansion in the number of public entities; large increases in the number of individuals who directly or indirectly own equity securities; and unprecedented growth in the market value of those securities.

1.10 The growth in equity values over the past decade has introduced extreme pressures on management to achieve earnings, revenue or other targets. These pressures are exacerbated by the unforgiving nature of the equity markets as securities valuations are drastically adjusted downward whenever companies fail to meet "street" expectations. Pressures are further magnified because management's compensation often is based in large part on achieving

[1] S. M. H. Wallman, "The Future of Accounting and Disclosure in an Evolving World: The Need for Dramatic Change," *Accounting Horizons* (September 1995).

earnings or other financial goals or stock-price increases. These pressures on management, in turn, translate into pressures on how auditors conduct audits and in their relationship with audit clients.

1.11 The expanded use of technology in both the operating and financial systems of companies also has significantly affected the audit environment, forcing audit firms to recruit, train and deploy a large number of information technology specialists to support their audit efforts. It also has caused firms to reconsider their audit methods and techniques in an effort to harness technology to improve audit efficiency and effectiveness. Some have questioned, however, whether the increased efficiency may have come at the cost of reduced, not enhanced, effectiveness.

1.12 The technology explosion also has contributed significantly to the enormous growth in large audit firms' consulting practices, to the point where revenue from their audit practices has declined from 70% or more of total firm revenue 25 years ago to about half that today. This shift has led to concerns about the relative importance of the audit practice to firms and about auditor independence when significant non-audit services are performed for audit clients. These concerns come at a time when the importance of public confidence in auditing has never been greater.

1.13 Thus, examining the efficacy of the audit process alone is not the answer to assessing audit effectiveness. Understanding the environment in which audit firms operate and the factors that drive their business was an important feature of the Panel's efforts. Accordingly, the Panel studied not only how audits are conducted but also whether non-audit services provided to audit clients pose a threat to auditor independence and whether the system of governance of the auditing profession is adequate or in need of change.

THE PANEL'S APPROACH TO THE PROJECT

1.14 The Panel's investigation encompassed a wide range of activities. Its principal effort was its Quasi Peer Reviews (QPRs) – in-depth reviews of the quality of 126 audits of SEC registrants in 28 offices of the eight largest audit firms.[2] In addition to the engagement reviews, meetings with two focus groups were held in most of the 28 offices – one with seniors and the other with audit managers, most of whom work on audits of public companies. The QPR process also included in-depth interviews with the partner-in-charge of the office's audit practice. Panel members attended most of the QPRs, and the Panel staff planned and directed all of them. The QPRs are a major source of the Panel's findings and recommendations for improving the conduct of audits.

1.15 The Panel's other activities included:

- Meetings early in the project with the accounting and auditing leaders of each of the

[2] The eight largest firms are: Arthur Andersen LLP; BDO Seidman, LLP; Deloitte & Touche LLP; Ernst & Young LLP; Grant Thornton LLP; KPMG LLP; McGladrey & Pullen, LLP; and PricewaterhouseCoopers LLP (see Appendix B).

eight largest firms to gain an understanding of their audit methodologies, their views on the environment in which audits are performed and their views of the key issues requiring attention

- Eleven focus group meetings – one with chief financial officers and controllers, one with internal auditors, one with individuals who perform peer reviews of smaller firms and eight with representatives of the eight largest firms (each firm was represented in each focus group)

- A survey, distributed to over 500 selected individuals and organizations representing a wide range of constituencies, titled, "Request for Opinions on Issues of Audit Effectiveness Addressed to Thought Leaders and Key Stakeholders"

- Two days of public hearings before the Panel's findings and recommendations were formulated, at which individuals from 21 organizations testified, including the SEC, auditors, financial statement preparers, analysts, plaintiffs' and defendants' attorneys, standard setters and educators

- Reviews of the eight largest firms' audit methodologies, policies and procedures manuals and other guidance materials, information about their risk management and professional development activities, audit-related marketing publications, and policies and procedures for recruiting, evaluating, compensating and promoting audit personnel

- Meetings with representatives of the SEC and various private-sector bodies involved in the governance of the profession, such as the AICPA, ASB, SEC Practice Section (SECPS) Executive Committee, SECPS Peer Review Committee, SECPS Quality Control Inquiry Committee, POB and Independence Standards Board (ISB)

- Research, with the assistance of the SEC staff, into the causes and circumstances that led to recent SEC Accounting and Auditing Enforcement Releases involving the five largest firms or their clients

- Analysis of the academic, professional and regulatory literature on the effects of non-audit services on auditor independence

- Studies of the profession's current governance structure and analysis of alternatives

- Collection of information on recent international initiatives to strengthen audit effectiveness on a global basis

- Two days of public hearings on the May 31, 2000, Exposure Draft of the Panel's *Report and Recommendations* at which individuals from 18 organizations testified, including the SEC, auditors, state boards of accountancy, professional organizations, standard setters and educators

- Analysis of 42 comment letters on the Exposure Draft received from the preceding types of organizations as well as from analysts and public companies

These activities are discussed in greater detail in the other chapters of this report.

CHAPTERS CONTAINING FINDINGS AND RECOMMENDATIONS

1.16 This section describes how the Panel's findings and recommendations are organized in this report.

Improving the Conduct of Audits

1.17 Chapter 2, "Improving the Conduct of Audits," discusses the profession's standards that provide guidance on how audits of financial statements should be conducted, the Panel's findings on how those audits actually are conducted and the Panel's recommendations for improving the conduct of audits. Because of the importance of earnings management and fraud, a separate chapter is devoted to those subjects.

1.18 Chapter 2 includes an overview of the conceptual foundation for audits of financial statements, referred to as the "audit risk model," and the profession's standards underpinning audits of financial statements, referred to as "generally accepted auditing standards." These are important concepts for readers of this report because they provide the context for the qualitative assessments made in the QPR. The QPR itself tracked the audit risk model created by the ASB to drive the auditor's decision-making process, and it focused on certain important audit areas, notably, assessing inherent and control risks (including clients' use of technology), analytical procedures, auditing revenue, auditing estimates and judgments, considering materiality and waived adjustments, and detecting fraud.

1.19 Each of the audit areas is addressed individually. The findings from the QPR and the Panel's analysis of them, together with information gathered from its other activities, form the basis for its recommendations. In large part, those recommendations are derived from three major themes:

- Definitive auditing standards form the starting point for promoting quality audits.

- Audit firms need comprehensive and vigorous audit methodologies, based on the standards, to drive the behavior of their auditors to a higher plane.

- The peer review process is a critical element in "closing the loop" to provide assurance to the public that audit performance measures up to high standards and continues to improve.

1.20 There are three major constituencies to whom the recommendations for improving the conduct of audits are made, namely, the ASB, the firms that audit the financial statements of public entities and the SEC Practice Section of the AICPA. (In certain areas, recommendations also have been made to the SEC, the AICPA, the POB, the Financial Accounting Standards Board and audit committees.)

1.21 The Panel also discusses its conclusions about the appropriateness of the audit risk model, and it provides recommendations to the ASB on establishing auditing standards and to the ASB and the POB on the priorities, timetable and process for addressing the Panel's recommendations.

Earnings Management and Fraud

1.22 Chapter 3, "Earnings Management and Fraud," focuses on the auditor's responsibility with respect to earnings management and fraud. It discusses the profession's standards that define fraud and that provide guidance to the auditor on detecting fraud. It also explores the concepts of earnings management and the quality of earnings, and how earnings management may lead to or constitute fraud.

1.23 The QPR findings in the areas of fraudulent financial reporting and misappropriation of assets are provided, and the Panel's broader consideration of fraud is described. Importantly, the Panel discusses certain perspectives about the responsibilities of auditors and others that it took into consideration in framing its recommendations. The recommendations are addressed to the ASB, audit firms, the SEC Practice Section of the AICPA (more specifically to the SECPS Peer Review and Quality Control Inquiry Committees) and audit committees.

Audit Firms

1.24 Chapter 4, "Audit Firms," addresses the Panel's study of the overall professional leadership in the audit firms (the "tone at the top"), the professional development of auditors (both collegiate and continuing professional education), the performance measures the firms use to evaluate audit personnel, time pressures on auditors and other issues. The Panel focused primarily, but not exclusively, on the eight largest firms.

1.25 The Panel's findings and recommendations to audit firms fall into four areas: professional leadership – tone at the top; professional development; personnel management; and time pressures on auditors. The Panel also makes certain recommendations to the AICPA designed specifically to benefit smaller firms.

Auditor Independence

1.26 Chapter 5, "Auditor Independence," discusses the historical background and evolution of non-audit services by audit firms, and the potential for conflict when an auditor provides such services to a public audit client. It addresses the process for assessing the effects of non-audit services on audits, including the findings from the QPR. The Panel's wide-ranging perspectives about the issue of non-audit services also are discussed, and statements of views supporting and opposing an exclusionary ban on non-audit services to public audit clients are provided. Finally, the subject of former firm personnel in client management is discussed and the Panel's findings are disclosed.

1.27 The Panel makes recommendations to the SEC, the ISB and audit committees with respect to the provision of non-audit services to public audit clients.

Governance of the Auditing Profession

1.28 Chapter 6, "Governance of the Auditing Profession," describes the auditing profession's current governance system, the limitations of that system and the Panel's recommendations for strengthening it. It also discusses briefly the current relationship between the profession and the SEC.

1.29 The Panel's recommendations are addressed to a number of constituencies, including most importantly the POB, which appointed the Panel. Other constituencies to whom recommendations are addressed include the AICPA, ISB, SEC Practice Section and SEC.

International

1.30 Chapter 7, "International," describes how the Panel's project sought information on issues of audit significance from a global perspective. However, the Panel did not make a comprehensive review of audit effectiveness on a global basis.

1.31 The chapter focuses on audit firms and the international organizations that play key roles in the international setting. The goal of transparency is discussed. Recent developments in international accounting standards, auditing, regulation and the governance of the profession are described. The Panel makes recommendations to the International Federation of Accountants relating to the global self-regulatory structure of the international auditing profession and to audit firms. It also makes a recommendation to the ASB and the International Auditing Practices Committee.

Looking Ahead

1.32 Chapter 8, "Looking Ahead," contains the Panel's vision about some issues that pose a challenge to the auditing profession's development in the years ahead and some final thoughts.

BENEFITS AND COSTS

1.33 The Panel believes that its recommendations are necessary to improve audit effectiveness. However, it recognizes that implementing those recommendations will increase audit costs for most entities. The Panel expects that those to whom the recommendations are addressed will attempt to analyze the added benefits and costs, when practicable.

1.34 The benefits of more effective audits include improving the reliability of financial statements, enhancing the credibility of and investors' confidence in those financial statements, improving management decision making, lowering entities' cost of capital, and increasing the effectiveness of the capital markets in allocating resources. More effective audits also deter misstatements in financial reporting. Therefore, the benefits also include reducing the costs of investigating fraudulent financial reporting and prosecuting its perpetrators, reducing litigation and related costs to both auditors and their clients, reducing the costs of both public and private regulatory systems aimed at preventing fraudulent financial reporting, and reducing the billions of dollars in losses incurred by those who have invested in entities that have issued fraudulent financial reports.[3] Finally, more effective audits also should enhance the "reputational capital" of audit firms.

1.35 The Panel has not tried to quantify the benefits of implementing its recommendations to increase audit effectiveness, nor does it believe that such an analysis is feasible. Many of those benefits are in the nature of foregone costs, improved self-regulation of the profession, more effective resource-allocation decisions, and clients' reduced costs of capital. None of these factors is measurable.

1.36 The costs of more effective audits include developing, applying, maintaining, monitoring and enforcing policies and procedures to enhance effectiveness. Thus, implementing the Panel's recommendations includes the costs of additional audit procedures and of enhancing the profession's system of self-regulation – for example, the expenses of the POB to strengthen its role in the governance of the profession and the costs of the ASB to develop new or revised auditing standards. Also, firms will incur costs to develop related guidance and train personnel in the new standards.

1.37 Some of those costs may be measurable – for example, the costs incurred by standard-setting and oversight bodies in implementing the Panel's recommendations. Some costs are non-recurring, and some may be offset at least in part by eliminating ineffective or unnecessary audit procedures or using technology more effectively.

1.38 While recognizing that difficult issues arise when assessing benefits and costs, the Panel believes that the benefits to the public and to other participants in the financial reporting process from implementing its recommendations, and thereby enhancing audit effectiveness, will justify the additional costs, producing a net benefit over time to all participants.

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[3] For example, at the Panel's public hearings in July 2000, the SEC noted that, based on amounts reported in *Public Accounting Report,* audit fees for the top seven firms were approximately $9.5 billion in 1999, while CNBC reported in 1999 that investors lost $32 billion as a result of restatements of the financial statements of five companies. (The Panel recognizes that the amounts of any losses will vary significantly from year to year and that the $32 billion is not a representative or average amount of annual losses.)

CHAPTER 2 – IMPROVING THE CONDUCT OF AUDITS

2.1 This chapter discusses the profession's standards that provide guidance on how audits of financial statements should be conducted, the Panel's findings on how those audits actually are conducted and the Panel's recommendations for improving the conduct of audits. Because of their importance, Chapter 3 is devoted in its entirety to the Panel's analysis, findings and recommendations regarding earnings management and fraud.

OVERVIEW

2.2 This section provides an overview of the audit risk model, explains the Panel's Quasi Peer Review (QPR) approach to assessing the effectiveness of audits, states the Panel's broad conclusions and presents its framework for developing recommendations to improve the quality of audits.

The Audit Risk Model

2.3 Starting in 1948, the membership of the American Institute of Certified Public Accountants (AICPA) adopted 10 statements referred to as "generally accepted auditing standards" (GAAS). The Auditing Standards Board (ASB), a senior technical committee of the AICPA, has been assigned the responsibility for amplifying and interpreting the 10 GAAS through pronouncements called Statements on Auditing Standards (SASs). The SASs and the 10 GAAS statements frequently are referred to collectively as generally accepted auditing standards.

2.4 GAAS fall into three broad areas: general standards (dealing with the professional qualities of auditors, including technical training and proficiency, independence and the exercise of due professional care), standards of fieldwork (dealing with planning and supervision, internal control, and sufficiency and competency of audit evidence), and standards of reporting (dealing with how GAAS are linked to "generally accepted accounting principles" (GAAP) and the consistent application of GAAP, the adequacy of disclosures in financial statements and the expression of opinions in audit reports).

2.5 The ASB has established a formal process for developing standards, including subjecting them to public scrutiny prior to issuance. Rule 202 of the AICPA's Code of Professional Conduct requires AICPA members to adhere to GAAS. Adherence to GAAS also is required of auditors by state accountancy laws and the Securities and Exchange Commission (SEC). Consequently, GAAS apply to all audits, not just to audits of financial statements of public entities.

2.6 United States auditing standards, which reputedly are the most comprehensive and demanding auditing standards in the world, generally call for auditors to achieve certain goals or objectives in carrying out an audit. In some cases, the standards require auditors to perform specified tasks (e.g., assess risk). In other cases, they require auditors only to consider attendant circumstances in deciding what to do. They typically allow wide latitude for auditors to exercise judgment. This flexibility is understandable. The standards are designed for audits of financial statements of large and small entities in all industries, and they are premised on auditors being professionals who possess the necessary skills and knowledge to make the required judgments.

2.7 GAAS include an "audit risk model" for carrying out audits that requires auditors to use their judgment in assessing risks, selecting an audit approach and deciding what tests to perform.[1] The model allows auditors to take a variety of circumstances into account in selecting the audit approach for a particular engagement. The model calls for auditors to have an understanding of the entity's business and industry, the systems employed to process transactions, the quality of personnel involved in accounting functions, and the entity's policies and procedures related to the preparation of financial statements. The model requires auditors to gain an understanding of an entity's internal control to assess the risk that controls will fail to prevent or detect material financial statement error and fraud, and to test the effectiveness of those controls that the auditor intends to rely on in designing and performing substantive tests of the entity's accounts. For example, if internal control over sales and accounts receivable is strong, the auditor might confirm a limited number of accounts receivable at an interim date and rely on the controls and certain other tests for updating the accounts to year end. Conversely, if controls are not strong, the auditor might confirm a larger number of accounts receivable, and do so at year end.

2.8 Based on the auditor's assessment of various risks, supported by appropriate tests of controls, the auditor makes judgments about the kinds of evidence (from sources that are both internal and external to the entity's organization) needed to support the audit opinion. On the one hand, GAAS set forth numerous requirements or matters that auditors should consider, such as an explicit requirement to assess the risk of fraud; on the other hand, the need to exercise professional judgment is embedded throughout GAAS.

The QPR Approach to Assessing Audit Effectiveness

2.9 The Quasi Peer Review undertaking was an important, but not the only, part of the Panel's assessment of audit effectiveness.[2] The QPR reviewed the audits of 126 SEC public companies in 28 offices of the eight largest audit firms. The engagements were selected on the basis of risk profiles established by the Panel for the purposes of:

- Assessing the quality of the audit work performed in specific key areas

- Assessing whether the individuals who performed and reviewed the work had the necessary knowledge, skills and experience

[1] A complete discussion of the audit risk model is included in Appendix A. That discussion provides an overview of the model, a technical briefing about it and a historical perspective about how the model evolved in GAAS. Also in Appendix A is a discussion about the audit methodologies used by audit firms to guide their work and how those methodologies have evolved over time.
[2] The QPR approach is discussed more fully in Appendix E.

- Assessing whether the work was performed appropriately and reviewed on a timely basis

- Developing ideas for enhancing audit effectiveness

2.10 The objectives and scope of the QPR differed from those of the peer review that a member of the SEC Practice Section (SECPS) of the AICPA must undergo triennially. The objectives of an SECPS peer review are to evaluate whether the reviewed firm's quality control system for its accounting and auditing practice met the objectives of the AICPA's quality control standards, and whether the firm complied with the system and with the SECPS membership requirements.[3] The QPR's objective, on the other hand, was to make qualitative assessments of audit effectiveness on a sample of recent audit engagements. The QPR generally tracked key elements of the audit risk model, providing the basis for evaluating its efficacy.

2.11 The scope of the QPRs also differed from that of SECPS peer reviews. For example, the QPRs included more interviews with engagement personnel; they were limited to certain specific key areas of the audit; and no reports or letters of comments were issued. In the specific areas reviewed, however, the reviews were more in-depth and subjective.

2.12 The QPR results are discussed in this and the following chapter under the following headings:

- Assessing engagement risk
- Assessing inherent risk
- Multi-location audits
- Assessing control risk
- Communicating and reporting on internal control
- Linking the risk assessments to substantive tests
- Analytical procedures
- Auditing revenue
- Auditing estimates and judgments
- Materiality, waived adjustments and analysts' expectations
- Going concern considerations
- Internal auditors
- Communicating with audit committees
- Earnings management and fraud

2.13 For each engagement selected for review, the QPR reviewers probed into the engagement team's risk assessment processes. The reviewers also selected three or four key risk areas at the specific account or class of transactions level for in-depth evaluation. Those evaluations covered the assessment of inherent, control and fraud risks, and how those assessments were linked to the

[3] Peer reviews are described in Appendix C.

substantive tests performed by the engagement team. The reviewers also assessed the design and performance of substantive tests. In addition to the key risk areas, they addressed the use of analytical procedures in five additional audit areas on each engagement. They also probed into how the audits were completed, including how engagement teams considered their audit findings and resolved issues. The QPR also evaluated how the auditors interacted and communicated with the entities' audit committees.[4]

Findings and Conclusions

2.14 The Panel is satisfied that the audit risk model is appropriate, but needs enhancing and updating. It embraces judgment in an organized and logical way. Input from the Panel's survey and other activities disclosed that the model is widely accepted, although some evidence suggested that the model is somewhat out-of-date and inconsistently implemented. Some participants suggested that the model is out-of-date for purely technical reasons, such as its failure to include the concept of engagement risk, its not clearly including fraud risk within the concepts of inherent risk or control risk, and because it does not adequately address the greater uncertainties resulting from increasingly complex transactions and events and the accounting for them. Others suggested that the model is not sufficiently specific and rigorous, does not call for a deep understanding of business processes and related risks, and thus cannot be applied consistently. Still others suggested that the model should drive more procedures directed at the detection of fraud. Some also believed that the concept of materiality in the model is too vague, both in how it is applied in planning audits and how it is used in evaluating audit results. Lastly, others believed that the model is linked too closely to audits of historical financial statements to accommodate an expanded notion of assurance services that contemplates providing assurance about many other kinds of information, in some cases on a continuous basis.

2.15 The Panel's recommendations to improve audit effectiveness are designed to enhance the audit risk model and promote its consistent application in financial statement audits. In the Panel's view, the recommendations do not call for a wholesale abandonment of the model, although some of them may be perceived as significantly modifying it. The recommendations are addressed to the constituencies that the Panel believes are in the best position to implement them. In the final analysis, however, the Panel recognizes that it is the conscientious performance of individual auditors that most contributes to audit effectiveness.

2.16 The Panel is confident that its recommendations will meet both the current needs of investors for assurances on financial statements and their needs for the foreseeable future. At the same time, the Panel recognizes that unprecedented changes are taking place in the global economy and capital markets, and that auditing standards and audit firms' methodologies will change as investors' needs for assurances on financial and non-financial information evolve. However, the Panel believes that many of its recommendations will enhance and update the audit risk model and provide a solid foundation for addressing the future needs of the marketplace.

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[4] The QPR was designed to provide a qualitative assessment of audit effectiveness; it was not designed to identify instances of non-compliance with specific standards or firm policies. Certain matters, resulting from QPR reviewers' disagreements with the quality or sufficiency of the work of an engagement team, were referred to the audit firm for appropriate follow-up.

2.17 Overall, the findings from the QPRs were favorable and did not support the view that audits are being conducted in an ineffective manner. Notwithstanding the generally positive QPR results and the Panel's conclusions about the appropriateness of the audit risk model, the Panel believes that audits should be strengthened in a number of important ways. In its analysis of the quality of audits and how audits should be improved, three major themes emerged:

- First, definitive auditing standards form the starting point for promoting quality audits.

- Second, audit firms need comprehensive and vigorous audit methodologies, based on the standards, in order to drive the behavior of their auditors to a higher plane.

- Third, the peer review process is a critical element in "closing the loop" to provide assurance to the public that audit performance measures up to high standards and continues to improve.

From these three themes, the Panel created a framework for developing its recommendations.

A Framework for Developing Recommendations

2.18 The Panel's framework for developing recommendations to improve the conduct of audits consisted of identifying the areas where the Panel believed improvements were desirable and specifying the key constituencies that are best able to carry out its recommendations.[5] Those key constituencies are:

- the Auditing Standards Board
- the firms that audit the financial statements of public entities
- the SEC Practice Section of the AICPA

2.19 The ASB promulgates auditing standards and quality control standards that auditors and their firms are required to follow in their accounting and auditing practices. Those standards measure the quality of performance that auditors should adhere to in conducting their audits and that firms should follow in conducting their practices. The audit firms obtain the clients; hire, train, develop and provide career opportunities for their personnel; and develop audit methodologies and quality control systems to help ensure that audits are performed in accordance with professional standards. The SECPS establishes requirements for its members. The SECPS Peer Review Committee determines whether the firms follow the quality control standards in their accounting and auditing practices and the auditing standards in the conduct of their audits, and thus serves to "close the loop" between the standards and the way audits

[5] The Panel's recommendations to improve the conduct of audits also include some that are addressed to constituencies that did not fall precisely in its framework. In certain areas, recommendations have been made to the SEC, the AICPA, the Public Oversight Board, the SECPS Quality Control Inquiry Committee, the Financial Accounting Standards Board and audit committees.

actually are performed. The activities of the SECPS are overseen by the Public Oversight Board (POB) to further ensure that the system functions as intended.

2.20 The recommendations to the various constituencies in the ensuing sections of this chapter and in Chapters 3 and 4 are based principally on the Panel's QPR findings, together with knowledge gained from its survey (Appendix H), public hearings and comments on its Exposure Draft (Appendices I, N and O), focus groups and interviews (Appendix G), reviews of firms' methodologies (Appendix J), research and analysis of cases of alleged audit failures (Appendix F) and other investigative and deliberative activities.

2.21 Thus, the Panel's recommendations spring from a variety of sources. They are intended to foster wider use of "best practices" that the Panel has identified, as well as suggest improvements for perceived deficiencies.[6] For example, some of the recommendations to the ASB call for enhancing professional standards to recognize practices that are widely, although not universally, applied. Similarly, some of the recommendations to audit firms are designed to bring the quality of all firms' internal guidance up to a "best practices" level.

2.22 The Panel believes that each of its recommendations is individually important, but also that they need to be viewed in their totality. Recommendations addressed to only one constituency are less likely to lead to major changes in how audits are conducted; action by all constituencies is necessary to assure the public that the recommendations will achieve their objectives.

Auditing Standards Board

2.23 Many of the Panel's recommendations to the ASB in specific areas suggest the need to examine existing auditing standards critically, with the objective of revising or replacing some or all of them with more specific and definitive guidance containing imperatives to guide auditors in formulating their judgments and carrying out their work. (Some of the recommendations to the ASB seek to make its quality control standards similarly more specific and definitive.) In so doing, the ASB should not pay blind homage to the current audit risk model when there are more useful or practical alternative approaches.

2.24 A call for standards that provide specific and definitive guidance is not a call for standards that diminish or remove the need for auditor judgment. Nor is it a call for standards that incorporate detailed checklists of auditing procedures. A good example of an existing standard that the Panel believes contains a specific and definitive imperative is found in the section of SAS No. 67, *The Confirmation Process,* titled "Confirmation of Accounts Receivable."[7] In fact, a number of the Panel's recommendations call for auditors to make explicit judgments in areas where they may not always be doing so.

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[6] The QPR reviewers were instructed not to limit themselves to the engagement team's compliance with the firm's policies or professional standards, but also to indicate strong points and best practices observed in the areas reviewed. See Appendix E.

[7] This aspect of SAS No. 67 is discussed in this chapter under "Linking the Risk Assessments to Substantive Tests," under the caption "*Substantive Tests.*" In this case, the imperative is stated as a presumption that the auditor will request confirmation of accounts receivable.

2.25 By observing that the ASB need not adhere to the current audit risk model, the Panel implicitly recognizes the potential for changes to that model to promote audit effectiveness and meet the ever-changing needs of the auditing profession. The ASB should not feel constrained to follow a model that is inflexible and incapable of being adapted to meet emerging needs or new business conditions. For now, however, the Panel's evaluation of the audit risk model essentially supports its continuation, as enhanced and updated by the Panel's recommendations.

2.26 A major objective of auditing standards should be to help audits serve not only to detect material fraud but also, by being perceived as rigorous, to deter fraud from occurring in the first place. Toward that end, the Panel recommends that auditing standards require auditors to possess a far deeper understanding of the entity's business processes, risks and controls, and that substantive tests with the principal objective of detecting material financial statement fraud be designed and performed on all audits.

2.27 The Panel believes that the ASB, with its access to staff and volunteer resources with information technology expertise and its contacts with the academic community, could act as a catalyst for identifying how technology might facilitate and improve the audit process. Research efforts in partnership with audit firms and academia might lead to breakthrough ideas that could benefit the auditing profession. The Panel encourages the ASB to pursue this suggestion.

Audit Firms

2.28 Many of the Panel's recommendations in specific areas suggest that audit firms need to undertake substantive efforts to reestablish the importance of the role of independent auditors within their organizations and thereby reinvigorate their audit practices. They should provide guidance to their audit personnel that is specific and definitive and should focus more on training audit personnel in the methodologies that support their audit practices (including how to both use technology and audit their clients' use of it). Audit firms should embed intolerance for audit failures in their cultures. The concept of professional skepticism should be taught effectively and the role of auditors in the detection, and implicitly in the deterrence, of fraud reinforced.

2.29 Definitive professional standards and well-conceived firm policies, procedures, guidance materials, practice aids and audit training programs must be accompanied by a strong commitment by the audit firms to make continuous improvements in their processes and strive to meet the goal of "zero defects." The firms' leaders should convey a tone of high professionalism as the principal message to their auditors and should develop systems for incentives, compensatory rewards and penalties, and promotions that not only mirror the tone but also make it a reality.

SEC Practice Section of the AICPA

2.30 Many of the Panel's recommendations reflect a belief that the SECPS should be the source of both leadership and specific guidance to audit firms in the effort to strengthen their quality controls. Only with specific guidance can peer reviewers effectively assess compliance with quality control standards. The SECPS Peer Review Committee should make its peer reviews of firms not only more frequent, but also more rigorous.[8] The role of peer review in a program of continuous improvement of audit effectiveness should be given high priority. The SECPS's role in providing assurance that audits are being conducted effectively, with appropriate oversight by the POB, is critical to maintaining the profession's right to regulate itself.

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2.31 The remainder of this chapter and Chapter 3 discuss the Panel's findings from the QPR process. Generally, for each specific audit area, there is an overview of the requirements of GAAS, the significant findings from the QPR and how the Panel considered them, and the Panel's recommendations. Not all aspects of the audits that were reviewed in the QPR process or all the qualitative assessments made by the QPR reviewers are discussed in detail, although all of the findings were reviewed and considered by the Panel.

ASSESSING ENGAGEMENT RISK

2.32 SAS No. 47, *Audit Risk and Materiality in Conducting an Audit,* notes that "in addition to audit risk, the auditor is also exposed to loss or injury to his or her professional practice from litigation, adverse publicity, or other events arising in connection with financial statements audited and reported on." This exposure, often referred to as "engagement risk," is not part of the audit risk model. It is present even though the auditor has performed the audit in accordance with GAAS and reported appropriately on the financial statements. Engagement risk usually is assessed as part of the audit firm's client acceptance and continuance procedures.

Requirements in Statements on Quality Control Standards (SQCS)

2.33 Client acceptance and continuance is one of the five elements of quality control identified in SQCS No. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice,* issued by the Auditing Standards Board.[9] The client acceptance and continuance process should be designed to provide the firm with reasonable assurance that the likelihood of association with a client whose management lacks integrity is minimized.

2.34 The process ordinarily is designed to enable the engagement team to identify and consider the risks associated with the overall engagement – such as the risk that the entity will fail, the risk that the entity's management lacks integrity, the risks inherent in the entity's industry, and the capabilities and track record of senior management – and then to use the resulting information to make an engagement risk assessment. The risks, individually and in the aggregate (or the absence of risks), also should affect the inherent, control and fraud risk

[8] Panel recommendations to the SECPS Peer Review Committee also are made under "Enhancing Peer Reviews" in Chapter 6.
[9] The ASB issues both SASs and SQCSs. Auditing standards relate to the conduct of individual audit engagements, while quality control standards relate to the conduct of a firm's audit practice as a whole. Firms that are members of the SECPS must adhere to the quality control standards as well as the SECPS membership requirements.

assessments discussed in subsequent sections of this and the following chapter, and in turn the nature, timing and extent of the auditor's tests.

2.35 The QPR examined the engagement risk assessment made during the client acceptance and continuance process and the specific actions, if any, taken to address the identified risks.

Findings

2.36 The QPR reviewers generally agreed that the engagement risk assessments (e.g., high, moderate or low) by the audit engagement teams were appropriate, that the thought processes applied in determining the engagement risk assessments and the specific actions to be taken were thorough and gave appropriate consideration to the appropriate factors, and that the right people, namely, partners, were involved in the process. The reviewers also generally agreed with the specific actions taken to address the specific risks identified; that the right people developed, reviewed and approved those actions; that they were completed effectively and in a timely manner by the right people; and that the working papers adequately documented the actions taken and the results.

2.37 All eight firms included in the QPR consider client acceptance and continuance, including the engagement risk assessment, to be a key element of their quality control system and risk management efforts. They all devote substantial attention to it at high levels within the firm. The firms have strengthened their policies and procedures in this area in recent years, and some have improved their processes by computerizing them. Computerization generally has enabled a firm to improve its abilities to identify the risks associated with potential and current clients and to monitor compliance with its policies more effectively. In addition, computerization has enabled high-level risk management personnel to be involved in client acceptance and continuance decisions on a more timely basis.

2.38 The Panel observed that some of these computerized systems are highly developed and involve both quantitative and qualitative factors, including a search for potentially derogatory or other information about the entity and its principal owners and officers. These systems require various levels of consultation and approvals depending on the particular circumstances, for example, the calculated "risk score," and they are monitored electronically to ensure that required procedures are completed in a timely manner. These systems also are integrated into the audit itself. Information regarding any significant risk factors that are identified and the action plans for dealing with them is included in the audit working papers and considered by the engagement team when planning and performing the audit.

Recommendations

To audit firms:

2.39 The Panel recommends that audit firms consider adopting sophisticated, computerized systems for identifying engagement risk that involve both quantitative and qualitative factors, including a search for potentially derogatory or other information about the entity and its principal owners and officers, and integrating those systems into their audits.[10] A cooperative effort by the firms to share best practices should facilitate implementing this recommendation.

ASSESSING INHERENT RISK

Overview of GAAS

2.40 SAS No. 47 defines inherent risk as "the susceptibility of an assertion to a material misstatement, assuming that there are no related controls."[11] The risk of misstatement is greater for some assertions and related account balances and classes of transactions than for others. For example, complex calculations are more likely to be misstated than simple ones. Cash is more susceptible to theft than an inventory of coal. Accounts consisting of amounts derived from accounting estimates pose greater risk of error than do accounts consisting of relatively routine, factual data.

2.41 External factors also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be reported at more than its net realizable value. In addition to factors that are unique to a specific assertion for an account balance or class of transactions, some factors may relate to various assertions for several or all of an entity's account balances or classes of transactions. These latter factors are referred to in this report as overall inherent risk factors and include, for example, a lack of sufficient working capital to continue operations, a declining industry characterized by a large number of business failures, aggressive analysts' forecasts and management compensation that is largely performance based.

2.42 SAS No. 47 notes that the auditor needs to have an understanding of inherent risk and an appropriate basis for assessing it below the maximum. The SAS does not specify the depth of knowledge necessary or require the auditor to perform any activities or procedures to assess inherent risk. Furthermore, it does not specify the depth of knowledge, activities or procedures necessary to assess inherent risk below the maximum, as in the case of control risk. Also, SAS No. 47 indicates that the auditor should assess inherent risk at the maximum when designing audit tests if he or she concludes that the effort required to assess inherent risk below the maximum for an assertion would exceed the potential reduction in audit procedures derived from such an assessment.

Findings

2.43 The QPR reviewers determined who performed and reviewed the inherent risk assessments both at the overall financial statement level and for each of the key areas selected. They also considered the appropriateness of the risk assessments and how they were made.

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[10] In Chapter 4, the Panel recommends that the AICPA develop, or promote the development of, a technology-driven tool that small firms can use to enhance the effectiveness of their client acceptance and continuance processes.

[11] The auditing literature defines an assertion as a representation by management that is embodied in a financial statement component. The five assertions are existence or occurrence, completeness, rights and obligations, valuation or allocation, and presentation and disclosure.

2.44 The reviewers generally agreed with both the overall inherent risk assessment and the inherent risk assessments at the specific account or class of transactions level. They also agreed that, in general, the people involved in those assessments had the appropriate knowledge and skills, that they gave appropriate consideration to the various factors and that the right people reviewed the assessments at the right time. The assessments generally were made at an appropriate level (e.g., the assertion level for account balances and classes of transactions). While generally expressing their agreement, some reviewers nonetheless indicated a need for improvements in this area.

2.45 In recent years, the eight firms that participated in the Panel's QPR have made efforts to provide their audit personnel with significant industry and entity-specific information (often in the form of electronic databases). They also have been increasing their emphasis on how the auditor's understanding of the entity's business and industry can be enhanced, for example, by interviewing entity personnel outside of the accounting and finance functions. Many of the participants in the focus groups spoke enthusiastically about these developments. The Panel applauds these efforts and believes they should assist auditors in making better inherent risk assessments. The Panel also believes that all auditors would benefit from similar efforts.

2.46 Moreover, the Panel believes that the professional standards, guidance and practices with respect to assessing inherent risk need strengthening, given the increasing emphasis on inherent risk assessments in determining the nature, timing and extent of audit tests.[12] For example, SAS No. 47 currently permits the auditor to assess inherent risk with respect to a particular account or class of transactions as a whole, rather than requiring the auditor to make the risk assessment at the assertion (or lower) level by considering what could go wrong. The Panel believes that it is not sufficient merely to indicate that inherent risk with respect to revenue recognition, for example, is high or at the maximum. Rather, the auditor should be required to determine precisely why it is "high" (e.g., as a result of the complexity of sales terms, potential cutoff problems, "channel stuffing," understated deferred revenue, or side agreements permitting rights of return if the goods are not sold). The Panel believes that such a requirement would better prepare the auditor to select and perform the appropriate tests of controls and substantive tests.

2.47 Also, by assessing inherent risk at the maximum because it is more efficient to do so, the auditor may design substantive tests without fully understanding what could go wrong. In so doing, the auditor unintentionally may omit certain important audit tests and assume a higher level of detection risk than is intended or appropriate. Requiring a level of knowledge even for an assessment at the maximum, and specifying the types of activities or procedures necessary to assess inherent risk below the maximum, also could help prevent similar results.

[12] For example, the Panel noted during its study of SEC Accounting and Auditing Enforcement Releases (AAERs) (see Appendix F) several instances in which the entity's inherent risk apparently increased as a result of significant changes in its business (e.g., the loss of a major customer or the existence of a new competitor with a better, cheaper product) and the auditors apparently did not assess accurately how those changes increased inherent risk.

Recommendations

To the Auditing Standards Board:

2.48 The Panel recommends that the ASB:

- Require the auditor to make inherent risk assessments for significant account balances and classes of transactions by considering what could go wrong at the individual assertion level

- No longer permit the auditor to default to assessing inherent risk at the maximum for efficiency or other reasons without considering what could go wrong in specific financial statement assertions

- Provide additional guidance regarding the factors that affect inherent risk, including the entity's business processes and risks, and the depth of the auditor's understanding of those factors[13]

- Indicate the depth of auditor knowledge and the nature of activities or procedures (and provide some examples of such activities or procedures) that the auditor might perform to support assessing inherent risk (at both the financial statement and account or class of transactions levels) below the maximum

To audit firms:

2.49 The Panel recommends that audit firms:

- Review and ascertain whether they need to augment their policies and guidance on assessing inherent risk, for example, to cover the types of matters described in the recommendations to the ASB

- Require that a partner be actively involved in making inherent risk assessments at both the overall financial statement level and the assertion level for significant account balances and classes of transactions

- Require that the inherent risk assessments for high-risk clients be reviewed by the concurring partner or an industry expert before the related tests of controls and substantive tests are designed and performed

[13] The Panel is aware that a Joint Working Group (JWG) made up of representatives from large accounting firms, auditing standard setters and academics submitted to the International Auditing Practices Committee (see Chapter 7), the Assurance Standards Board of the Canadian Institute of Chartered Accountants, the Auditing Practices Board of the United Kingdom and Ireland, and the ASB in May 2000 a paper containing recommendations arising from a study of recent developments in the audit methodologies of the largest accounting firms. The JWG suggests that a greater business risk orientation by auditors might benefit audit quality, and the ASB may wish to evaluate its suggestions.

- Review their training materials on assessing inherent risk and ascertain whether they need to be augmented, in terms of either the time devoted to the subject or the materials used, such as by "real-life" case studies on assessing inherent risk. The training should reinforce the need for every engagement team to take the necessary time to gain a thorough understanding of the entity's business and industry and do a thorough job of assessing inherent risk, at both the overall financial statement level and the assertion level for significant account balances and classes of transactions.

To the SECPS Peer Review Committee:

2.50 The Panel recommends that the SECPS Peer Review Committee:

- Request that peer reviewers evaluate the adequacy and extent of implementation of firms' methodologies, guidance and training materials relating to assessing inherent risk

- Include items in the peer review questionnaires that address the appropriateness of the inherent risk assessments made, whether they were made at the appropriate financial statement levels, who made and reviewed them, and whether they were made and reviewed on a timely basis

- Request that peer reviewers include their findings in this area in their reports to the SECPS Peer Review Committee

MULTI-LOCATION AUDITS

Overview of GAAS

2.51 SAS No. 47, as amended by SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, requires that the auditor consider the extent to which audit procedures should be performed at selected locations or components of an entity with operations in multiple locations or with components. The auditor's identification of the specific locations or components is an important outcome of the risk assessment process. Auditing standards provide examples of the inherent and control risk factors an auditor should consider when selecting the particular locations or components to visit, such as the materiality of the location, the effectiveness of the entity's control environment, and the frequency, timing and scope of monitoring activities by the entity or others at the location. The decisions regarding which locations or components to visit and how much audit work to perform at each of them can be complex, especially in audits of large multi-national entities with numerous businesses in many countries. These decisions on the scope of work in an audit are integral elements in the application of the audit risk model.

2.52 The first standard of fieldwork requires that audit personnel be properly supervised. SQCS No. 2 requires firms to establish policies and procedures to provide reasonable assurance that the work performed by engagement personnel meets applicable professional standards, regulatory requirements and the firm's standards of quality. This includes firm personnel who perform work at all locations, including foreign locations. Developing an appropriate structure for supervising personnel on large, multi-location engagements requires careful consideration by experienced personnel.

2.53 The SECPS *Standards for Performing and Reporting on Peer Reviews* (Peer Review Standards) require that peer reviews cover the supervision and control, in accordance with U.S. professional standards, of any work on segments performed by U.S. and foreign offices or by domestic or foreign affiliates or correspondents.[14] The Peer Review Standards also specify certain matters regarding work performed at other locations that should be documented in the working papers of the auditors in charge of the overall engagement. Such matters include the independence of the auditors at the other locations; how the auditors in charge of the overall engagement obtained reasonable assurance that the auditors at the non-U.S. locations are familiar with GAAS, GAAP and SEC regulations; and the procedures performed and conclusions reached when the auditors in charge of the overall engagement visited other locations.

Findings

2.54 The QPR reviewers were directed to address certain matters when the engagement involved an entity with significant facilities or operations that either were not audited or were audited by individuals who were not under the direct supervision of the engagement team whose work was being reviewed. The reviewers probed into the audit procedures, if any, performed at each location and the supervision and control that the auditors in charge of the overall engagement exercised over the work performed at other locations.

2.55 With one exception, which was addressed appropriately by the firm involved, the QPR reviewers agreed with the engagement teams' determination of the audit procedures to be performed for each location and the scope of those procedures. The reviewers also agreed that: the people involved in determining the audit procedures, if any, for each location had the appropriate knowledge and skills; the engagement partners were involved in a substantive, timely manner in the decision-making processes; and the engagement teams' supervision and control of the work performed at the various locations were adequate to provide reasonable assurance that the audits complied with GAAS (including complying with GAAS in audits conducted outside of the United States).

2.56 The Panel noted that there is little specific guidance in the professional literature on the appropriate audit coverage in a multi-location audit. The Panel believes there should be additional guidance in view of the increasing growth and globalization of many entities.[15] The

[14] The Peer Review Standards are issued by the SECPS Peer Review Committee and provide guidance on performing and reporting on peer reviews that are intended to meet the SECPS membership requirements.

[15] The Panel noted during its study of AAERs (see Appendix F) several instances of material fraud, sometimes fraudulent financial reporting and other times misappropriation of assets, at relatively small divisions or subsidiaries. In some of these instances, the auditors apparently had not visited the locations in several years even though the entities did not have any internal auditors, controls at the locations were weak or competition for the locations' products had increased substantially.

Panel also noted that some firms have extensive guidance in this area that the ASB might find helpful in developing similar assistance.

Recommendations

To the Auditing Standards Board:

2.57 The Panel recommends that the ASB:

- Develop more specific and definitive standards for multi-location audits to cover such matters as:
  - How the auditor's consideration of the control environment (taken alone or in combination with other factors) should influence the selection of locations to be covered or the way procedures are to be carried out
  - The extent of knowledge and involvement needed by the auditor with final responsibility for decisions about the locations and the key personnel assigned to perform the work at them
  - Criteria (including materiality considerations) for periodically rotating the coverage of smaller locations
  - Reliance on internal auditors for coverage of various locations
  - Methods of establishing materiality at different locations
  - The scope of work to be performed at different sizes and types of locations
- Emphasize in its guidance that accounting systems, controls, personnel and other circumstances can vary widely from location to location within an entity, and that these variations should be considered explicitly in decisions about how many and which locations to visit and the nature, timing and extent of work to be performed at each of them. The guidance also should recognize that analytical procedures may be useful in helping to select the locations to be visited, especially when there are many rather homogeneous locations.

ASSESSING CONTROL RISK

Overview of GAAS

2.58 SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement*

Audit: An Amendment to SAS No. 55, describes the auditor's responsibilities with respect to an entity's internal control, including the responsibility to assess control risk.

2.59 SAS No. 78 defines internal control as "a process – effected by an entity's board of directors, management, and other personnel – designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) reliability of financial reporting, (b) effectiveness and efficiency of operations, and (c) compliance with applicable laws and regulations."[16] Controls that are relevant to an audit are those that pertain to the entity's preparation of financial statements for external purposes.

2.60 Internal control consists of five interrelated components:[17]

- The *control environment* sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.

- *Risk assessment* is the entity's identification and analysis of relevant risks to the achievement of its objectives, forming a basis for determining how the risks should be managed.

- *Control activities* are the policies and procedures that help ensure that management directives are carried out.

- *Information and communication* are the identification, capture and exchange of information in a form and time frame that enable people to carry out their responsibilities.

- *Monitoring* is the process that assesses the quality of internal control performance over time.

2.61 GAAS require, in all audits, that the auditor "obtain an understanding of internal control sufficient to plan the audit by performing procedures to understand the design of controls relevant to an audit of financial statements and whether they have been placed in operation." This knowledge is used to:

- Identify types of potential financial statement misstatements
- Consider factors that affect the risk of material misstatement
- Design substantive tests

2.62 The risk that a material misstatement will not be prevented or detected on a timely basis by the entity's internal control is referred to as *control risk*. Some control risk always exists

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[16] The definition is the same as that adopted by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control – Integrated Framework*, September 1992.
[17] Safeguarding of assets is an integral part of each of the components.

because of the inherent limitations of internal control and the possibility of control override by supervisory personnel.

2.63 Obtaining an understanding of internal control does not require the auditor to reach any conclusions about the effectiveness of internal control. GAAS allow the auditor to assess control risk as very high or at the maximum level in specific areas of the financial statements if he or she believes that controls are unlikely to be effective, or that evaluating and testing their effectiveness would be inefficient. This process is commonly expressed as "defaulting" to an audit approach that relies entirely on detailed substantive audit tests with little or no testing of controls.

2.64 GAAS further provide that the auditor may assess control risk at a lower level, below the maximum, by:

- Identifying specific controls that are likely to prevent or detect material misstatements relative to specific aspects of the financial statements

- Performing tests of those controls to evaluate their effectiveness

2.65 Assessing control risk below the maximum enables the auditor to adjust the nature, timing and extent of substantive audit tests, for example, by performing fewer tests, obtaining less persuasive (and presumably less costly) evidence, performing tests before year end or reducing sample sizes. When auditors "rely" on controls in an area, it means they have assessed control risk below the maximum level and have tested the effectiveness of those controls.

Findings

2.66 The QPR reviewers looked at auditors' work in assessing control risk at the control environment level and in the key areas reviewed on each engagement, and at how the risk assessment was documented.

Control Environment

2.67 In all engagements, the auditors assessed the entity's control environment. The work in this area generally was performed by an in-charge auditor with three to five years' experience, working under timely and effective supervision and review by more experienced professionals. In substantially all situations, the QPR reviewer agreed with the engagement team's assessment of the control environment.

2.68 The results indicated, however, that on nearly 17% of the reviewed engagements the audit would have been improved by more thoughtful analysis and in-depth auditor knowledge of the entity's control environment. In addition, the QPR reviewers believed that, on about 21% of the engagements, more effective use of the audit firm's information technology specialists would have been desirable and would have improved the team's assessment of the control environment.

Assessing Control Risk and Testing Controls

2.69 The QPR reviewers found that the depth of understanding about information systems and controls, the substance of the risk assessments performed and the degree of reliance on controls varied considerably among engagements, even within the same firm. The process of obtaining an understanding of internal control typically consisted of some combination of completing checklists, interviewing entity personnel and examining individual transactions. On almost 24% of the reviewed engagements, the reviewers raised questions about the engagement team's thought process or depth of knowledge and understanding of the information system and related controls, including consideration of the entity's computer environment and processing.

2.70 The reviewers noted that firms' information technology specialists frequently were used by engagement teams to assist in understanding general computer controls or specific application controls in more complex computer-based systems. In some cases, these specialists also were used in the design and execution of related audit testing. The reviewers also observed, however, that the level and effectiveness of the coordination between the technology specialists and audit personnel varied, and in almost 20% of the engagements could have been improved. In addition, the reviewers frequently noted that an increased understanding of computer-based systems by engagement teams and the involvement of information technology specialists would have improved the control risk assessment process.

2.71 Assessing control risk below the maximum level and relying on controls to reduce detailed substantive audit tests were found to be somewhat uncommon, particularly for small and medium-sized entities. Testing and relying on specific application controls were more common on larger engagements. In high-risk key areas, controls usually were not relied on in lieu of detailed tests. The reviewers noted no situations in which they considered the planned reliance on internal control to be inappropriate.

2.72 When the auditor planned to rely on controls, however, the nature, timing and extent of tests of controls varied considerably. In some cases, there appeared to be some confusion about what constitutes an internal control over an identified risk versus simply a procedure for processing a transaction. Identification of controls relevant to the auditor's selection of substantive tests, and the corollary nature, timing and extent of controls testing that was appropriate in the circumstances, also seemed to be somewhat unclear to some engagement teams. In addition, the QPR reviewers concluded that the tests of controls were not completely effective in about 12% of the key areas reviewed where controls were tested.

2.73 The QPR reviewers often commented about the circumstances permitting rotation of tests of controls over two or more years, the circumstances in which tests of controls also may serve as substantive tests (referred to as "dual purpose tests"), and the necessary level of testing of management reports and other internal data sources used by the auditor in performing analytical procedures or other audit tests. The reviewers generally concurred with the concept of rotation, but sometimes questioned the appropriateness of the time lag between testing of specific areas or whether changes in the entity or the engagement team called for updated testing. The reviewers generally expressed reservations about whether the dual purpose tests were adequate as substantive tests to enable the auditors to achieve the desired audit objectives. Their comments on the level of testing of management reports and other internal data sources that were used in performing analytical procedures or other audit tests indicated inconsistencies in practice.

Documentation

2.74 Engagement teams' documentation of their understanding and assessment of internal control takes different forms, including firm-specific checklists and preparation of detailed descriptions of the entities' policies and procedures. The QPR disclosed that documentation of the control environment was viewed as needing improvement on 15% of the engagements reviewed. The documentation of control work in the key areas was similarly lacking in substance or completeness on nearly 23% of the engagements and 14% of the key areas reviewed.

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2.75 The findings are consistent with a widely held perception that auditors tend to focus on substantive tests rather than relying on and testing controls. The findings also are consistent with views expressed by both QPR engagement team members and focus group participants, which can be summarized as follows:

- Professional standards in this area are perceived by many as complex and difficult to apply, particularly with respect to the guidance on how much knowledge auditors need about internal control, the need to test controls and the nature and extent of controls testing.

- Professionals have a wide range of beliefs about the relevance of internal control and how internal control is, or should be, considered in audits. In addition, the level of knowledge about internal control, including understanding the types of errors that can result from internal control weaknesses, and how internal control fits or should fit into the audit process, varies widely among auditors.[18]

- Testing controls is considered time consuming and seems to be viewed by some auditors, including partners, as less effective than detailed substantive audit tests. There is confusion about when, if ever, an auditor can rely entirely on substantive tests for assurance about a particular assertion.

- There is a diversity of views about the most effective way of coordinating the work of information technology specialists with that of auditors and the role of those specialists in understanding, assessing and testing controls. The ability of engagement personnel to supervise the work of these specialists is often questioned.

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[18] During its study of the AAERs (see Appendix F), the Panel noted numerous instances of management overriding controls unbeknown to the auditors. These included controls over the aging of accounts receivable, recording shipments, changing computer programs and classifying payments. As a consequence, the auditors assessed control risk and fraud risk as being lower than they actually were. The Panel also noted that entities often used information technology to facilitate material fraud, such as by making inappropriate modifications to computer programs, making large numbers of small non-standard entries rather than a few large ones, and "freezing the date" in the computer system.

2.76 In contrast, the Panel is aware that some auditors and firms believe that increasingly there is little choice but to focus the audit more on controls, given the pervasiveness of complex computer systems and the volume of transactions. To do otherwise, they argue, is not responsive to the need for highly reliable interim, as well as year end, financial data and increasingly will result in highly inefficient, costly and often ineffective audits. Firm methodologies seem to be focusing more on controls in planning the audit.

Recommendations

To the Auditing Standards Board:

2.77 The Panel recommends that the ASB:

- Provide more specific guidance on:
  - The required depth of auditor knowledge and understanding about internal control
  - Whether and to what extent auditors may rely on their assessments of the effectiveness of the control environment (including corporate governance) and management's high-level monitoring of the business to support control risk assessments below the maximum[19]
  - The nature and extent of documentation needed, particularly to support the auditor's consideration of internal control in planning the audit and in assessing control risk
  - The circumstances, if any, in which auditors may rely entirely on detailed audit tests with either no reliance on controls or reliance only at the control environment level
  - Identifying and focusing on key controls for the purpose of determining what could go wrong and what controls to test
  - Linking the "components of internal control," including transaction-level controls, with identified risks and detailed audit tests
  - The nature, timing and extent of controls testing in varying circumstances
  - The circumstances, if any, permitting rotating tests of controls over two or more years in areas in which the auditor intends to rely on controls

[19] The JWG paper (see note 13) contains observations about these matters that the ASB may wish to evaluate.

    - The circumstances, if any, in which tests of controls also may constitute substantive tests (dual purpose tests)

    - The necessary level of testing of management reports and other internal data sources used by the auditor in performing analytical procedures or other audit tests

- Indicate the importance of having personnel with significant audit and industry experience participate in performing internal control work, particularly at the planning stage

- Give priority to completing the work of the ASB technology task force that was formed to consider the manner in which auditing standards taken as a whole appropriately reflect the use and impact of information technology and whether changes should be made to auditing standards

To audit firms:

2.78 The Panel recommends that audit firms place a high priority on enhancing the overall effectiveness of auditors' work on internal control, particularly with respect to the depth and substance of their knowledge about companies' information systems. The following areas should be addressed:

- *Audit practice* – Firms of all sizes should examine critically their audit work on internal control. In many situations, firms should increase the engagement time allotted to internal control, particularly in the audit planning phase. They also should raise the level of involvement by more experienced audit personnel. Audit personnel who supervise engagements should be directed to focus on increasing the engagement team's knowledge of important information systems and controls. They should focus particularly on (1) obtaining a more thorough understanding of information systems relevant to financial reporting and the related risks and controls, (2) identifying and evaluating the design of key controls, (3) linking controls with identified risks and substantive audit tests, (4) designing tests of the operating effectiveness of controls, (5) considering the results of the tests of controls, and (6) considering how decisions about the nature, timing and extent of controls testing affected audit effectiveness.

- *Professional development* – Training programs should place greater emphasis on each of the components of internal control as well as on assessing and testing controls. The objective should be to increase significantly the overall effectiveness of auditors in identifying and responding to risks, key controls and control deficiencies in the control environment and information systems.

- *Information technology* – The Panel sees an increasing need for auditors to have a higher level of technology skills and for more effective participation in audits by information technology specialists. Their participation should include assessing the risk that erroneous information may affect the financial statements, assessing the adequacy of controls and designing tests of their operating effectiveness. Firms should develop specific training materials and programs to make auditors more knowledgeable about information technology, and information technology specialists more knowledgeable about auditing. Information technology specialists should be integrated more effectively and consistently into the audit process. There should be joint training of auditors and specialists, starting at the partner and manager levels. Firms without such specialized capabilities should develop appropriate cooperative arrangements to ensure that information technology risks and controls are fully addressed in the audit.

- *Inspection programs* – Internal inspection programs should increase their focus on internal control work, the effective involvement of information technology specialists and the effective involvement of experienced audit personnel in this area.

To the SECPS Peer Review Committee:

2.79 The Panel recommends that the SECPS Peer Review Committee:

- Develop more detailed inquiries for peer reviewers about firms' methodologies and engagement performance relating to audit work on internal control, focusing particularly on internal control considerations in planning the audit. Peer review inquiries also should focus on the depth of the engagement team's understanding of the entity's information system and related risks that are relevant to financial reporting. In addition, they should address the engagement team's effectiveness in identifying, testing and assessing key controls, and the sufficiency of the involvement of experienced professionals.

- Instruct peer review team captains to include professionals with the necessary specialized technology expertise on their peer review teams

- Request that peer reviewers include their findings in this area in their reports to the SECPS Peer Review Committee

COMMUNICATING AND REPORTING ON INTERNAL CONTROL

Overview of GAAS

2.80 The auditor's standard report on a financial statement audit does not address internal control or purport to give any assurance about it, and auditors are not required to assess the overall effectiveness of internal control or search for control deficiencies. During the course of an audit, however, the auditor may become aware of matters relating to internal control that may be of interest to management or the audit committee (or equivalent body). SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, requires that auditors communicate such matters if they meet the definition of a *reportable condition* – a significant deficiency in the design or operation of internal control that could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with management's assertions in the financial statements.

2.81 A reportable condition may be of such magnitude to be considered a *material weakness*. A material weakness is defined as "a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions."

2.82 An auditor may be engaged to report on the effectiveness of internal control over financial reporting under the attestation standards (such standards are similar in concept to auditing standards and also are issued by the ASB). Statement on Standards for Attestation Engagements (SSAE) No. 2, *Reporting on an Entity's Internal Control Over Financial Reporting* (as amended), prescribes performance and reporting standards for engagements to examine management's assertion on the effectiveness of internal control over financial reporting. The Panel understands that SSAE No. 2 engagements and reports are rare outside of the banking industry. While there are statutory requirements for auditors to report on internal control over financial reporting in all larger banking institutions, the attestation reports on those engagements are provided only to the regulators and the audited entity. In addition, they are available to the public upon request.

2.83 Mandatory management and auditor reporting on the effectiveness of internal control for public entities has been considered in the past and continues to be advocated in some quarters. The 1987 *Report of the National Commission on Fraudulent Financial Reporting* (the Treadway Commission) specifically recommended that the SEC require management reporting to shareholders on the effectiveness of internal control. Similarly, in a 1993 report, *In the Public Interest*, the POB recommended that the SEC require management and auditor reporting on the effectiveness of internal control. The 1996 GAO *Report on the Accounting Profession – Major Issues: Progress and Concerns* contains an extensive discussion about the importance of internal control and states:

> While the accounting profession now supports internal control reporting, the SEC has not been convinced of the merits of reporting on internal control. SEC support is critical to further progress in this area. In the long run, GAO expects that audits will be expanded to include internal control reporting, either because of market demand or some systemic crisis.

Findings

2.84 The QPR disclosed only a few instances of auditors specifically communicating "reportable conditions" or "material weaknesses." This may result from (a) a lack of such conditions on the engagements reviewed, (b) the limited amount of internal control work performed by the auditors, (c) the subjectivity of the criteria for identifying reportable conditions and material weaknesses, or (d) a combination of the above. The QPR results indicate that it is very common for auditors to report that the audit did not identify any "material weaknesses."

2.85 The Panel believes, based on focus groups and comments from QPR reviewers, that management and auditor communications with audit committees frequently do not devote sufficient time and attention to internal control. Audit committees likely presume that auditors do more work in this area than they actually do, and they take more comfort than is warranted or intended by the auditors. Audit committees seldom ask management and the auditors in-depth questions about internal control.

2.86 The Panel recognizes that many public companies include statements by management in their annual reports acknowledging management's responsibility for the system of internal control. Some of these management reports – typically found among the larger public companies – express management's views about the effectiveness of the system and, in some cases, the basis for its views. Management reports generally include references to the auditors, and some may lead users to incorrect inferences about the auditors' work on controls in the context of a GAAS audit, particularly since companies seldom engage their auditors to report on such management reports. (The QPR did not address attestation engagements to report on the effectiveness of internal control over financial reporting.)

2.87 It is widely recognized that effective internal control is critical to the reliability of the financial reporting process. The use of information technology, the growing complexity of systems and processes, the sheer volume of transactions, the global reach of business entities and other factors were cited as evidence of this by many of those responding to the Panel's requests for input. It also is clear from discussions with focus group participants, firm leadership and others that there has been and continues to be a significant gap between what management, audit committees and investors believe auditors' involvement with internal control is or should be, and reality. Input to the Panel on the need for management reporting on the effectiveness of internal control, and auditor involvement and reporting thereon, was mixed. A number of survey respondents addressed this issue, with some constituencies supporting both management reporting and auditor involvement and reporting thereon, while others opposed auditor involvement and reporting. After considering all these views, the Panel concluded that, while it would not make a recommendation to the SEC that it require management and auditors to report on internal control, it would emphasize the need for greater audit committee involvement with internal control matters. The Panel also recognizes that, as the demand for new and timelier information rises, management and auditor reporting on controls may become inevitable.[20]

Recommendations

To audit committees:

2.88 The Panel recommends that audit committees increase the time and attention they devote to discussions of internal control with management and both the internal and external auditors. Specifically, audit committees should:

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[20] See "The Information Demand" in Chapter 8.

- Obtain a written report from management on the effectiveness of internal control over financial reporting (ordinarily using the criteria in the 1992 report of the Committee of Sponsoring Organizations of the Treadway Commission [COSO]).[21] Annual reporting by management on internal control to the audit committee is necessary for the effective discharge of the audit committee's responsibilities and will serve as a catalyst for its more substantive involvement in the area of internal control and a more meaningful dialogue with the internal and external auditors about controls. It also should provide a basis for discussions about the degree of the external auditor's involvement with internal control during the financial statement audit.

- Establish specific expectations with management and the internal and external auditors about the qualitative information needs of the committee related to internal control. Particular emphasis should be given to understanding management's and the auditors' views on (1) the control environment and (2) the controls (or lack thereof) over financial reporting, with particular attention to controls in higher-risk areas of the company's information systems. In addition, these discussions should include the effects of technology on current and future information systems.

To the Securities and Exchange Commission:

2.89 The Panel recommends that, if management is required to report to shareholders on the effectiveness of internal control, the SEC require either external auditor reporting on internal control or management to explicitly state that the external auditors do not express an opinion on internal control. Otherwise, the Panel believes that investors may draw unwarranted inferences about auditors' involvement with and responsibility for the appropriateness of management's assertions in such reports or about the degree of internal control work that auditors perform in connection with their audits of financial statements.

LINKING THE RISK ASSESSMENTS TO SUBSTANTIVE TESTS

Overview of GAAS

2.90 The major reason for the auditor's risk assessment activities is to provide a basis for determining the nature, timing and extent of substantive tests to be performed to provide the reasonable assurance the auditor needs about the reliability of the assertions that are embedded in the financial statements. This determination often is referred to as "linkage"; it is one of the most difficult and important sets of decisions that the auditor must make, requiring considerable judgment, and should be made and reviewed by experienced personnel with the appropriate level of knowledge and skills.

2.91 All other things being equal, the higher the risks, the more the auditor should focus on the nature of the substantive tests, the more extensive the substantive tests need to be, the more

[21] See note 16. Such reports also may be provided jointly with the internal auditors.

persuasive the evidence they provide should be, and the nearer to the balance sheet date they should be performed. (SAS No. 39, *Audit Sampling,* provides additional guidance on linking risk assessments to sample sizes in situations in which sampling is appropriate.) While the auditor is permitted to exercise considerable judgment in the linkage process, SAS No. 47 cautions that it is not appropriate to rely completely on the risk assessments to the exclusion of performing substantive tests of material account balances and classes of transactions. The auditor also should consider the various risk assessments in assigning staff and determining the appropriate level of supervision.

Findings

2.92 The QPR reviewers evaluated the engagement team's linkage decisions for the key areas on each engagement reviewed. The reviewers also considered the appropriateness of the substantive tests performed, the timing of the tests, whether the number of items included in a particular test or sample was adequate, the adequacy of the documentation, whether the appropriate personnel performed and reviewed the work, whether any "exceptions" were resolved appropriately and whether the responses of entity management to the auditors' inquiries were adequately corroborated. At the conclusion of both the review of each key area and the overall engagement, the reviewers evaluated whether all major issues that arose in the key area or on the engagement, respectively, were resolved appropriately and whether consultation had occurred when it should have and, if so, the appropriateness of the consultation process.

Linkage

2.93 The QPR reviewers generally agreed that the specific tests performed or other actions taken in response to each of the risk assessments were appropriate and sufficient and that they clearly addressed the specific potential misstatements that the engagement team identified. The reviewers also generally agreed that the thinking that led to the specific tests or actions gave appropriate consideration to the appropriate factors, that those who initially selected the specific procedures had the appropriate knowledge and skills to perform those tasks, and that those who reviewed and approved them also had the appropriate knowledge and skills and did so on a timely basis. Although the reviewers generally agreed that the number of items examined in particular substantive tests was adequate in light of the risk assessments, they noted significant differences in sample sizes – sometimes in reasonably similar circumstances, even within the same firm. Even though the reviewers generally agreed with the linkage decisions, they believed the linkage needed improvement in 7% of the key areas reviewed.

Substantive Tests

2.94 In approximately 10% of the key areas reviewed, the QPR reviewers did not agree that the substantive tests (nature, timing and extent) appropriately addressed the relevant assertions to achieve the necessary level of audit assurance. In addition, in approximately 15% of the key areas reviewed, the reviewers did not agree that the documentation of the substantive tests and their results was appropriate (e.g., that there was sufficient information in the working papers to enable someone else to replicate the original work and understand the nature of the evidence examined).

2.95 The QPR reviewers generally agreed that the engagement teams clearly understood the entity's policies and processes related to the key areas reviewed and that the people who performed the tests, including specialists when appropriate, had the necessary knowledge and skills.

2.96 The reviewers also generally were satisfied that the engagement teams performed appropriate procedures to understand and evaluate the work performed by specialists, that sufficient tests were performed for the period between interim and year end when interim testing was performed, and that sufficient substantive tests were performed. The reviewers generally agreed that key entity documents (e.g., contracts) and the results of the substantive tests were reviewed on a timely basis by an engagement team member with appropriate knowledge and skills, that exceptions found in testing were resolved appropriately and that decisions about the need for additional substantive tests were appropriate.

2.97 The QPR reviewers noticed a tendency in some instances for engagement teams not to confirm material receivables even though SAS No. 67, *The Confirmation Process*, states that:

> Confirmation of accounts receivable is a generally accepted auditing procedure. … [I]t is generally presumed that evidence obtained from third parties will provide the auditor with higher-quality audit evidence than is typically available from within the entity. Thus, there is a presumption that the auditor will request the confirmation of accounts receivable during an audit unless one of the following is true:
>
> - Accounts receivable are immaterial to the financial statements.
>
> - The use of confirmations would be ineffective. For example, if based on prior years' audit experience or on experience with similar engagements, the auditor concludes that response rates to properly designed confirmation requests will be inadequate, or if responses are known or expected to be unreliable, the auditor may determine that the use of confirmations would be ineffective.
>
> - The auditor's combined assessed level of inherent and control risk is low, and the assessed level, in conjunction with the evidence expected to be provided by analytical procedures or other substantive tests of details, is sufficient to reduce audit risk to an acceptably low level for the applicable financial statement assertions. In many situations, both confirmation of accounts receivable and other substantive tests of details are necessary to reduce audit risk to an acceptably low level for the applicable financial statement assertions.

2.98 When questioned, the engagement teams generally responded that they had not attempted to confirm receivables, even though they were material, on the basis that the second or third condition was met. In some instances, it was clear that one or both of the conditions were met;

however, in other instances, it was not apparent that either condition was met. The Panel is aware from the focus groups and other input that some auditors believe that confirmation is not a particularly effective audit procedure in many situations.

2.99 On a few engagements, the QPR reviewers noted that the engagement team permitted the entity's personnel (other than internal auditors) to mail or receive the confirmation requests or the auditors accepted facsimile responses without taking appropriate precautions, such as verifying the source and contents of the response by a telephone call to the purported sender. (SAS No. 67 requires the auditor to maintain control over the confirmation requests and responses and to consider taking certain precautions to verify the propriety of any facsimile responses.) These conditions also were present in some of the cases the Panel studied in its review of litigation or enforcement actions against auditors.[22]

2.100 In approximately 8% of the key areas where the engagement teams noted confirmation exceptions, the QPR reviewers found that the exceptions were resolved inappropriately and that the decisions regarding the need for additional substantive tests were inappropriate. This condition also was present in some of the cases the Panel studied in its review of litigation and enforcement actions against auditors.

Resolution of Issues

2.101 The QPR reviewers generally agreed that the engagement issues raised in the key areas were resolved appropriately, that the engagement teams performed appropriate tests to obtain reasonable assurance that they had all of the relevant information pertaining to those issues, and that, if necessary, there was appropriate consultation.

2.102 In 14% of the situations, the QPR reviewers found that the documentation concerning the issues in the key areas and their resolution was inappropriate. When the reviewers were able to conclude that the resolution of those issues was appropriate, they ordinarily did so on the basis of discussions with members of the engagement team and, when applicable, with those consulted by the engagement team.

2.103 The reviewers also generally agreed, on an overall basis when completing their review of the audit, that the engagement team carefully reviewed and objectively evaluated, in light of all of the circumstances, all of the issues identified during the course of the audit. The reviewers also generally found that the people involved with the issues and their resolution had the appropriate knowledge and skills, and that the audit partner was involved sufficiently and on a timely basis in their consideration and resolution.

2.104 The reviewers also generally concluded that there was appropriate and timely consultation about the key issues with the right persons at the right time, that all the relevant

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[22] The Panel noted during its study of AAERs (see Appendix F) numerous other instances in which the auditors' substantive procedures apparently were inadequate to detect material misstatements. Examples were: (a) not adequately following up on exceptions found through testing, (b) not adequately testing cutoff, charges to asset accounts, or the valuation of securities or property, plant and equipment, and (c) not ascertaining whether the financial statements agreed or reconciled with the accounting records.

information was provided to those consulted and that the nature, timing and extent of the concurring partner's involvement in the resolution of the issues were appropriate. Finally, the reviewers generally agreed that the conclusions reached with respect to each of the issues were appropriate, that the issues were identified and resolved on a timely basis (e.g., not late in the audit), and that there were sufficient discussions with management regarding the identified issues.

2.105 The QPR reviewers on 13% of the engagements indicated that they became aware of other issues about which they believed consultation with others in the firm would have been prudent or was required by firm policy, but did not take place.

Recommendations

To the Auditing Standards Board:

2.106 The Panel recommends that the ASB:

Linkage

- Develop more definitive authoritative guidance on linking the nature, timing and extent of substantive tests to risk assessments, including guidance aimed at the nature of procedures and at reducing the incidence of inadequate sample sizes and variations in sample sizes in similar circumstances. (The ASB, when developing that guidance, may wish to consider the non-authoritative AICPA Auditing Practice Release, *Audit Sampling*, published in 1999.)

Substantive Tests

- Articulate more precisely the considerations that should be present to overcome the presumption that it is necessary to send confirmations

- Undertake research to develop more effective methods of confirmation or other means of obtaining evidence from third parties, such as through the use of technology

To audit firms:

2.107 The Panel recommends that audit firms:

Linkage

- Review their policies and procedures and guidance materials with respect to linking risk assessments to the nature, timing and extent of substantive tests, including designing substantive procedures that address all assertions where risk is not low, and establishing sample sizes that are large enough to provide sufficient evidence whenever sampling (as defined in SAS No. 39) is employed

- Review their training materials with respect to linkage and sampling and ascertain whether they need to be augmented, with respect to either the time devoted to the subjects or the materials used, such as by developing “real-life” case studies

Substantive Tests

- Emphasize to their personnel the importance of obtaining evidence from third parties whenever possible and that the presumption that receivables are to be confirmed when they are material is not easily overcome

- Provide more guidance to their personnel on other types of information, in addition to or in lieu of receivable balances, that might be confirmed

- Develop case studies or other communications to audit personnel that illustrate the dangers of losing control over the confirmation process, of accepting facsimile responses to confirmation requests without taking appropriate precautions, and of not following up and appropriately resolving all exceptions noted during the audit

- Require that at least an experienced audit manager review the resolution of all “exceptions” noted during the audit and be satisfied that they were resolved appropriately and that appropriate decisions regarding the need for additional substantive tests were made

Resolution of Issues

- Reinforce the importance of consulting on important issues

- Vigorously enforce their consultation policies by taking strong actions with respect to those who do not consult when they should, as revealed by the firm’s inspection program or other events

To the SECPS Peer Review Committee:

2.108 The Panel recommends that the SECPS Peer Review Committee:

Linkage

- Request that peer reviewers evaluate the adequacy of firms’ policies, procedures, guidance and training materials relating to linkage decisions, including those involving the selection of the appropriate procedures and sampling

- Request that peer reviewers determine whether firms have conducted the requisite training in these areas and evaluate the effectiveness of the engagement teams’ implementation of the firms’ methodology and guidance materials

- Include items in the peer review questionnaires that are similar to those covered in the QPRs, such as whether the specific tests performed or other actions taken in response to the risk assessments were appropriate and sufficient, whether the thought processes that led to the specific tests or actions were thorough and gave appropriate consideration to the appropriate factors, whether those who initially selected and subsequently reviewed the specific tests or other actions had the appropriate knowledge and skills and did so on a timely basis, and whether the extent of substantive tests (including, when appropriate, sample sizes) was sufficient

Substantive Tests

- Request that peer reviewers evaluate whether engagement teams are (a) confirming receivables whenever they are material unless the presumption that receivables will be confirmed clearly has been overcome, (b) confirming other types of information in addition to, or in lieu of, receivable balances, when appropriate, (c) maintaining control over the confirmation process, (d) taking appropriate precautions when facsimile responses to confirmations are received, and (e) appropriately following up and resolving any exceptions noted and, when appropriate, performing additional audit tests

Resolution of Issues

- Request that peer reviewers consider whether there were any issues on the audit engagements reviewed for which they believed consultation would have been prudent (or was required by firm policy) and for which it did not occur (or was not documented)

Reporting

- Request that peer reviewers include their findings in these areas in their reports to the SECPS Peer Review Committee

ANALYTICAL PROCEDURES

Overview of GAAS

2.109 Analytical procedures are defined by SAS No. 56, *Analytical Procedures*, as "evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. . . . A basic premise underlying the application of analytical procedures is that plausible relationships among data may reasonably be expected to exist and continue in the absence of known conditions to the contrary." SAS No. 56 requires that analytical procedures be used in audit planning and in the overall review stage of the audit. Analytical procedures also may be used as substantive tests to identify potential material misstatements.

2.110 Analytical procedures involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor. SAS No. 56 notes that "the expected effectiveness and efficiency of an analytical procedure in identifying potential misstatements depends on, among other things, (a) the nature of the assertion, (b) the plausibility and predictability of the relationship, (c) the availability and reliability of the data used to develop the expectation, and (d) the precision of the expectation.

2.111 Analytical procedures by nature tend to elicit inquiries to management as auditors search for explanations when investigating significant unexpected differences or the absence of expected differences. SAS No. 56 admonishes, however, that "management responses … should ordinarily be corroborated with other evidential matter."

Findings

2.112 The QPR was designed to address all aspects of the use of analytical procedures in audits. Analytical procedures used in planning were addressed in the QPR's probe into the risk assessments made by engagement teams, and analytical procedures used in the overall review stage of audits were examined in the QPR's probe into the resolution of audit issues. In the key areas for each audit engagement, the QPR reviewers made direct inquiries concerning the effectiveness of analytical procedures used as substantive tests. Lastly, in five additional audit areas for each audit engagement, the reviewers addressed the effectiveness of analytical procedures when used as the primary or sole substantive test for the particular area.

Analytical Procedures in Audit Planning

2.113 For audit planning purposes, analytical procedures are employed as a tool to help the auditor understand the entity's business and to identify areas that may represent specific risks relevant to the audit. Since most audits are planned before the end of an entity's fiscal year, it is understandable that the expectations developed at the planning stage often are not made with a high degree of precision and the analytical procedures based on them are not intended to provide a high level of assurance. Analytical procedures in planning are one of a number of important elements, however, in the risk assessment process and in designing the scope of the audit, including making decisions about the locations the auditor will visit.

2.114 The QPR results indicated that analytical procedures used in planning were appropriate and were performed effectively. Furthermore, the results also indicated that the people involved in the analytical review process had the appropriate knowledge and skills to carry it out effectively. The QPR disclosed room for improved documentation of planning-stage analytical procedures in 14% of the engagements.

Analytical Procedures in the Overall Review

2.115 In the overall review stage of the audit, the objective of analytical procedures is to assist the auditor in assessing the conclusions reached and in evaluating the overall financial statement presentation. The auditor considers the adequacy of evidence gathered in response to unusual or unexpected balances or relationships identified in the planning and testing stages of the audit and unusual or unexpected balances or relationships that were not previously identified. This overall review may indicate the need for additional evidence.

2.116 The QPR results paint a mixed picture of how well auditors perform analytical procedures in the final stage of the audit. In general, the analytical procedures performed were appropriate, the people involved had the requisite knowledge and skills, the thought process was thorough and considered the appropriate factors, and the timing of the analytical review was appropriate. However, the adequacy of inquiries and corroboration of explanations was questioned in 14% of the engagements reviewed. That, together with a perceived absence of sufficient documentation in 25% of the engagements reviewed, raised some doubt about the efficacy of the analytical review process at the completion of the audit.

Analytical Procedures as Substantive Tests

2.117 Analytical procedures that serve as substantive tests are used in many contexts. Some are used in combination with tests of details; others are used as the primary or only substantive tests. The selection of substantive analytical procedures can differ significantly between balance sheet accounts and income statement accounts. The procedures selected also may vary with the assessment of, and extent of testing undertaken on, internal control over a particular account or class of transactions.

2.118 The QPR disclosed that, in 73% of the key areas, substantive analytical procedures were predominantly supplemental procedures used in combination with tests of details. When the analytical procedures were the primary or only substantive tests, the QPR results indicated that ordinarily they were designed and performed appropriately.

2.119 In the five additional audit areas selected for each audit engagement, the QPR addressed whether substantive analytical procedures were the primary or sole substantive tests. For the most part, these five additional audit areas were not considered high-risk areas. The QPR results indicated that, in 75% of those areas, analytical procedures were *not* the primary or sole substantive procedures.

2.120 In the remaining 25% of the additional audit areas, analytical procedures were used as the primary or sole substantive tests. In 20% of these remaining areas, the QPR reviewers deemed the substantive analytical procedures insufficient to provide the necessary level of assurance. In these instances, the insufficient procedures related to the income statement, such as sales or revenue trends, gross profit ratios, and selling, general and administrative expenses. The QPR reviewers found that the analytical procedures were sufficient when they were employed as substantive tests of balance sheet areas. In those cases, the explanations of the results of the procedures generally were corroborated appropriately, and the procedures themselves were documented adequately. The QPR results generally reflect a belief by engagement personnel that, when analytical procedures were used as the primary or sole substantive tests of balance sheet accounts, they generated stronger evidence than when they were used as the primary or sole substantive tests of income statement accounts.

2.121 In assessing the mixed results of the QPR findings with respect to the use of analytical procedures as substantive tests, the Panel observed that analytical procedures were not as effective as primary procedures when expectations were not properly developed, materiality thresholds for investigating differences were not clearly established, the analytical procedures were superficial or explanations were not corroborated,[23] and the documentation was inadequate. The Panel reviewed the firms' audit methodologies and guidance materials, guidance available from the AICPA in the form of a 1998 Audit Practice Release, *Analytical Procedures*, and other commercially available materials. All in all, the quantity of information on analytical procedures is impressive, yet the QPR disclosed practice issues of sufficient importance that the Panel concluded that the area needs attention.

* * * * *

2.122 The Panel noted that the degree of specificity in audit firms' methodologies and in their guidance on applying those methodologies varies significantly. It also appears to the Panel that a gap exists between (a) what is available in the firms' audit methodologies, professional standards and other guidance materials, and (b) what actually transpires in practice. The gap closes and the analytical procedures are more effective if a firm's audit methodology contains clear and unequivocal guidance requiring the appropriate use of analytical procedures in different circumstances (including guidance on the characteristics of the data to be used, establishing expectations, setting precision levels, employing explicit materiality thresholds, deciding on the desired levels of assurance and resolving differences). In addition to guidance materials and methodology, training auditors in the effective use of analytical procedures by using "real-life, practical, how-to" cases would appear to be invaluable.

Recommendations

To the Auditing Standards Board:

2.123 The Panel recommends that the ASB:

- Enhance auditing standards for analytical procedures to provide more specificity about what auditors need to do to design and perform analytical procedures in differing circumstances. The auditing standards should:

  - Provide guidance on how to design substantive analytical procedures for different types of accounts and assertions

  - Clearly articulate how relevant auditing concepts (e.g., the concepts of planning

[23] The Panel noted during its study of AAERs (see Appendix F) that the entities that engaged in the most sophisticated frauds ordinarily were very concerned about whether "the numbers and the relationships among them would 'look right' to the auditors" when they performed analytical procedures. Thus, these entities would "play around" with the numbers, often through the use of unsupported non-standard entries. In these circumstances, key ratios such as the accounts receivable and inventory turnover ratios and the gross margin percentages would meet the auditors' expectations rather than raising questions that might reveal the fraud. During its study of the AAERs, the Panel also noted instances where the auditors apparently over-relied on management's explanations for unusual fluctuations that the auditors noted when performing analytical procedures.

materiality, control risk assessment and testing of controls, and desired levels of assurance) influence the design and performance of analytical procedures

- Provide guidance on linking analytical procedures in the overall review stage to the auditor's conclusions reached in the audit and the sufficiency of the audit evidence that supports those conclusions

- Develop more guidance on when it is appropriate (and when it is inappropriate) for the auditor to rely on management's explanations during the course of the audit and on obtaining additional evidence to corroborate those explanations[24]

- Specify appropriate documentation requirements

To audit firms:

2.124 The Panel recommends that audit firms:

- Ensure that their audit methodologies provide definitive guidance on analytical procedures. At a minimum, specific guidance should be provided in the following areas:

  - Developing expectations

  - Characteristics and reliability of different types of data

  - Using planning materiality in designing substantive analytical procedures

  - Establishing desired levels of assurance for substantive analytical procedures

  - Establishing precision levels that depend on the level of assurance the auditor desires from analytical procedures

  - Relating control risk assessments to the objectives of analytical procedures

  - Considering the role of account-level or assertion-level risk assessments (e.g., low-risk vs. high-risk assessments) in designing analytical procedures

  - The effect of the nature of particular accounts or assertions (e.g., balance sheet vs. income statement accounts) on analytical procedures

  - Identifying, investigating and evaluating the results of analytical procedures (including obtaining additional evidence to corroborate the responses to inquiries)

[24] The Canadian Institute of Chartered Accountants published a research report, *Audit Enquiry, Seeking More Reliable Evidence From Audit Enquiry* (2000), that, among other matters, studies the reliability of inquiry as an information-gathering technique. The ASB may wish to consider this research.

- Specifying the appropriate level of personnel assigned to perform analytical procedures, and the responsibilities of those assigned to review their work

- Assessing the results of analytical procedures in the final stage of the audit

- Documentation requirements consistent with the objectives of the analytical procedures

- Ensuring that training programs specifically address analytical procedures, are taken by all levels of audit personnel and employ "real-life, practical, how-to" case examples in varying circumstances that illustrate the firm's methodology and guidance. Depending on levels of personnel, such training programs should include basic concepts of financial statement analysis as well as techniques used by analysts in evaluating the securities of different types of entities.

To the SECPS Peer Review Committee:

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

- Evaluate firms' methodology, guidance and training materials relating to analytical procedures

- Determine whether firms have carried out the requisite training and evaluate the effectiveness of the firms' implementation of their methodology related to analytical procedures on audit engagements

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

AUDITING REVENUE

Overview of GAAS

2.126 The 1999 COSO Report[25] noted that either premature revenue recognition or recognition of fictitious revenue occurred in approximately half of the cases of misstated financial statements reported in the SEC's AAERs issued in the period 1987–1997.[26] Similarly, a substantial portion of litigation against audit firms reported to the SECPS Quality Control Inquiry Committee

[25] *Fraudulent Financial Reporting: 1987–1997, An Analysis of U. S. Public Companies*, research commissioned by the Committee of Sponsoring Organizations of the Treadway Commission (1999 COSO Report).
[26] Revenue is used in its broadest sense to encompass, among others, sales of products or services, income from leasing property and income from investments.

involves revenue recognition issues. Finally, a study of recent SEC enforcement actions made on behalf of the Panel also indicated many problems related to revenue recognition.[27]

2.127 Auditing standards generally do not prescribe procedures for auditing specific financial statement elements, and revenue is no exception. Auditing revenue starts with audit planning, and SAS No. 22, *Planning and Supervision*, requires the auditor to gain an understanding of the entity's business, internal control, types of products and services, related parties, locations, and production, distribution and compensation methods. Other SASs that are relevant to testing revenue deal with audit sampling, confirmations and other evidential matter, auditing accounting estimates, analytical procedures, management representations, related parties and using the work of a specialist.

2.128 In addition, in November 1998, the AICPA SEC Practice Section issued Practice Alert No. 98-3, *Revenue Recognition Issues*, and in January 1999 the AICPA staff issued a Notice to Readers, *Audit Issues in Revenue Recognition* (sometimes referred to as the revenue recognition "tool kit"). Both documents were intended to alert auditors to circumstances that could signal improper revenue recognition and to describe procedures that auditors can use to limit audit risk arising from improper revenue recognition.

2.129 The authoritative literature provides guidance on confirming receivables as a means of obtaining evidence that the receivables exist and are genuine. Since revenue often is recognized from transactions that concomitantly give rise to accounts receivable from a third party, confirming those receivables provides evidence that the revenue transactions actually occurred. SAS No. 67 provides guidance on selecting the items to be confirmed, designing the confirmation requests, communicating with the appropriate third party, and obtaining and evaluating the responses. SAS No. 67 establishes a rebuttable presumption that the auditor will confirm accounts receivable. SAS No. 67 also discusses alternative procedures when receivables are not confirmed.

Relevant Accounting Standards

2.130 Authoritative accounting guidance for recognizing revenue is mostly industry-specific and addresses such industries as franchising, software, construction contracting, real estate and leasing. The general guidance is sparse,[28] and the industry guidance is not wholly consistent. Some of the restatements of revenue in recent years could be characterized as resulting from a lack of clear guidance on how to deal with the many elements critical to revenue recognition,

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[27] The Panel noted during its study of AAERs (see Appendix F) that approximately 70% of the cases in the study involved the overstatement of revenue, either from premature recognition or from recognizing fictitious revenue. This finding is consistent with the findings of the 1999 COSO Report and other studies. Appendix F describes the most frequent techniques noted for overstating revenue.

[28] Examples of general guidance on revenue recognition include Statement of Financial Accounting Concepts (SFAC) No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*; Accounting Principles Board Opinion No. 10, *Omnibus Opinion – 1966*; and Statement of Financial Accounting Standards No. 48, *Revenue Recognition When Right of Return Exists*.

such as the timing of delivery of products or services or the performance of activities over long periods of time.[29]

2.131 Revenue has always been an important indicator of a company's vitality and growth prospects. Recently, however, revenue has taken on even more significance, as it has become the primary basis for valuing some companies' equity securities. For example, for some Internet-based companies without any current earnings or prospects for earnings in the short term, the market looks to surrogates for earnings or operating cash flows for valuation, and in some cases revenue is the surrogate.

2.132 In December 1999, the staff of the SEC issued Staff Accounting Bulletin (SAB) No. 101, *Revenue Recognition in Financial Statements*, which summarizes certain of the staff's views on applying GAAP to revenue recognition in financial statements.[30] In addition to codifying the staff's views in some specific areas, such as "bill and hold" transactions, SAB No. 101 discusses broad principles of revenue recognition. Some observers have noted that the SAB is in apparent conflict with certain well-established practices.[31]

2.133 Further, in December 1999, the SEC asked the Emerging Issues Task Force to add to its agenda accounting for revenue-generating arrangements that include multiple deliverables of products or services.[32] Expressing a view that allocations to deliverable elements should be based on relative fair values, the SEC also asked the ASB to develop guidance for practitioners on what constitutes sufficient, verifiable and objective evidence of fair values. The Panel understands that the ASB is developing an audit guide on revenue recognition.

Findings

2.134 The 1999 COSO Report, the information the Panel gathered from its analysis of AAERs and other litigation naming auditors all indicate a particular need for auditors to examine revenue transactions near the end of the period under audit. Also, auditors should be alert for indications of management override of controls with respect to period-end transactions. The COSO Report notes, "Findings suggest a continued need for evaluating and testing controls related to recording end-of-period accounts and transactions…."

2.135 The number of negative comments made by the QPR reviewers related to auditing revenue was relatively low, but generally was higher than in other areas. The specific aspects of auditing revenue for which the rate of negative responses was higher than in the other key areas included:

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[29] The 1999 COSO Report noted, however, that half of the frauds that related to improper revenue recognition involved purely fictitious sales.

[30] SABs are not Commission rules or interpretations and are not officially approved by the Commission. They represent staff interpretations in administering the disclosure requirements of the federal securities laws. SABs are usually narrow in focus and issued in question and answer format. Because they are not official SEC rules, SABs are issued without exposure for comment.

[31] For example, some observers would argue that the SAB gives greater weight than is necessary in many cases to contractual customer acceptance clauses in determining whether revenue recognition is appropriate.

[32] As of August 2000, Emerging Issues Task Force Issue No. 00-21, *Accounting for Multiple-Element Revenue Arrangements,* was in an early stage of development.

- Obtaining a sufficient understanding of information systems and control activities, including consideration of the computer environment and processing, to identify and assess control risk

- The resultant assessment of control risk

- The appropriate involvement of information technology specialists in understanding, assessing and testing the information systems and control activities

- Focusing tests at the right controls

- The appropriateness of the nature, timing and extent of tests of controls

2.136 Despite these results, the QPR reviewers generally agreed that the resulting substantive tests were adequate because little reliance was placed on internal control, even when controls were tested. The reviewers noted, however, that a better understanding of the systems and controls might have led the auditors to design more effective or additional substantive tests.

2.137 There also were many positive findings. For example, the reviewers reported that they believed that appropriate consultation had occurred in all instances in which it was necessary (although the documentation could have been better), and that substantive analytical procedures were well executed.

2.138 Many respondents to the Panel's survey and commentators at the public hearings expressed the belief that auditors should pay more attention to, and be better trained in, accounting for and auditing revenue. One analyst opined that, unlike financial statement restatements resulting from other issues, revenue recognition issues may signal fundamental problems with the business.

Recommendations

To the Auditing Standards Board:

2.139 The Panel recommends that the ASB:

- Require that auditors test the cutoff of revenue when inherent or control risks relating to such transactions are other than low and specifically when there is a high level of sales transactions or individually significant sales transactions near the end of the reporting period. Cutoff tests should be more extensive than tests of only a few transactions before and after the close of the period. Cutoff testing often should require the auditor's physical presence at the entity's location(s) at period end.

- Clarify its standard on the confirmation process (SAS No. 67) to address the circumstances in which confirmation of the *terms* of transactions should be required.

The terms of revenue transactions should be confirmed whenever the transactions are individually significant and the risks associated with revenue recognition or the existence of receivables are high. This might be appropriate even if the auditor believes that confirmation of *balances* is ineffective.[33]

- Give the highest priority to completing its proposed audit guide for revenue recognition

To audit firms:

2.140 The Panel recommends that audit firms:

- Test the cutoff of revenue when inherent or control risks relating to such transactions are other than low, and specifically when there is a high level of sales transactions or individually significant sales transactions near the end of the reporting period. Cutoff tests should be more extensive than tests of only a few transactions before and after the close of the period. Cutoff testing often should require the auditor's physical presence at the entity's location(s) at period end.

- Develop training materials, including case studies, focused on auditing revenue recognition issues in specific industries. Require professionals working on engagements in those industries to complete the training.

To the SECPS Peer Review Committee:

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

- Consider the adequacy of firms' policies, guidance and training (and any changes in them) in the area of auditing revenue recognition

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

To the Financial Accounting Standards Board:

2.142 The Panel recommends that the FASB add revenue recognition to its agenda. The Panel believes that an authoritative statement on the broad principles of revenue recognition is sorely needed. Because this may be a long-term project, in the interim the FASB (or other appropriate

[33] Confirmation of terms can be helpful in identifying the existence of any "side agreements," which the 1999 COSO Report identified as a significant factor in some misstatements of revenue, as did the Panel's study of AAERs (Appendix F).

bodies such as the Accounting Standards Executive Committee [AcSEC] or the Emerging Issues Task Force [EITF]) should identify and resolve or clarify areas of diverse or uncertain practice.[34]

AUDITING ESTIMATES AND JUDGMENTS

Overview of GAAS

2.143 Financial statements generally are replete with accounting estimates and judgments. Concerns most frequently cited about auditing those estimates and judgments relate to restructuring and merger-related reserves[35] and the use of those and other reserves to "manage" earnings.

2.144 The Panel is aware of a research study on earnings management nearing completion.[36] That study indicates that, although many financial frauds are related to revenue recognition, manipulation of reserves is the technique most frequently used to manage earnings (see Chapter 3).

2.145 SAS No. 57, *Auditing Accounting Estimates*, defines an *accounting estimate* as an approximation of a financial statement element, item or account.[37] It describes aspects of an entity's internal control that may reduce the likelihood of material misstatements of accounting estimates, and contains guidance for evaluating (a) whether management has identified all accounting estimates that could be material to the financial statements and (b) the reasonableness of an estimate.

2.146 The SAS states that, in evaluating reasonableness, the auditor should obtain an understanding of how management developed the estimate. Based on that understanding, the auditor should use one or a combination of the following approaches: (a) review and test the process used by management to develop the estimate, (b) develop an independent expectation[38] of the estimate to corroborate the reasonableness of management's estimate, and (c) review subsequent events or transactions occurring prior to completion of fieldwork. SAS No. 57 also

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[34] The Panel understands that the FASB has received a number of requests to add a project specifically on revenue recognition, and that the FASB is considering them as part of its agenda-decision process. Also, AcSEC recently has issued industry-specific revenue recognition guidance, and the EITF is addressing some revenue recognition and financial display issues.

[35] The term *reserves* is used in this report to refer to allowances for estimated losses that are displayed either as liabilities (e.g., a product warranty reserve) or as reductions of assets (e.g., a loan loss reserve). Modern usage generally avoids the term *reserves* in financial statements, and instead refers to "estimated liabilities" and asset "allowance" accounts. The term *reserves*, however, continues to be widely used in other contexts. It sometimes is used pejoratively to suggest abuses in earnings management. This is not the Panel's intent.

[36] A study by Mark W. Nelson and John A. Elliot of Cornell University, and Robin L. Tarpley of George Washington University.

[37] SAS No. 57 states that "accounting estimates are often included in historical financial statements because (a) the measurement of some amounts or the valuation of some accounts is uncertain, pending the outcome of future events or (b) relevant data concerning events that have already occurred cannot be accumulated on a timely, cost-effective basis."

[38] See "Analytical Procedures" in this chapter for a discussion of the concept of developing expectations, and related recommendations to the ASB.

provides guidance on how to review and test management's process (including the possibility of using the work of a specialist regarding certain assumptions).

Unique Audit Problems

2.147 There are at least three reasons why it is difficult to audit accounts involving estimates and judgments.

2.148 First, there may be little "hard" evidence supporting the amounts. Unlike a transaction with a third party, there is seldom any external documentation, such as a contract, invoice or purchase order. Except in a few instances, the authoritative accounting literature has no required minimum levels of documentation to support the establishment of or subsequent activity in reserves.[39] Sometimes the only significant documentation may be that prepared by auditors to support their conclusions.

2.149 Second, the amounts involve subjective estimation and judgment.[40] Unlike most third-party transactions, the amounts involved are not fixed. They may be based on a range of potential results, and reasonable people may disagree on the most likely outcome or amount.

2.150 Third, activity in reserves may be driven principally by management's intentions and decisions rather than by external events or transactions. (For example, management has the ability to determine whether it will offer to settle outstanding litigation.) Indeed, determining just when management's intentions create a liability has vexed accountants and auditors for decades, and, for example, has been a significant factor in the uncertainties surrounding the accounting for restructuring and similar reserves.

Relevant Accounting Standards

2.151 The principal accounting guidance for reserves is Statement of Financial Accounting Standards (SFAS) No. 5, *Accounting for Contingencies*, issued in 1975.[41] That statement calls for the accrual of a loss contingency when it is *probable* that an asset has been impaired or a liability incurred at the date of issuance of the financial statements and the loss can be *reasonably estimated.* General or unspecified business risks do not meet these conditions for accrual. Inappropriate reserves also include (a) amounts accrued in excess of those meeting the SFAS No. 5 conditions and (b) amounts maintained in reserves that are not reversed into income after the event for which they had been established occurred or failed to occur.

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[39] Among the accounting pronouncements on estimates and judgments that do address documentation are: EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)* (see note 42); EITF Issue No. 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination*; and SAB No. 100, *Restructuring and Impairment Charges*. SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, although unrelated to reserves, addresses the appropriate documentation when management designates financial instruments as hedges.

[40] Because of the pervasiveness of estimates, AICPA Statement of Position 94-6, *Disclosure of Certain Risks and Uncertainties*, requires disclosure (a) that the preparation of financial statements in conformity with GAAP requires the use of management's estimates and (b) when it is reasonably possible that a material change in estimate will occur in the near term.

[41] Additional guidance includes FASB Interpretation No. 14, *Reasonable Estimation of a Loss*.

2.152 SFAS No. 5 offers little clarification as to when management's intent can result in an asset having become impaired or a liability having been created. Certain accruals that are triggered in part by management intent are addressed in the literature.[42] In other cases, it may be difficult to distinguish between the appropriate accrual of a loss contingency based on GAAP and an inappropriate accrual of future expenses.[43]

2.153 Another apparent area of confusion is the belief by some that reserves are "fungible," and are therefore "allocable" to financial statement accounts other than those for which the reserves were established initially. For example, a company with an excess income tax accrual and an understated allowance for doubtful accounts might "reallocate" the tax reserve, rather than reversing the unneeded tax accrual into income and separately accruing a provision for doubtful accounts. Similarly, an unused or excessive restructuring reserve might be used to offset the cost of a new restructuring. Such reallocations are not appropriate under SFAS No. 5; rather, GAAP would require separate accounting and disclosure of both amounts, if material.

2.154 In his testimony at the Panel's open hearings, the chairman of the FASB noted that there is a direct relationship between the effectiveness of accounting standards and the financial reporting system on the one hand, and the ability of auditors to be effective on the other hand. The Panel agrees. It appears to the Panel that the confusion (warranted or not) over the appropriate application of SFAS No. 5 and related guidance, such as that for restructuring and similar reserves, may reduce audit effectiveness. Among the matters that could be clarified are:

- Which future expenses or operating losses qualify for loss accrual when management intends or commits to incur them? (That is, when does management intent create a liability?)

- What is the "date of issuance" of financial statements for purposes of loss accruals?[44]

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[42] See, for example, Accounting Principles Board Opinion No. 30, *Reporting the Results of Operations – Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions;* EITF Issue No. 94-3 (see note 39); and SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of.* On June 30, 2000, the FASB issued a proposed SFAS related to asset impairment and disposal issues that would supersede most or all of the preceding three standards. Under this proposal, an entity's commitment to a plan would not be sufficient to recognize liabilities associated with disposal activities; the definition of a liability in SFAC No. 6 also would have to be met.

[43] An example of the latter would be the accrual of incremental or redundant future costs, such as the anticipated costs of running parallel accounting systems during the introduction of a new system. (To illustrate the point in the extreme, if expenses that are only "committed" could be accrued, then, arguably, next year's budget might be accruable because such expenses are both probable and estimable.)

[44] The Panel understands that there have been widely differing views as to the date of issuance, ranging from a public release of earnings to the filing of a Form 10-K or 10-Q. The Panel is aware that in December 1999 the SEC staff indicated its general view that financial statements are "issued" as of the date they are distributed for general use and reliance, and that a press release of earnings does not constitute issuance. However, that may present significant public policy questions: Should the investing community view all earnings releases as tentative? Should they be considered subject to change for revisions of estimates for events that may occur between the release of earnings and an uncertain future date? The Panel doubts that this view is understood by investors today and believes that investors base decisions on earnings releases, which are assumed to be reliable unless otherwise indicated.

- Are there minimum levels of documentation that entities should prepare regarding activity in reserves? Examples of minimum documentation might include a description and the dates of the specific event or events that caused the reserve activity, an analysis of compliance with SFAS No. 5 and other relevant standards, and approvals by appropriate levels of authority.

- Are there minimum levels of homogeneity and other characteristics that must exist for contingent losses to be collectively evaluated? (To what extent – if any – are reserves "fungible" or "allocable"?)

2.155 In January 2000 the SEC proposed changes to clarify and expand disclosures related to changes in certain reserves.[45] The proposal also would reposition the disclosures (which companies currently present in a schedule) to the forepart of the filing document.

Findings

2.156 The QPR reviewers found that the most effective auditing of amounts subject to estimation and judgment occurred when the senior members of the engagement team (including the engagement and concurring partners, designated consulting partners and functional specialists) were involved significantly and on a timely basis. The reviewers reported positive findings in the areas of risk assessment and linkage of those assessments to substantive tests. The matters cited most frequently for potential improvement involved documentation and corroboration of management's representations and responses to inquiries. Because the audit evidence usually is generated internally, management's representations often are critical to the audit process, although the auditor should corroborate those representations. The reviewers did not find widespread development of independent expectations related to reserves, one of the techniques suggested by SAS No. 57 for evaluating the reasonableness of estimates. Finally, in some instances the reviewers were concerned that not all issues related to reserves had been resolved appropriately. In those few instances, the reviewers were satisfied nonetheless that the overall audit results were satisfactory.

2.157 The QPR disclosed that auditors generally did not document internal control in the area of reserves. An entity's lack of specific controls related to accounting estimates – including documentation and adequate review and approval by appropriate levels of authority – presents an audit issue as well as a possible matter to be communicated to the entity.[46] In some instances, the QPR reviewers noted confusion or misunderstanding by both the entity and the auditors about the appropriate application of the relevant accounting standards.

2.158 Many respondents to the Panel's survey and speakers at the public hearings urged more

[45] *Proposed Rule: Supplementary Financial Information* (Release Nos. 33-7793 and 34-42354), January 21, 2000.
[46] The auditor should consider whether such a situation could represent a *reportable condition* that should be communicated to the audit committee (SAS No. 60, *Communication of Internal Control Related Matters in an Audit*). A registrant's lack of controls and related documentation potentially might constitute a violation of Section 13(b)(2)-(7) of the Securities Exchange Act of 1934 (known as the "books and records and internal control provisions" section of the Foreign Corrupt Practices Act of 1977), which requires keeping books, records and accounts in reasonable detail and devising and maintaining a sufficient system of internal control.

auditor involvement in entities' reporting of reserves in their interim financial statements. Some noted that financial frauds often originate in interim periods. The SEC recently adopted rules requiring reviews of interim financial information by the company's independent auditors before that information is filed with the SEC. The Panel believes this should improve financial reporting and audit effectiveness.

2.159 Some participants in the Panel's study noted that many accounting standards involving accounting estimates are complex and require a significant amount of judgment.[47] In establishing new standards, the FASB evaluates (among other things) the cost-effectiveness of requiring additional accounting information. Some have expressed concern that FASB standards are increasingly difficult not only to implement but also to audit. On the one hand, the FASB may receive few, if any, comments regarding audit practicability during the period of exposure of proposed standards. On the other hand, auditors may not be able to identify all of the issues until a new standard is implemented and the results first audited. The Panel understands that there is communication between the staffs of the ASB and the FASB as audit issues related to new standards are identified. Those efforts often take place after the standards have been issued, however, and there is little formal assessment of the auditability of proposed accounting standards.

Recommendations

To the Auditing Standards Board:

2.160 The Panel recommends that the ASB:

- Provide detailed guidance regarding the auditing of reserves.[48] The Panel understands that the ASB intends to prepare a guide for auditing reserves along the lines of the Notice to Readers, *Audit Issues in Revenue Recognition*, that it issued in 1999. The Panel urges the ASB to assign a high priority to this effort and provide guidance on

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47 Recent examples include:

- SFAS No. 109, *Accounting for Income Taxes* – Measurement of deferred tax assets is based on an assessment of whether realizability is "more likely than not." In certain circumstances, the assessment must include tax planning strategies that meet certain criteria, which expands even further the judgment required.
- SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* – Both recognition and measurement of impairment may be based on forecasts of future cash flows.
- SFAS No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* – Determination of whether an asset has been sold or a liability extinguished may depend on complicated legal determinations. Auditors must assess whether legal opinions support those determinations.
- SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* – All derivatives are recognized and measured at fair value. Techniques for valuation may be intricate, and may include expected future cash flows, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis.

48 The Panel notes that in December 1999 the Chief Accountant of the SEC recommended that the ASB add this project to its agenda. He indicated that the SEC was aware of audit problems involving reserves and suggested areas where additional guidance was needed.

what constitutes sufficient evidence to support reserve balances and activity, including what is needed to corroborate documentation generated by the entity.

- Establish a protocol to assess the auditability of proposed accounting standards prior to their issuance. Any field tests of proposed standards also should include evaluations of their auditability. Further, the liaison between the ASB and the FASB that exists currently should be made formal to help ensure timely identification of and reaction to audit issues related to accounting standards.[49]

To audit firms:

2.161 The Panel recommends that audit firms:

- Provide training on the application of SAS No. 57 and the provisions of SFAS No. 5 and related guidance

- Encourage engagement teams to apply audit tests to reserve activity on a timely basis – for example, during the performance of interim reviews

- Adopt policies or internal guidance that promotes partner and manager involvement in the evaluation of reserve activity during interim reviews (if they do not already have such policies or guidance)

To the SECPS Peer Review Committee:

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

- Evaluate firms' policies, training and guidance materials on auditing estimates and judgments

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

To the Financial Accounting Standards Board:

2.163 The Panel recommends that the FASB:

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[49] AcSEC issues comment letters on behalf of the AICPA on standards proposed by the FASB. These letters usually are limited to accounting matters and generally do not address implementation or auditability issues. This may occur because of an often-held view that, if an accounting standard can be implemented by financial statement preparers, the results also can be audited. The Panel recognizes that the current staff levels and structure of the ASB do not lend themselves to easy implementation of this recommendation. For the most part, the profession has looked to the firms to identify implementation and auditability issues and to forward them directly to the FASB. Nonetheless, the Panel believes that AcSEC and the ASB should analyze both the accounting and auditing aspects of proposed accounting standards.

- Clarify the accounting for contingencies to enable more consistent application of the criteria for accruing losses.

- Establish a protocol with the ASB to assess the auditability of proposed accounting standards before they are issued, including evaluations of auditability when proposed standards are field tested

- Formalize the existing liaison between the ASB and the FASB to help ensure timely identification of and reaction to audit issues arising from newly issued standards

To audit committees:

2.164 The Panel recommends that audit committees evaluate the nature of entities' reserves and review activity in them with both management and the auditors.

MATERIALITY, WAIVED ADJUSTMENTS AND ANALYSTS' EXPECTATIONS

Overview of GAAS

2.165 SAS No. 47 recognizes that the auditor may become aware of misstatements during the audit that, individually and in the aggregate, are not material to whether the financial statements are presented fairly in conformity with GAAP.[50] The SAS instructs the auditor to aggregate the misstatements that the entity has not corrected in a way that enables him or her to consider whether, in relation to individual amounts, subtotals or totals in the financial statements, they materially misstate the financial statements taken as a whole. SAS No. 47 points out that there are both qualitative as well as quantitative aspects of materiality.

2.166 In recent years there have been numerous instances of the price of a company's stock dropping precipitously when the company failed to meet analysts' earnings forecasts by only a penny or two a share, or failed to meet their revenue forecasts. The Chairman and the Chief Accountant of the SEC, among others, have expressed concerns that some entities may have been "managing" their earnings inappropriately (often referred to as "earnings management") in order to meet analysts' forecasts and thereby avoid a precipitous drop in the price of their stock. They also have expressed concern that auditors have not challenged these actions, but instead

[50] Paragraph 132 of SFAC No. 2, *Qualitative Characteristics of Accounting Information,* describes the concept of *materiality* as follows: "The omission or misstatement of an item in a financial report is material if, in light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item." This formulation is in substance equivalent to the holding of the U.S. Supreme Court (TSC Industries v. Northway, Inc., 426 U.S. 438, 449 [1976]) that a fact is material if there is "a substantial likelihood that the … fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." Each Statement of Financial Accounting Standards adopted by the FASB states, "The provisions of this Statement need not be applied to immaterial items."

have "waived" known potential misstatements of earnings or revenue because the amounts involved were quantitatively immaterial.

2.167 In August 1999, the staff of the SEC issued SAB No. 99, *Materiality*, which states that entities and auditors should not rely exclusively on quantitative benchmarks, such as 5% of net income, to determine whether an item, or the aggregation of items, is material to the financial statements. The SAB describes various qualitative factors (e.g., whether a misstatement affects the trend of earnings, whether analysts' forecasts are met and whether a loan covenant is violated) that also should be considered when making materiality decisions.

2.168 In December 1999, the ASB issued SAS No. 89, *Audit Adjustments*, which requires the representation letter that the auditor obtains from management to include an acknowledgment by management that it has considered the misstatements aggregated by the auditor and concluded that any uncorrected misstatements (often referred to as waived adjustments) are immaterial. The SAS also requires that a summary of the waived adjustments be included in or attached to the representation letter and that those misstatements be reported to the audit committee.

Findings

2.169 The QPR reviewers determined whether the audit engagement teams were aware of and considered analysts' forecasts, especially when evaluating waived adjustments. The reviewers also considered whether they agreed with the engagement teams' conclusions that it was appropriate to waive the uncorrected misstatements and whether waiving the adjustments enabled the companies to meet analysts' forecasts.

2.170 The QPR found that analysts' forecasts were publicly available for 60% of the audits reviewed. The QPR reviewers reported that the engagement team considered those forecasts when evaluating waived adjustments on 60% of the engagements for which analysts' forecasts were available. (During the QPR, the Panel became aware that one firm provides all its engagement partners with the latest information regarding analysts' forecasts, as well as the entity's latest earnings announcements, for each of their clients.)

2.171 The QPR reviewers reported that waiving the adjustments did not affect whether the company met the analysts' forecasts on 66% of the engagements reviewed where analysts' forecasts were publicly available, that they could not ascertain whether waiving the adjustments affected whether the company met the forecasts on 33% of the engagements reviewed where analysts' forecasts were publicly available, and that waiving the adjustments may have affected whether the company met the analysts' forecasts on, at most, only one of the engagements reviewed.

2.172 The QPR reviewers generally agreed with the engagement team's conclusions that it was appropriate to waive the proposed adjustments and with the engagement team's reasons for waiving them. The reviewers also generally agreed that the upper-level engagement team members (ordinarily the engagement partner, concurring partner, manager and in-charge accountant) thoroughly reviewed the summary of waived adjustments, and that the engagement team thoroughly discussed the waived adjustments with upper-level entity management.

2.173 In those few situations (approximately 4% of the engagements reviewed) in which the QPR reviewer did not agree with the engagement team's conclusion that it was appropriate to waive the proposed adjustments, either the reviewer was satisfied that the waived adjustments did not have a material effect on the overall financial statements or the matter was referred to the firm for appropriate resolution.

2.174 The Panel understands that the ASB currently is working on a project to update the auditing standards as they relate to materiality in view of the issuance of SAB No. 99 and changing views regarding the criteria for determining whether an item is material.[51]

2.175 The QPR reviewers reported that the audit firms treat proposed adjustments differently in judging whether they are material. Some firms use the so-called "iron curtain" approach, in which the effects of all (cumulative) uncorrected misstatements are deemed to affect the current period's income statement as well as the balance sheet. Other firms use the so-called "rollover" approach in which the cumulative uncorrected misstatements, net of the uncorrected misstatements carried over from the prior year (i.e., "rolled over"), are deemed to affect the current period's income statement. The balance sheet effects are the same under both methods. Both techniques are permitted under SAS No. 47. While good arguments can be made for either method, the Panel believes that permitting both methods is potentially confusing, especially in view of the provisions in SAS No. 89 requiring that waived adjustments be addressed in management's representation letter and be reported to the audit committee.

2.176 The Panel believes, based on its own observations and experience, the focus group discussions and interviews with audit professionals during the QPRs and in other forums, that auditors will improve their understanding of the entity's control environment, business and industry if they are aware of analysts' forecasts and reports on the entity, the information management provides to the analysts, and management's policies and processes for communicating that information.

Recommendations

To the Auditing Standards Board:

2.177 The Panel recommends that the ASB:

- Provide additional authoritative guidance to assist auditors in determining whether identified misstatements are material. (The Panel understands the ASB is considering this subject.)

- Specify, in cooperation with the FASB if necessary, that there be only one method of handling prior periods' uncorrected misstatements when determining whether proposed adjustments are material. (The Panel understands that this matter is on the

[51] The Panel has not attempted to assess all of the implications of SAB No. 99, which was issued after the audits covered in the QPR were conducted and the related audit reports issued.

ASB's agenda and recognizes that the ASB and FASB likely would need to develop an appropriate method of transitioning to the chosen method.)

- Require the auditor to consider published analysts' reports and forecasts (in addition to other information) when gaining an understanding of the entity's business and industry, assessing risks and considering whether the effects of identified misstatements are qualitatively material.

To audit firms:

2.178 The Panel recommends that audit firms adopt policies (unless they already have done so) requiring engagement teams to:

- Obtain analysts' reports and forecasts as part of gaining an understanding of the entity's business, consider the effects of those forecasts and the information in those reports when assessing risks and evaluating important issues, and include them among the factors considered when evaluating the materiality of potential adjustments

- Obtain an understanding of the entity's policies and processes, if any, for communicating information to analysts

- Become aware of the information management provides to analysts, such as by reading transcripts of the presentations or by listening to management's presentations to analysts when the presentations are available by telephone, videotape, the Internet or other public communications vehicles

To the SECPS Peer Review Committee:

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

- Evaluate the effectiveness with which engagement teams implement SAS No. 89 and SAB No. 99 and determine whether additional guidance or training is needed

- Review and evaluate firms' policies, if any, for understanding the entity's policies and processes for communicating information to analysts; obtaining analysts' reports and forecasts, and considering them when assessing risks and evaluating important issues and the materiality of potential adjustments; and becoming aware of the information management provides to analysts

- Evaluate the effectiveness with which engagement teams implement their firm's policies and determine whether additional guidance or training is needed

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

GOING CONCERN CONSIDERATIONS

Overview of GAAS

2.180 Financial statements are prepared on the assumption that the entity will continue as a going concern. SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, requires the auditor to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.[52] Conditions and events identified through the performance of audit tests over the course of the audit are considered in the aggregate to determine whether there could be such doubt.[53] In the face of such doubt, the auditor expands the audit tests to obtain evidence about management's plans that are intended to mitigate the effects of the identified conditions and events, and assesses the likelihood that such plans can be implemented effectively.[54] After evaluating management's plans, the auditor should conclude whether substantial doubt exists about the entity's ability to continue as a going concern for a reasonable period of time. If substantial doubt exists, an explanatory paragraph is included in the auditor's report.

2.181 Authoritative accounting pronouncements contain no explicit going concern disclosure requirements. The established practice is for the entity to include going concern disclosures in the financial statements. SAS No. 59 requires that an auditor consider the adequacy of any going concern disclosures in the financial statements, whether or not an explanatory paragraph has been added to the auditor's report. Such disclosures might include the conditions and events giving rise to the assessment of substantial doubt, including their possible effects and management's evaluation of their significance, mitigating factors, possible discontinuance of operations, and management's plans.

2.182 SAS No. 59 does not require an auditor to predict future conditions or events, and states that the absence of a reference to substantial doubt in an auditor's report should not be viewed as providing assurance that an entity will continue as a going concern.

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[52] "A reasonable period of time" is defined in SAS No. 59 as a period of time not to exceed one year beyond the date of the financial statements being audited, and often is referred to as the one-year time horizon in SAS No. 59. The concept also is recognized in Section 10A(a) of the Securities Exchange Act of 1934, as amended, which requires that the auditor evaluate whether there is substantial doubt about the ability of the issuer to continue as a going concern during the ensuing fiscal year.

[53] These conditions and events may include negative trends (e.g., recurring operating losses, working capital deficiencies, negative cash flows from operating activities or adverse key financial ratios), indications of financial difficulties (e.g., default on loan agreements, restructuring of debt or need to seek new sources or methods of financing), internal matters (e.g., work stoppages or substantial dependence on the success of a particular project) or external matters (e.g., legal proceedings that might jeopardize an entity's ability to operate, loss of a key license or patent, or loss of a principal customer).

[54] Management's plans may include plans to dispose of assets, borrow money, restructure debt, reduce expenditures or increase equity ownership.

Findings

2.183 The QPR reviewers sought to assess whether engagement teams were alert to the audit risks relating to an entity's liquidity, particularly when there may have been substantial doubt about an entity's ability to continue as a going concern or when there were severe concerns about the entity's liquidity. Indications of significant audit risks involving the entity's viability existed on 49 of the 126 QPR engagements. For these 49 engagements, QPR reviewers made inquiries specifically targeted at the audit risks and issues resulting from concern about the entity's viability.

2.184 The reviewers agreed that in all cases the engagement teams were alert to the presence of information that could give rise to the need to evaluate whether there was substantial doubt about the entity's ability to continue as a going concern, evaluated management's plans in sufficient depth, reached supportable conclusions regarding the entity's ability to continue as a going concern, and gave appropriate consideration to the need for financial statement disclosure when the substantial doubt was alleviated. Generally, reviewers agreed with engagement teams' decisions regarding the need to consult and the depth of such consultations.

2.185 Similar to other areas in the QPR, corroboration of management's representations and, more frequently, documentation were cited as areas needing improvement, particularly in connection with the evaluation of prospective financial information that was significant to management's plans. Even in those cases, however, the reviewers still agreed with the engagement teams' overall conclusions.

2.186 In addition to evaluating the generally positive QPR results, the Panel considered factors in the current economic environment that highlight the importance of the auditor's going concern responsibilities. Some entities, particularly certain service- and technology-based "new economy" companies, rely heavily on the availability of external financing, rather than profitable operations, for continuing in business. The current economic climate has accommodated these entities, but that could change quickly. Liquidity pressures can arise quite suddenly, raising the question of the adequacy of financial statement disclosures about financial flexibility and the possible consequences on an entity's going concern status. Furthermore, formalizing the notion that management, not the auditor, has the primary responsibility for going concern assessments and disclosures would provide a sound conceptual underpinning for users' understanding of the going concern concept. As a result, the Panel concluded that, in addition to its recommendations designed to improve audit performance, it should address certain of its recommendations to the FASB.

Recommendations

To the Auditing Standards Board:

2.187 The Panel recommends that the ASB provide expanded guidance and specific examples of the auditing procedures to be performed and the audit evidence to be obtained when considering management's plans for mitigating the adverse effects of conditions and events that raised the auditor's substantial doubt about the entity's ability to continue as a going concern.

Particular consideration should be given to circumstances in which reliance is placed on proposed cost reductions and other prospective financial information.

To audit firms:

2.188 The Panel recommends that audit firms incorporate the following matters into their training programs and audit methodologies:

- Specific guidance on considering management's plans for mitigating the adverse effects of conditions and events that created the auditor's substantial doubt about the entity's ability to continue as a going concern, including guidance on evidence supporting proposed cost reductions or other prospective financial information

- Practice aids, such as a template for confirming plans involving third-party financial support, and "real-life" examples of evidential matter that corroborates representations regarding management's plans, as well as examples of evidential matter that does not

To the SECPS Peer Review Committee:

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

- Evaluate the adequacy of firms' guidance and training (and any changes in them) in the area of going concern considerations

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

To the Financial Accounting Standards Board:

2.190 The Panel recommends that the FASB:

- Define the *going concern concept* and clarify that management, not the auditor, has the primary responsibility to assess whether the entity has the ability to remain a going concern[55]

- Consider the appropriateness of the one-year time horizon in SAS No. 59. The FASB

[55] The Panel notes that international accounting standards (IASs) require that management make an assessment of an enterprise's ability to continue as a going concern and disclose material uncertainties about its ability to do so (IAS 1, *Presentation of Financial Statements,* revised 1997, under the caption "Going Concern"). Similarly, international auditing standards (ISAs) require auditors to evaluate management's assessment of the entity's ability to continue as a going concern and the adequacy of disclosures (ISA 570, *Going Concern,* revised 1999). The ISA cites IAS 1 as a source of guidance on such assessments and disclosures. (For a discussion of international accounting and auditing standards, see Chapter 7.)

should evaluate this time horizon and recognize its importance to auditors in framing their audit reports.

- Promulgate explicit going concern disclosure requirements to fit various circumstances. Such requirements should include disclosures about the entity's reliance on the financial support of related or third parties to mitigate the adverse effects of conditions and events that create substantial doubt about the entity's ability to continue as a going concern.

INTERNAL AUDITORS

2.191 Internal auditors are responsible for providing analyses, evaluations, assurances, recommendations and other information to an entity's management and audit committee or others with equivalent authority and responsibility. To fulfill this responsibility, internal auditors must be objective with respect to the activity being audited. Although the objectives of internal audit are multi-faceted and vary from company to company, most internal audit functions monitor the performance of the entity's controls.

2.192 The Panel believes that an internal audit function that focuses on financial reporting matters can improve the quality of financial reporting. It acknowledges the importance of this function and encourages a high degree of coordination and cooperation between internal and external auditors. This coordination ideally includes communications concerning inherent, control and fraud risks. Cooperation will need to increase as information systems become more sophisticated, resulting in greater emphasis on controls, particularly in developing interim financial information.

Overview of GAAS

2.193 SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, provides guidance on the external auditor's use of internal audit. It requires the external auditor to obtain an understanding of the internal audit function sufficient to identify those internal audit activities that are relevant to planning the audit.

2.194 If, after obtaining an understanding of the internal audit function, the external auditor concludes that the internal auditors' activities are not relevant to the financial statement audit, the external auditor does not have to give further consideration to the internal audit function, unless the external auditor requests direct assistance from the internal auditors. Even if some of the internal auditors' activities are relevant to the audit, the external auditor may conclude that it would not be efficient to consider further the work of the internal auditors. If the external auditor decides that it would be efficient to consider how the internal auditors' work might affect the nature, timing and extent of audit tests, the external auditor should assess the competence and objectivity of the internal audit function. The internal auditors' work may affect the procedures that the external auditor performs in obtaining an understanding of the entity's internal control and assessing risk, and the substantive tests he or she performs.

2.195 When the work of the internal auditors is expected to affect the audit, the external auditor should consider the extent of the effect, coordinate the audit work with the internal auditors, and evaluate and test the effectiveness of the internal auditors' work. These tests may be accomplished by either (a) examining some of the controls, transactions or balances that the internal auditors examined or (b) examining similar controls, transactions or balances not actually examined by the internal auditors.

2.196 In performing the audit, the external auditor may request direct assistance from the internal auditors. This direct assistance relates to work that the external auditor specifically requests the internal auditors to perform to complete some aspect of the external auditor's work. When direct assistance is provided, the external auditor should assess the internal auditors' competence and objectivity, and, to the extent appropriate in the circumstances, supervise, review, evaluate and test the work performed by the internal auditors.

Findings

2.197 The QPR reviewers reported that, on 16% of the engagements reviewed, the external auditors made significant use of the work of internal audit, or used internal audit to provide direct assistance to the engagement team to document internal control, test internal control or perform substantive tests of details.

2.198 The reviewers generally agreed that the people involved in assessing the overall effectiveness of internal audit and reviewing its work had the appropriate knowledge and skills to do so, that the engagement teams had a sufficient basis for making use of the work of internal audit or for using internal audit to provide direct assistance to the engagement team, and that the engagement team's review of the direct-assistance work was sufficient to support its use. Some questioned the sufficiency of the engagement team's review of the direct-assistance work and whether adequate retesting of internal audit work was performed.[56]

Recommendations

To the Auditing Standards Board:

2.199 The Panel recommends that the Auditing Standards Board revise SAS No. 65 to establish more definitive and specific criteria and requirements for testing the work performed by internal audit.

To audit firms:

2.200 The Panel recommends that audit firms:

- Review the adequacy of their policies requiring auditors to test the work performed

[56] The Panel noted during its study of AAERs (see Appendix F) a very limited number of situations in which the external auditors may not have tested, supervised and reviewed the internal auditors' work as thoroughly as would have been desirable.

by internal audit and to document their work relating to internal audit

- Consider during their internal inspection programs whether engagement teams are using the work of internal audit excessively, especially on large engagements

To the SECPS Peer Review Committee:

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

- Address the adequacy of firms' policies, procedures and guidance on the testing of internal audit work and the documentation of auditors' considerations and work related to internal audit

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

COMMUNICATING WITH AUDIT COMMITTEES

Background and Overview of GAAS

2.202 Audit committees of boards of directors have become a well-recognized and important element in the governance of U.S. public entities and increasingly of entities in other countries.

2.203 The SEC has long supported strong, independent audit committees. In 1974 and 1978, the SEC adopted rules requiring annual disclosures about the existence and composition of the audit committee, the functions it performed, and the number of meetings it held. In 1999, the SEC adopted new rules and amendments that, among other things, require companies to include reports by their audit committee in their proxy statements and disclose whether their audit committee is independent and has a charter. Listing requirements of the New York Stock Exchange, the American Stock Exchange and the NASDAQ national market require that listed companies have audit committees with membership limited solely to independent directors.

2.204 The skills and experience required of audit committee members, as well as the committees' roles, responsibilities and operating practices, historically have not been specified by the stock exchanges or the SEC. "Best practices" have evolved over time and have been published by various professional organizations and firms. Audit committees, the independence of committee members and committee best practices have been studied in depth, most notably by the National Commission on Fraudulent Financial Reporting,[57] the Advisory Panel on Auditor

[57] *Report of the National Commission on Fraudulent Financial Reporting*, October 1987.

Independence,[58] and the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees.[59]

2.205 Several auditing standards govern independent auditors' communications with audit committees. In general, SAS No. 61, *Communications With Audit Committees*, establishes auditor communication requirements relating to financial statements and other information in documents containing audited financial statements. Those requirements also include informing audit committees about significant accounting policies and their application, management judgments and the process used in formulating particularly sensitive accounting estimates, significant audit adjustments, disagreements with management, consultation by management with other accountants, major issues discussed with management prior to being retained, and difficulties encountered in performing the audit. The ASB recently amended SAS No. 61 with SAS No. 89, *Audit Adjustments*, and SAS No. 90, *Audit Committee Communications*. SAS No. 89 requires auditors to communicate to audit committees uncorrected misstatements whose effects management believes are immaterial. SAS No. 90 requires auditors to discuss with the audit committee their judgments about the quality, not just the acceptability, of the entity's accounting principles and the estimates underlying its financial statements. In addition, auditors are required to attempt to discuss with the audit committee certain matters identified in their quarterly review of interim financial information before it is filed with the SEC.

2.206 SAS No. 54, *Illegal Acts by Clients*, requires auditors to assure themselves that audit committees are adequately informed about illegal acts that come to the auditors' attention. SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, calls for reporting to the audit committee fraud involving senior management and fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statements.

2.207 The SECPS requires its member firms to report annually to audit committees the total fees received by the audit firm for management advisory services during the year under audit. In addition, Independence Standard No. 1, *Independence Discussions with Audit Committees*, calls for auditors to discuss with and confirm to audit committees their independence and disclose all relationships between the auditor and the entity that in the auditor's professional judgment may reasonably bear on independence.

Findings

2.208 The QPR revealed that audit committees had been established for all but five of the 126 public entities whose audits were reviewed. The reviewed engagements included eight companies where no committee meetings were held during the year and eight where the reviewers considered the number of meetings (typically one) to be inadequate. There were three additional instances in which the reviewers questioned the timeliness of the meetings.

2.209 The QPR reviewers addressed the following areas:

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[58] *Strengthening the Professionalism of the Independent Auditor*, Report to the Public Oversight Board of the SEC Practice Section, September 1994.
[59] *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees*, 1999.

- The substance of the audit engagement partner’s relationship with the committee chair
- The timeliness, frequency and quality of interaction among the auditor, audit committee and management
- The extent of the audit engagement and other partners’ involvement with the committee
- The relevance and completeness of the auditor’s written and oral communications with the audit committee
- Whether the audit committee had established and communicated its expectations to the auditor and management

2.210 The reviewers found a large number of comprehensive, well-written reports to audit committees that demonstrated candid and comprehensive communications on numerous matters, including business risks, audit scope and approach, analyses and discussion of important financial statement issues, and waived adjustments. The communications required by SAS No. 61 were complete and well documented in almost every situation. In one area, however, namely, the requirement in SAS No. 61 to "determine that the audit committee is informed about the process used by management in formulating particularly sensitive accounting estimates and about the basis for the auditor’s conclusions regarding the reasonableness of those estimates,” the reviewers found that the relevant written communication very often was limited to the auditor simply indicating agreement with management's position.

2.211 The reviewers also found that certain topics considered important to audit committees often were not communicated. These included:

- The overall quality of annual financial reporting (not communicated on 20% of the engagements)
- Financial statement risks (15%)
- Estimates and judgments (12%)
- Internal control matters (13%)
- Risk of fraud (20%)
- Compliance with laws and regulations (19%)
- Interim financial reporting (21%)

2.212 Many situations were identified in which auditor–audit committee relationships were excellent and reflected timely, candid communications and an apparent sense of mutual trust. There is clear evidence, however, that the frequency of contact and substantive interaction between the auditor and the audit committee or its chair often can and should be improved.

2.213 The results of the Panel’s survey, focus groups and interviews reflect very strong support for audit committees. Many participants commented, however, that the effectiveness of audit committees can and should be improved and communications and other relationships between audit committees and auditors need to be enhanced.

2.214 The reviewers sought to identify best practices regarding audit committees and specific opportunities to improve the committees' effectiveness. Essentially all of the best practices observed related to activities involving auditor–audit committee relationships and, more specifically, to the frequency of formal and informal contacts between the auditor and the committee or its chair. Not surprisingly, opportunities for improvement were focused largely on more auditor and audit committee contact, more frequent committee meetings, a higher level of committee activity and the committee's establishment of explicit expectations of the auditors.

2.215 The Panel supports the work of the Blue Ribbon Committee and the published responses of the following groups to which its report was addressed:

- Securities and Exchange Commission
- Auditing Standards Board
- New York Stock Exchange
- National Association of Securities Dealers

2.216 In addition, the Panel strongly supports more proactive audit committees and the development of stronger relationships between boards of directors (and their audit committees) and auditors that recognize that the auditors are ultimately accountable to the board of directors and the audit committee as representatives of the shareholders. The Panel also believes the development of explicit mutual expectations of the board and audit committee, management and the auditors is an essential initial step in the process.

Recommendations

To audit firms:

2.217 The Panel recommends that audit firms:

- Recognize the board of directors and audit committee, acting on behalf of the shareholders, as the parties to whom they are accountable and tailor their relationships and communications accordingly

- Make sure the audit committee's expectations are fully understood and that their communications with the committee are directly responsive to those expectations

- Reexamine firm guidance for reporting to audit committees and, if applicable, modify the guidance to promote candid discussions with the committee on:

    - Significant information system risks, including those related to any industry-specific regulations or issues

    - Qualitative observations about internal control

To the SECPS Peer Review Committee:

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

- Address the adequacy of firms' guidance on reporting to audit committees

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

To audit committees:

2.219 The Panel recommends that audit committees:[60]

- Specify in their charters and reflect in their actions, as recommended by the Blue Ribbon Committee, "that the outside auditor is ultimately accountable to the board of directors and the audit committee, as representatives of the shareholders, and that these shareholder representatives have the ultimate authority and responsibility to select, evaluate, and where appropriate, replace the outside auditors (or to nominate the outside auditors to be proposed for shareholder approval in any proxy statement)."

- Develop a formal calendar of activities related to those areas of responsibility prescribed in the committee charter, including a meeting plan that is reviewed and agreed to by the entire board. The meeting plan should include communications between the committee chair or full committee and the auditor before the release of interim or year-end financial data. In addition, the Panel recommends a minimum of two face-to-face meetings during the year with the external auditor and at least one executive session with the internal and external auditors without management's presence.

- Take charge of their agenda and ensure, in particular, that it focuses on, among other matters, risks directly affecting the financial statements, key controls, interim financial information, policies and practices for management's communications with analysts, and the qualitative aspects of financial reporting

- Inquire about time pressures on the auditor, including pressures on the timing of audit procedures; the degree of management's cooperation with the auditor; and their potential effects on audit effectiveness

- Review the internal and external auditors' performance on an annual basis; exercise responsibility, as the external auditor's primary client, to assess the auditor's responsiveness to the committee's and board of directors' expectations; and be

[60] The Panel also has made recommendations to audit committees in "Communicating and Reporting on Internal Control" and "Auditing Estimates and Judgments" in this chapter, and in Chapters 3 and 5.

satisfied that the auditor is appropriately compensated for performing a thorough audit

- Require the auditor and management to advise the committee of the entity's plans to hire any of the audit firm's personnel into high-level positions, and the actions, if any, that the auditor and management intend to take to ensure that the auditor maintains independence

ESTABLISHING AUDITING STANDARDS

The GAAS Hierarchy

2.220 Various forms of guidance in addition to the SASs are provided to auditors by the AICPA, for the most part under the auspices of the ASB. For example, the ASB's Audit Issues Task Force (AITF) issues auditing interpretations on the application of the SASs. While these interpretations are reviewed by the ASB, they are not as authoritative as the SASs. In addition, the AICPA from time to time issues other forms of auditing guidance, such as audit and accounting guides, auditing practice releases and statements of position. These other forms of guidance often are related to specific industry issues or accounting pronouncements. Guidance also is provided by the AICPA through other communications (e.g., audit risk alerts), conferences and seminars (e.g., an annual conference on SEC developments) and other means. Textbooks, reference materials, and training materials and courses also are available to auditors from a wide variety of sources.

2.221 The guidance to auditors in the SASs alone is formidable. Yet many SASs lack imperatives that compel auditors to take definitive steps in specified circumstances. For example, in some cases an SAS may impose an imperative on an auditor by indicating what an auditor definitively "should" do, while in other cases an SAS might only indicate what an auditor "should consider," allowing significant latitude for the exercise of judgment based on the circumstances of the engagement and on the auditor's assessment of risk and materiality.

2.222 Furthermore, the SASs do not indicate in an organized fashion the vast array of other guidance discussed above that is available to auditors from the AICPA. In addition, some of that other auditing guidance is not readily accessible to auditors, although the AICPA has made efforts to improve retrieval of some of its literature via its website. As a result, auditors might feel less compelled to comply with auditing guidance that goes beyond the SASs and related AITF auditing interpretations. In summary, there is no formal GAAS "hierarchy" that establishes the authoritative status of auditing pronouncements.

Working Papers and Documentation

2.223 SAS No. 41, *Working Papers*, calls for auditors to prepare and maintain working papers, the form and content of which should be designed to meet the circumstances of a particular engagement. Working papers provide the principal support for the auditor's report, including the auditor's representation regarding observance of the standards of fieldwork. They also aid in planning, conducting and supervising the audit. The SAS provides broad guidance on the nature of working papers and the documentation to be contained in them, indicating that they may be in the form of data stored on tapes, films or other media. SAS No. 41 observes, however, that there is no intention to preclude the auditor from supporting the audit report by other means in addition to working papers.

2.224 Beyond this broad standard relating to working papers, certain individual SASs require the auditor to document specified matters (e.g., SAS No. 82 requires documentation in the working papers of the auditor's fraud risk assessment and response). For the most part, however, the standards leave the extent of documentation to the judgment of the auditor. Individual firms' methodologies also specify certain documentation to meet their own needs.

2.225 The Panel believes that working papers and the documentation contained in them constitute an important quality control safeguard. Working paper documentation often is reviewed by persons other than the auditors who prepared the working papers. For example, auditors who are new to an engagement may review the prior year's working papers to gain an understanding of the work performed to aid in planning and performing the current audit. Supervisory personnel on an audit review the working papers prepared by assistants. Engagement partners or concurring partners may review all or selected working papers. Successor audit firms often review the predecessors' working papers. Internal inspection teams review engagement working papers as part of a firm's annual quality control review. Peer reviewers review the working papers on engagements selected for external peer review. Working papers also may be subject to review by other parties, for example, by representatives of a party to an acquisition, by regulators or by litigants' legal counsel.[61] Access to auditors' working papers may be granted voluntarily by the audit firm (usually with client approval and some restrictions) or obtained by legal action, such as by subpoena.

2.226 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. Among the actions taken by the ASB to implement its initiatives was establishing a task force on working paper documentation, and this task force is looking into some or all of the areas discussed in the Panel's recommendations. The Panel applauds the efforts by the ASB to reevaluate and update its strategic plan on an ongoing basis. The Panel believes that many of its recommendations to the ASB will affect the ASB's future priorities.

Recommendations

2.227 A number of the Panel's recommendations contained in this chapter urge the ASB to modify, amend or improve its standards by making them more specific and definitive. Other recommendations to the ASB suggest that clarification is needed to enhance audit effectiveness.

2.228 The Panel believes that auditing standards must serve to provide both reasonable and measurable benchmarks for performance by auditors. Standards need to be reasonable in that they should not force auditors to adhere to rules that do not take into account the myriad of

[61] The Panel is aware that in certain cases regulatory requirements prescribe minimum guidelines for working paper content.

circumstances that may exist on audits. To serve as effective measures of the quality of performance, however, auditing standards need to provide clear, concise and definitive imperatives for auditors to follow.

2.229 The QPR disclosed that working paper documentation often was less than adequate from the reviewers' perspective, and some of the Panel's individual recommendations address documentation. The Panel also was informed that documentation deficiencies are common in many peer reviews, although the criteria for asserting such deficiencies are subjective.

2.230 The Panel understands that working papers and the documentation contained in them taken alone cannot be expected to support fully all of the activities constituting an audit, including the subtleties of judgments made throughout the audit process. No one expects the auditor's working papers to duplicate the entity's records or to contain unnecessary information. At the same time, reasonable documentation requirements can avoid over reliance on the recollections of those who performed the audit work – a potential consequence of reduced documentation as firms seek to streamline their audit methodologies and processes. The Panel believes that, within reasonable limits, the work of auditors needs to be documented appropriately.

2.231 It is with these points in mind that the Panel has developed the following recommendations.

To the Auditing Standards Board:

2.232 The Panel recommends that the ASB:

GAAS Hierarchy and Access to Guidance

- Definitively set forth the "hierarchy" of GAAS, including the authoritative status of existing AICPA guidance. The SASs should specify the guidance auditors should use in performing audits, whether that guidance is explicitly in the SASs or elsewhere.

- Ensure distribution and accessibility of ASB pronouncements to all AICPA members who provide attest services

Auditing Standards and Quality Control Standards Generally

- Review all the standards of fieldwork not addressed elsewhere in this report for the purpose of ensuring that they are sufficiently specific and definitive, either within the SASs or elsewhere in the GAAS hierarchy, to guide auditors in formulating their judgments and carrying out their work. While the ASB may decide to differentiate between auditing standards applicable to both non-public and public entities and those applicable only to public entities, in general the Panel discourages such practice, especially with standards of fieldwork, since investors might be confused by the varying levels of audit quality that could result.[62]

- Perform a similar review, in collaboration with the Peer Review Committee and QCIC, of the Statements on Quality Control Standards to ensure that they also are specific and definitive. (See the Panel's recommendations to the SEC Practice Section and the ASB in the section "Enhancing Peer Reviews" in Chapter 6.)

Materiality

- Evaluate the guidance in SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, on the auditor's consideration of materiality in planning the audit and designing audit tests and on how materiality and risk assessments are related. Some of the findings and observations in this report that have resulted in recommendations to the ASB implicitly or explicitly raise questions about whether materiality guidelines used by auditors are too liberal or are not modified appropriately to reflect information obtained and conditions encountered in the course of the audit.

  Materiality judgments are an integral part of the audit risk model and inevitably influence decisions on the areas of audit emphasis and the extent of audit testing, including sample sizes. Accordingly, as part of this effort, the ASB also should review its auditing standard on audit sampling, SAS No. 39, *Audit Sampling*. The ASB's review should address whether more definitive guidance in the area of materiality – including the effects of materiality judgments on decisions about audit emphasis, the extent of audit testing and sample sizes related to specific objectives – might lead to more effective audits.[63]

  The ASB should request firms to share with it their guidance on materiality to assist it in its deliberations. The ASB also should consider appropriate research (possibly with the cooperation of firms, academic researchers and peer reviewers) on how the materiality concept is applied in practice.

  The Panel believes that this effort likely will result in modifications to auditing standards, unless the ASB is satisfied on the basis of its research that the present guidance is sufficient to drive effective materiality judgments in planning the audit and designing audit tests.

[62] Some auditing standards are designed to address matters unique to either public or non-public entities. For example, much of the guidance in SAS No. 71, *Interim Financial Information*, applies only to engagements to review interim financial information or statements of a public entity. The auditor communications called for by SAS No. 61, *Communications With Audit Committees*, are applicable only to audits of entities with audit committees (or the equivalent) and to audits of public entities. SAS No. 72, *Letters for Underwriters and Certain Other Requesting Parties* (as amended), is designed primarily for engagements related to registration statements filed with the SEC. Those SASs generally interpret the standards of reporting, not the general or fieldwork standards.
[63] The ASB also should consider the discussion of "*Materiality Issues*" under "Consideration of Exposure Draft Comments on the Forensic-type Phase" in Chapter 3.

Working Papers and Documentation

- Enhance SAS No. 41, *Working Papers*, to include criteria regarding the minimum documentation working papers should contain. The criteria for documentation to be included in working papers should be sufficiently specific to enable reviewers to understand the audit work performed, who performed and reviewed the work, and the nature of the audit evidence examined.

- Provide sufficient guidance in the quality control standards about working paper documentation to enable firms and peer reviewers to judge the quality of engagement performance (including the supervision of the work of assistants). The ASB should link the two sets of working paper standards to each other.

- Review all the fieldwork standards to ensure that there is definitive guidance within the SASs (or elsewhere in the GAAS hierarchy) on the type and extent of documentation that should be contained in the working papers. For example, the ASB should consider areas where specific documentation requirements similar to those contained in SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, would likely enhance audit effectiveness, and it should amend or modify the SASs accordingly.

To the Public Oversight Board and the Auditing Standards Board:

2.233 The Panel recommends that, consistent with the POB's role of oversight over the ASB's agenda and processes, the POB review the ASB's prioritization, timetable and process for addressing the Panel's recommendations to it.[64] In so doing, the POB and the ASB should consider the following observations and insights offered by the Panel:

Priorities and Timetable

- This chapter and Chapter 3 contain many recommendations to the ASB. These recommendations have been organized along the same lines as the QPR, generally tracking the key elements of the audit risk model, but they have not been assigned priorities. The Panel has expressed the view that its recommendations to the ASB in Chapter 3 reasonably could be effective starting with audits of financial statements for periods commencing after December 31, 2001. Otherwise, it has not endeavored to prioritize its recommendations or set forth a timetable for their implementation. The Panel recognizes, however, that its recommendations in some audit areas are closely linked with those in other areas and require coordination when the ASB sets priorities and its agenda.[65] The POB should ensure that the recommendations are addressed in a timely and effective manner.

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[64] The POB's proposed oversight role over the ASB is discussed in Chapter 6.
[65] The Panel is aware that the ASB already is addressing some of the Panel's recommendations and has set in motion a process for prioritizing and scheduling others.

ASB Due Process

- The Panel is aware that the ASB follows due process in formulating and promulgating GAAS and quality control standards, including subjecting its proposed pronouncements to public exposure and comment.[66] The ASB process weighs the relative benefits of its proposals with the attendant costs of implementing them. While respecting the importance of the ASB's due process, the Panel expresses confidence that its recommendations to the ASB, taken as a whole, are both reasonable and capable of implementation in a cost-effective manner.

Research and Innovation

- The Panel is aware that current or future research by the academic community and others may be relevant to matters addressed in its recommendations to the ASB.[67] Furthermore, the Panel acknowledges that the ASB will need to adapt GAAS and quality control standards to respond to new or evolving business conditions and demands on auditors. The Panel has developed its recommendations to meet both the current needs of investors for assurances on financial statements required under the present securities laws and the needs of investors in the reasonably foreseeable future. The Panel has not attempted, however, to predict the future "state-of-the-art" in accounting, the quantity or nature of financial and non-financial information that will be demanded by the marketplace, or how such information might be disseminated to and assimilated by investors in the longer term. (Chapter 8 contains the Panel's vision of some issues that pose a challenge in the years ahead.) Although the Panel believes that the ASB should consider carefully the results of research and the visions of accounting and auditing futurists, the ASB should not delay its timely pursuit of the Panel's recommendations until the research has been completed and evaluated.

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[66] See "Standard-Setting Bodies" in Appendix C.
[67] See, for example, the JWG paper referred to in note 13, the "earnings management" study referred to in note 36 and the SAS No. 82 research referred to in note 3 in Chapter 3.

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

[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. . . ."

investigative powers, such as the power to subpoena witnesses and obtain evidence under oath. 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

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[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*

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[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]

[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."

Members of top management are especially subject to pressures to demonstrate that shareholder 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 ris k 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

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[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

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[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

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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.

engagements the auditors did not have an adequate understanding of the client's system for 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]

[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.

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 *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

[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.

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 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 policies[35]

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[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:

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[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.

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[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

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[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.

from an expanded discussion of the Panel's consideration of the factors that would influence how 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*

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[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.

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 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

[51] Tests 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."

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]

- *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.

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[52] These matters also should influence the selection of the accounts that should be subjected to retrospective audit procedures.
[53] See note 15 to Chapter 2 regarding the Panel's study of AAERs.

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

CHAPTER 4 – AUDIT FIRMS

4.1 Approximately 15,000[1] 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 audit would appear to have value

[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.

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 requirements[6] are often included among the factors contributing to this decline.[7] While the larger firms generally believe that they have been able to hire sufficient numbers

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

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

[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 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

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

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

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

[10] See Appendix F.

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 Commission[3] 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.

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[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.

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[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 fees[9]:

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

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 below[10]:

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

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.

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[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] Earnscliffe 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 rules[15]:

  - Bookkeeping and similar services
  - Financial information systems design and implementation
  - Appraisal or valuation services
  - Actuarial services (to determine policy reserves and related accounts)

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[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. 1[17] and the SEC's new audit committee disclosure requirements[18] 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 Board[19] 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

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[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 250[21] 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 firms[22] 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

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[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 management[31] 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.

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[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

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

SEC's allocation of 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.

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[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.

6.10 Audit firms establish, maintain and enforce quality control policies and procedures that are 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 Independence[5] 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

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

help ensure that the governance system works more effectively and that the public is the system's primary beneficiary.

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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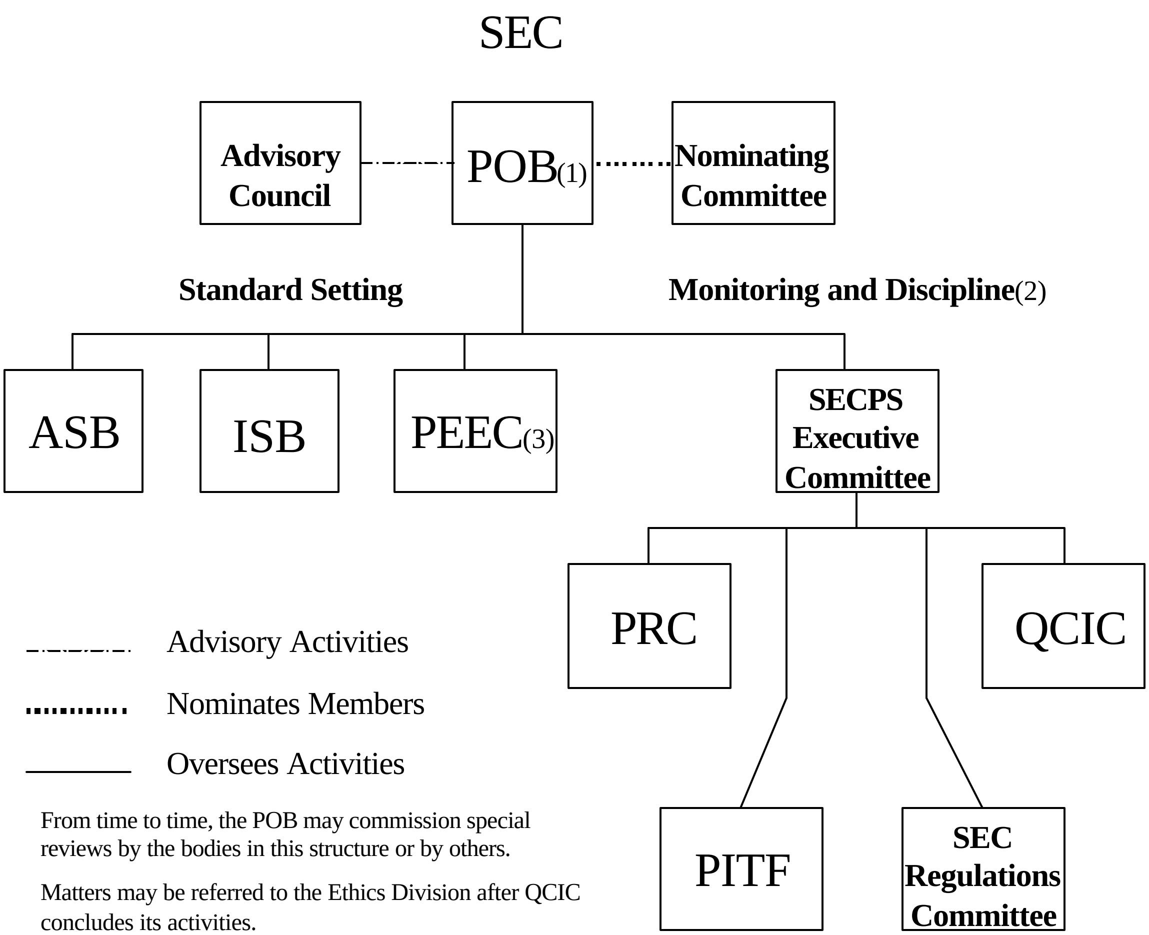
PROPOSED GOVERNANCE STRUCTURE



(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

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

the review performed

- 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

[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.

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.

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. Finally, the Division is able to

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[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]).

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:

[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.

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 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 partner[13] 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.

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[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.

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[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]

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[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 Firms[24]

- 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 firms[29]:

- Implement uniform audit methodologies throughout the world that use international auditing standards as the base minimum[30]

- 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.)

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[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.

APPENDIX A – THE AUDIT RISK MODEL

INDEPENDENT AUDITS OF FINANCIAL STATEMENTS

1 Publicly held companies and other entities (referred to in this report as *public companies* or *public entities*) are required by securities laws to file with the Securities and Exchange Commission (SEC) financial statements audited by independent auditors. Most users of financial statements are aware that such audits are being performed and that auditors issue reports that conclude with an opinion on whether the financial statements are in conformity with "generally accepted accounting principles" (GAAP).[1] GAAP is a technical accounting term that encompasses the conventions, rules and procedures necessary to define accepted accounting practice at a particular time. In general, the Financial Accounting Standards Board is the body that promulgates GAAP.

2 All auditors are required to perform audits in accordance with "generally accepted auditing standards" (GAAS).[2] The Auditing Standards Board (ASB) of the AICPA promulgates GAAS. The SEC historically has accepted GAAS as necessary and sufficient to comply with the requirements of the securities laws that call for independent audits of financial statements.

3 Audit firms are engaged by their clients (i.e., the preparers of financial statements) to perform audits. The management of a publicly held company is responsible for the preparation of the company's financial statements. Auditors are responsible for carrying out their audits of those financial statements in accordance with GAAS, which state that auditors are responsible for planning and performing their audits to obtain *reasonable, though not absolute, assurance* about whether the financial statements are free of *material* misstatement, whether caused by error or fraud. The purpose of independent audits therefore is not to produce financial statements but rather to enhance their reliability.

THE AUDIT RISK MODEL

Overview of the Model

4 GAAS establish a "model" for carrying out audits that requires auditors to use their judgment in assessing risks and then in deciding what procedures to carry out. This model often is referred to as the "audit risk model." The model allows auditors to take a variety of circumstances into account in selecting an audit approach. For example, the model calls for auditors to have an understanding of the client's business and industry, the systems employed to process transactions, the quality of personnel involved in

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[1] To distinguish GAAP or GAAS in the United States from accounting or auditing standards outside of the United States, these terms are sometimes modified as U.S. GAAP and U.S. GAAS (see Chapter 7).

[2] See note 1.

accounting functions, the client's policies and procedures related to the preparation of financial statements, and much more. The model requires auditors to gain an understanding of a company's internal control, and to test the effectiveness of controls if the auditor intends to rely on them when considering the nature, timing and extent of the substantive tests to be carried out. For example, if controls over sales and accounts receivable are strong, the auditor might send a limited number of accounts receivable confirmation requests at an interim date and rely on the controls and certain other tests for updating the accounts to year end. Conversely, if controls are not strong, the auditor might send a larger number of accounts receivable confirmations at year end. The model requires an assessment of the risk of fraud (intentional misstatements of financial statements) in every audit.

5 Based on the auditor's assessment of various risks and any tests of controls, the auditor makes judgments about the kinds of evidence (from sources that are internal or external to the client's organization) needed to achieve "reasonable assurance." On the one hand, GAAS set forth numerous requirements or matters that auditors should consider; on the other hand, the need to exercise audit judgment is embedded throughout GAAS.

Technical Briefing About the Model

6 Statement on Auditing Standards (SAS) No. 47, *Audit Risk and Materiality in Conducting an Audit*, essentially provides the high-level conceptual underpinning for the audit risk model, but the concepts in the model permeate GAAS. For example, the model directly influences audit sampling, which is the application of an audit procedure to less than 100% of the items in a given population for the purpose of evaluating some characteristics of the population.

7 Audit risk (AR) is the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. Audit risk is the *product* of the following three interrelated factors:

> IR = Inherent risk (the risk that an assertion is susceptible to a material misstatement, assuming there are no related controls)
>
> CR = Control risk (the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the entity's internal control)
>
> DR = Detection risk (the risk that the auditor will not detect a material misstatement that exists in an assertion)

8 Thus, the "mathematical" depiction of the audit risk model in simple terms is AR = IR x CR x DR. Despite the precision implied by rendering the model in mathematical terms, in reality it is highly judgmental. The objective in an audit is to limit audit risk (AR) to a low level, as judged by the auditor.

9 Essentially this objective is accomplished as follows. Auditors are required to assess inherent risk (IR) and control risk (CR) along a spectrum. Often in practice this assessment is reduced to three levels: maximum risk, moderate risk or low risk (or similar terms, such as high, medium or low risk). These assessments are complex matters to carry out, and GAAS set forth a number of requirements on how to accomplish them at both the financial statement level and the individual account balance or class of transactions level. GAAS also contain a specific requirement that, if control risk is to be assessed at less than the maximum level, the auditor must test the effectiveness of controls to support that assessment. A maximum risk assessment (i.e., 100%) means that the auditor believes controls are unlikely to pertain to an assertion or are unlikely to be effective, or the evaluation of their effectiveness would be inefficient. In all cases, the auditor is permitted to "default" to a maximum risk assessment for inherent or control risk.

10 The importance of the assessments of inherent and control risk is highlighted by their effects on detection risk (DR). The effects can be depicted in mathematical form by the equation $DR = AR / (IR \times CR)$. The auditor mitigates or compensates for the assessed levels of risk by designing and performing procedures to detect material misstatements. The greater the inherent and control risks, the lower the detection risk needs to be, resulting in "more" procedures ("more" includes their nature and timing as well as their extent) that the auditor would need to carry out. At the end of the day, the objective is to limit audit risk to an appropriately low level, thus enabling the auditor to achieve *reasonable assurance* that the financial statements are free of material misstatement.

11 Some added observations about what the audit risk model contains and does not contain are worthy of discussion. First, the model subsumes the concept of "materiality." Auditors do not have to concern themselves with every possible misstatement of a financial statement that might occur. Consequently, the concept of materiality enters into the risk assessment process, and the selection of the nature, timing and extent of the audit procedures is an integral part of the model. Furthermore, the model calls for auditors to make "fraud risk" assessments that encompass attributes of both inherent and control risk.

12 Lastly, the auditor also is exposed to risks that are not embraced in the audit risk model. For example, auditors may be exposed to loss or injury to their professional practice from litigation, adverse publicity or other events arising in connection with financial statements they audited and reported on. This exposure is present even though the auditor has performed the audit in accordance with GAAS and has reported appropriately on the financial statements. Even if the auditor assesses this exposure as low, the auditor is not permitted to perform less extensive procedures than otherwise would be appropriate under GAAS. The "risks" that fall outside of the audit risk model generally are referred to as "engagement risk," "client risk" or "client continuance (or acceptance) risk."

Historical Perspective of the Model in GAAS

13 The audit risk model is codified in GAAS (although not by name), primarily in SAS No. 47. The ASB issued SAS No. 47 in 1983, and it was amended in 1997 by SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*. Prior to SAS No. 47, many auditors employed some of the model's concepts in practice, albeit they were not explicitly codified and embedded in GAAS. There is, however, no clear record of exactly what practice was in this area prior to SAS No. 47. Generally, it is believed that, while auditors' judgments entered into the audit process, many auditors employed "procedural" approaches that were not fully supported by strict conceptual underpinnings. In other words, audits tended to be conducted using a variety of substantive testing approaches with less reliance on judgments about risk. Testing of internal control, primarily by testing individual transactions, was common and sometimes extensive.

14 Since 1984, auditors have been required to follow SAS No. 47; in other words, they have been required to employ the audit risk model. Notwithstanding this requirement, anecdotal and other evidence indicates that many (but by no means all) audits continued to be performed using substantive testing approaches with little or no attention paid to the results of the risk assessments called for by the model. This phenomenon perhaps is facilitated by the fact that the model permits "defaulting" to an assumption that risks are at a *maximum level*.

15 Over time, however, audit firms began to evaluate both the effectiveness and efficiency of their audits. The sheer volume of transactions processed by client organizations, the fast pace of technological developments affecting client organizations and audit firms alike, and economic constraints on the ability of audit firms to recover rising costs were influential drivers in these evaluations. They led some firms to conclude that many audits were being conducted without sufficient consideration being given to the risk assessment process and that they consequently lacked in both effectiveness and efficiency. Some firms responded by making important changes to their audit methodologies. Furthermore, changes to audit methodologies continue to be made by firms and some of those changes are highly significant.

AUDIT FIRM METHODOLOGIES

16 While all audits of financial statements of publicly held companies are required to comply with GAAS, audit firms are at liberty to design their audit processes or methodologies in whatever manner best suits their needs so long as the processes or methodologies result in audits that comply with GAAS. Historically, audit firms have adapted their processes or methodologies in response to such matters as changes in business or industry conditions, changes in clients' systems or use of technology, and new or changed requirements of GAAS or GAAP.

17 Auditors are guided in many ways by their firms' processes or methodologies – for example, how personnel are assigned to engagements, how they are supervised and their work is reviewed, the way audit working papers are prepared (e.g., by electronic means or otherwise) and the nature and extent of documentation retained in the working papers. For multi-location audits, including those for which work is to be performed outside of the United States, the processes or methodologies guide how that work is carried out and by whom, and how it is reviewed. Included in the processes and methodologies are policies and guidance on matters for which consultation within the audit firm is required or advisable, and on other quality control matters.

18 Audit firms also take into consideration their clients' expectations, such as expectations that the auditor will inform them of matters that might benefit their businesses. Clients' expectations often go well beyond GAAS requirements for performing financial statement audits. Auditors respond to those expectations by providing information or services beyond the financial statement audit, either separately or as an integral part of their audit processes and methodologies.

APPENDIX B – THE AUDIT FIRMS

1 There are approximately 15,000 entities, including about 1,200 international companies, that file financial statements with the SEC.[1] The financial statements included in those filings are audited by a variety of international, national, regional and local audit firms. The differences among the firms in terms of structure and service offerings, client demographics and size of practice usually result in their being stratified into two groups, the eight largest firms and all other firms. Additional information about audit firms is included in Chapter 5 of this report (comparative mix of revenue data) and Appendix D.

2 Substantially all U.S. registrants are audited by member firms of the SEC Practice Section (SECPS). Not all members of the SECPS audit public companies. According to recent AICPA data, the SECPS membership profile by number of SEC clients is as follows:

Number of SEC clients	Number of member firms
0	478
1	352
2 – 4	298
5 –10	104
11-15	19
16-20	9
21-30	11
Over 30	14
Total	1,285

Thus, 65% of the SECPS member firms have only one or no SEC clients; almost 90% have four or less. In addition, approximately 50 U.S. firms that are not SECPS members audit the financial statements of U.S. registrants. Some of those firms are not eligible for SECPS membership because of past violations of the membership requirements.[2] Most foreign registrants are audited by foreign firms that are not members of the SECPS.[3]

[1] SEC staff estimates as of March 2000.

[2] SEC Practice Section, *Annual Report – Year Ended June 30, 1997.*

[3] See Chapter 7 for a description of recent changes to SECPS membership requirements for member firms with foreign associated firms that perform audits of foreign registrants. Each SECPS member firm is required to seek the adoption of the changes by 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.

EIGHT LARGEST FIRMS

The Big 5 Firms

3 The five largest audit firms are (in alphabetical order) Arthur Andersen LLP, Deloitte & Touche LLP, Ernst & Young LLP, KPMG LLP and PricewaterhouseCoopers LLP. They are commonly referred to as the "Big 5 firms." Since their founding over 100 years ago, these firms have become highly regarded as established leaders in the accounting and auditing profession. In 1999, these firms collectively audited approximately 76% of U.S. public registrants[4] and had U.S. revenues of approximately $26 billion, of which approximately $9.5 billion was for accounting and auditing services.[5]

International Presence

4 The Big 5 firms are international accounting, auditing and consulting firms whose U.S. practices are organized as limited liability partnerships. The average size of a Big 5 firm in the United States is approximately 90 offices, 2,000 partners and 24,000 professionals.[6] Globally, these firms average approximately 100,000 professionals serving clients across 130 countries.[7]

5 The global organization of the Big 5 firms varies. Their structure may range from an affiliation of firms joined by international marketing and cost-sharing agreements without central management to a single integrated firm that is managed internationally. Globalization efforts have focused primarily on common branding and marketing, consistent service delivery, common infrastructure and access to additional capital resources. The majority of the Big 5 firms have established their international presence through international affiliations. Historically, the affiliate structure has presented obstacles in delivering seamless global service to clients and achieving uniform management policies because of the level of autonomy that may remain with the individual affiliates.

6 Increasingly, there is market pressure to be organized as an integrated global firm that can act as one entity, deliver uniform worldwide services and implement consistent business policies. Recently, some of the firms have moved toward complete globalization by combining member firms in certain regional areas, which has strengthened the delivery of global services to clients and assisted in creating and implementing uniform accounting and auditing standards worldwide.

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[4] Data provided by SECPS staff.
[5] Compiled from information in "Annual Survey of National Accounting Firms – 2000," *Public Accounting Report*, March 31, 2000.
[6] Compiled from 1999 firm annual reports submitted to the SECPS.
[7] Compiled from data on firm websites as of February 2000.

Service Offerings and Structure of Practice

7 The Big 5 firms offer a wide array of services, encompassing:

- Assurance services, including traditional audit, information systems security, internal audit outsourcing and risk assurance services
- Tax services, including corporate and individual planning and compliance and global strategic tax planning
- Consulting services, including strategic change management, process improvement, systems design and implementation, and human resources

8 The increased demand for and competitive pressures to expand these service offerings, differentiate them and identify new markets have led the Big 5 firms to:

- Adopt the term "assurance" services as an umbrella for audit activities and other services historically provided by the audit staff, such as assistance in mergers and acquisitions, as well as newly developed services that are audit related, such as internal audit outsourcing and risk assurance
- Assign the delivery of specialized assurance services, such as transaction-based services (e.g., due diligence and financing advice), to teams of experts in those fields
- Develop new service offerings to address emerging market needs, such as e-business
- Expand the breadth of consulting services to compete with traditional consulting firms
- Expand tax services to include legal services

The expansion of these services has contributed significantly to the Big 5 firms' annual double-digit revenue growth over the past decade. Three of the Big 5 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, as discussed in Chapter 5.

The Next Three Largest Firms

9 The next three largest firms are (in alphabetical order) BDO Seidman, LLP, Grant Thornton LLP and McGladrey & Pullen, LLP. In 1999, these firms collectively audited approximately 6% of U.S. registrants. The average size of these firms is 47 U.S. offices, 330 partners and 2,200 professionals.[8] Globally, they average 483 offices across 86 countries.[9]

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[8] Compiled from 1999 firm annual reports submitted to the SECPS.
[9] Compiled from data on firm websites as of August 2000.

10 BDO Seidman, LLP and Grant Thornton LLP are international accounting and consulting firms organized in the United States as limited liability partnerships. Their global reach is achieved through various international affiliations. In addition, BDO Seidman has formed the BDO Seidman Alliance, which is an alliance of more than 30 independent U.S. firms.

11 McGladrey & Pullen, LLP (McGladrey) is a national accounting firm that is represented internationally through its affiliation with RSM International. McGladrey provides audit and accounting services and certain income tax services to its clients. McGladrey is related to RSM McGladrey, Inc., which offers clients nonattest professional services. McGladrey and RSM McGladrey, Inc. are separate legal entities. McGladrey is wholly owned by its partners, and RSM McGladrey, Inc. is an indirect wholly owned subsidiary of H&R Block, Inc. In August 1999, H&R Block, Inc. acquired the non-attest assets and business of McGladrey and consolidated them with those of other smaller accounting firms in a "roll-up" transaction.

12 Like the Big 5 firms, these firms provide accounting, tax and consulting services, but the services are directed primarily to middle market, entrepreneurial clients. Competitive pressures for firm growth and capital needs and regulators' concerns for auditor independence have led these firms to focus on many of the same growth strategies as the Big 5 firms.

OTHER FIRMS

13 There are approximately 45,000 local and regional accounting firms in the United States, generally organized as partnerships or sole proprietorships,[10] of which approximately 800 audit SEC registrants and are members of the SECPS.[11] Collectively, these SECPS members audit approximately 17% of U.S. registrants.[12] Over 7,200 of the smaller firms[13] are members of the AICPA's Partnering for CPA Practice Success, which was founded in 1977 to serve as an advocate for smaller firms within the AICPA and to improve the quality of their services and operations. The smaller firms play a significant role in contributing to the leadership of the profession. They participate extensively in AICPA boards, committees and initiatives such as the CPA Vision Project and CPA Web Trust.[14]

International Presence

14 The smaller firms generally have not had a significant international presence as their practices have been focused regionally or locally. However, that is changing as these

[10] Data provided by AICPA staff.
[11] See paragraph 2.
[12] SECPS 1997 Annual Report.
[13] AICPA website, August 2000.
[14] The purpose of the CPA Vision Project is to define a comprehensive and integrated vision of the profession's future. CPA Web Trust is an example of expanding assurance services beyond their traditional boundaries.

firms increasingly form networks of independently owned firms within the United States and internationally. These domestic and international associations seek to leverage the firms' collective knowledge, obtain client referrals, establish strategic alliances, expand their geographic reach and increase their service offerings. There are now more than 130 associations of accounting firms, including 30 international associations, that together include approximately 1,000 U.S. regional and local firms.[15]

15 Generally, association membership requires annual dues to fund the activities of the association and may require correspondent fees for certain referrals and labor sharing. There is no profit sharing or common name among the association members, and common branding is limited generally to references by a firm to its membership in the association on its letterhead or website.

Practice and Structure

16 Alternative structures for small firms have emerged as a result of corporate purchases of their non-attest businesses and roll-up transactions in which the purchasing entity (frequently referred to as a "consolidator") acquires the non-attest assets and employees of small firms. Because state laws generally require that CPAs own at least a majority of audit firms, the audit practices of these firms are retained in partnerships controlled by their former partners. In these structures, several audit firms may be affiliated with, but not owned by, the consolidator, or the firms may be merged into a single audit firm. As a result of these transactions, an operational link is formed between the audit partnership and the new corporate entity performing the non-attest services. Various business arrangements, such as cost sharing and employee leasing, may occur between the two entities.

17 Many industry leaders believe that consolidation in one form or another is the business model of the future for small firms because it provides for expanded services, improved name recognition, higher staff retention and expanded capital resources. Some view consolidators and associations as a means of leveling the playing field between the small firms and the large firms in the middle market arena.

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[15] David Albrecht, professor of accounting, Bowling Green State University, Bowling Green, Ohio, as quoted in Richard Glickman, "International Associations," *Journal of Accountancy* (January 2000).

APPENDIX C – CURRENT GOVERNANCE SYSTEM

OVERVIEW AND HISTORICAL PERSPECTIVE

1 Society often grants professions the right to regulate themselves to protect the interests of both their members and the public. The auditing profession has long maintained a voluntary, self-regulatory governance system through the activities of the American Institute of Certified Public Accountants (AICPA)[1] and, in more recent years, the Financial Accounting Standards Board (FASB), Independence Standards Board (ISB), SEC Practice Section (SECPS) and Public Oversight Board (POB). This system has been improved and modified continually as political, social and economic conditions and needs have changed.

2 Although the goals of self-regulation and public regulation are similar – protecting the public interest – and the two systems operate in concert with one another, there are important differences. Robert K. Mautz noted that:

> Public regulation is conducted with the full power of the state in support of established requirements. Self-regulation has no equivalent authority. At most, it can exclude noncomplying members from whatever benefits group membership confers or impose whatever sanctions members have voluntarily agreed to accept. Such powers as the ability to subpoena records and witnesses are not available in self-regulation.[2]

3 In the mid-1970s, reports of U.S. companies paying bribes to foreign officials and several highly publicized corporate bankruptcies resulted in the U.S. Congress looking into the accounting profession. Hearings were held in both the House of Representatives (chaired by John E. Moss) and the Senate (chaired by Lee Metcalf) to investigate these matters and the role of independent auditors. In 1977, the profession created the SEC Practice Section as part of the Division for CPA Firms of the AICPA, which gave rise to unprecedented voluntary self-regulatory initiatives:

- Independent oversight of the SECPS by the POB
- Mandatory peer review
- Mandatory continuing professional education
- Establishment of the Quality Control Inquiry Committee (QCIC) (initially called the Special Investigations Committee)

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[1] Including the Auditing Standards Board (ASB) (see Appendix A).

[2] Robert K. Mautz, "Self-Regulation: Perils and Problems," *Journal of Accountancy* (May 1983) (initially presented as an address at the AICPA's tenth national conference on current SEC developments [January 1983]).

These initiatives required SECPS member firms to subject their professional practices to peer review, independent oversight by the POB and scrutiny by the SEC.

4 Initially, membership in the SECPS was voluntary. Membership grew rapidly in the initial three years to include CPA firms that audited approximately 75% of all SEC registrants. There was criticism, however, of the voluntary nature of participation and the fact that non-participating CPA firms that audited SEC registrants numbered in the hundreds. In response, in 1988, the AICPA membership changed its by-laws to mandate that each individual member of the AICPA who provides attest services to an SEC client (as defined in the SECPS membership requirements) be employed by or affiliated with a CPA firm that is an SECPS member.[3] Presently, there are approximately 1,300 member firms in the SECPS that collectively audit more than 99% of all U.S.-based SEC registrants.

5 The SECPS created a structure and requirements for its member firms with one end in mind – to protect the public interest by improving the quality of practice by CPA firms before the SEC. Each member firm is required to install a system of quality control to provide reasonable assurance that the firm conforms with professional standards in conducting its accounting and auditing practice. The requirements are flexible enough to allow firms of all sizes (from sole practitioners to international firms) to design and operate systems that are appropriate for their practice. The system of quality control must include elements related to independence, integrity and objectivity; personnel management; acceptance and continuance of clients and engagements; engagement performance; and monitoring.

THE COMPONENTS OF SELF-REGULATION

6 The profession's self-regulatory system complements public regulation. Self-regulation extends beyond public regulation in some areas (discipline, for example), while in other areas, such as standard setting, it largely takes the place of public regulation. The profession's self-regulatory structure includes bodies that set professional standards as well as bodies that conduct the related compliance and disciplinary procedures that apply to CPAs and CPA firms as a result of their voluntary memberships in the AICPA. The standards include technical, ethical and quality control standards, and requirements for continuing professional education. A chart of the current governance structure is included in Table 1 at the end of this appendix.

Public Oversight Board

7 At the time of its formation, the SECPS sought to quiet those who might question the effectiveness of a voluntary self-regulatory model whose cornerstone would be a review by, and among, peers. Although a public regulatory system was already in place, the

[3] Non-compliance by an individual AICPA member results in his or her expulsion from the AICPA.

SECPS wanted an independent component that would represent the public interest. This led to the POB.

8 The POB comprises five independent public members – primarily non-accountants with a broad spectrum of business, professional, regulatory and legislative experience – who represent the public interest. The POB nominates and elects its own replacements. The current members are:

- Charles A. Bowsher, Chairman, Comptroller General of the United States and head of the General Accounting Office (1981–1996), Partner of Arthur Andersen & Co. (1971–1981), Assistant Secretary of the Navy—Financial Management (1967–1971) and corporate director

- Donald J. Kirk, Vice Chairman, Financial Accounting Standards Board, member (1973–1977) and Chairman (1978–1986), Partner of Price Waterhouse & Co. (1967–1973), Columbia Business School, Professor (1987–1994), Executive-in-Residence (1995–present) and corporate director

- Melvin R. Laird, Secretary of Defense (1969–1973), Counselor to the President (1973–1974), nine-term member of the U.S. House of Representatives (1953–1969)

- Norman R. Augustine, Chairman and CEO of Martin Marietta Corporation (1987–1995), Chairman and CEO of Lockheed Martin Corporation (1996–1997), Assistant (1973–1975) and Under (1975–1977) Secretary of the Army, Chairman and Principal Officer of the American Red Cross (1992–present) and corporate director

- Paul H. O'Neill, Chairman and CEO of Alcoa (1987–1999) and corporate director

9 The POB has sole discretion in the hiring and replacement of its Executive Director, who is responsible for hiring and supervising the technical and administrative staffs. Dues paid by SECPS member firms support the POB; however, the POB is responsible for determining all aspects of its budget, including compensation levels of the Board members and the staff.

10 The POB's primary function is to monitor and report on the activities of the SECPS. Its objective is to safeguard, and act as an advocate of, the public interest. Accordingly, the POB meets regularly with standard-setting bodies, public regulators and those responsible for the various SECPS activities.

11 Over the years the POB has expanded its role by identifying and commenting on issues related to the quality of auditing and financial reporting in the United States. In that capacity, the POB has issued reports that include:

- *Scope of Services by CPA Firms* (1979), an analysis of and recommendations regarding non-audit services provided by CPA firms to their SEC audit clients

- *Public Perceptions of Management Advisory Services Performed by CPA Firms for Audit Clients* (1986), a research report prepared by the Survey Division, Audits & Surveys, Inc., which reported the survey results of nine key publics' perceptions of the management advisory services (MAS) issue. The survey results suggested that members of the key publics think that performing certain MAS can impair objectivity and independence and that caution needs to be exercised when CPAs perform any MAS for their audit clients.

- *In the Public Interest* (1993), a special report dealing with issues confronting the accounting profession

- *Strengthening the Professionalism of the Independent Auditor* (1994), by the Advisory Panel on Auditor Independence, chaired by Donald J. Kirk and often referred to as the Kirk Panel Report. The Advisory Panel was formed in response to concerns expressed by the Chief Accountant of the SEC in January 1994 regarding his perceptions of auditors' acquiescence to clients' accounting policies. The recommendations in the report called for auditors to look to the audit committee and the board of directors – the shareholders' representatives – as the audit client, not corporate management.

- *Allies in Protecting Shareholder Interests* (1994), a report to directors, management and auditors that discusses the corporate governance recommendations contained in the Kirk Panel Report

SEC Practice Section

12 The SECPS's activities are carried out by its Executive Committee, Peer Review Committee, QCIC, SEC Regulations Committee, and the Professional Issues Task Force (PITF).

SECPS Executive Committee

13 The SECPS Executive Committee governs the SECPS's activities, which are subject to oversight and public reporting by the POB. The responsibilities of the SECPS Executive Committee include:

- Establishing the SECPS membership requirements
- Establishing budgets and dues requirements to fund the SECPS's activities
- Determining sanctions to be imposed on member firms for failing to comply with the SECPS membership requirements
- Appointing persons to serve on such committees and task forces as are

necessary to carry out the SECPS Executive Committee's functions
- Consulting from time to time with the POB

14 Well-defined membership requirements are critical to the SECPS's overall success. The SECPS adopted numerous membership requirements at the outset, and has continued to amend and add to them as times and circumstances have changed. The principal membership requirements include:

- Adhering to quality control standards established by the AICPA
- Submitting to a peer review of the firm's accounting and auditing practice every three years
- Ensuring that all professionals within the firm participate in specified amounts of continuing professional education
- Assigning an audit partner to be in charge of each SEC engagement up to a maximum of seven years
- Assigning a second partner to perform a preissuance concurring review of the auditor's report and financial statements of each SEC client
- Establishing independence policies covering relationships between (a) the member firm, its benefit plans and its professionals (and the close relatives of such professionals) and (b) "restricted entities" of the firm (i.e., all audit clients that are SEC registrants and certain entities related to such clients)
- Maintaining an independence database that includes, at a minimum, (a) all restricted entities and (b) for firms with at least 7,500 professionals, partners' and managers' investment holdings, so the two can be matched on a timely basis
- Designating a senior-level partner to be responsible for timely updates to the independence database and for overseeing the adequate functioning of the firm's independence policies and consultation process
- Seeking adoption of policies and procedures by a firm's international organizations or individual foreign associated firms whereby (a) a "filing reviewer" (a person or persons knowledgeable in accounting, auditing and independence standards generally accepted in the United States) would perform certain limited review procedures prior to the submission of certain SEC filings that include or incorporate the foreign associated firm's audit report, and (b) a sample of SEC audit engagements would be reviewed as part of the annual inspection program of the international organization or the individual foreign associated firms
- Reporting annually the names and countries of the foreign associated firms that have represented that they have established such policies and procedures
- Filing with the SECPS each year an annual report containing certain demographic and statistical data related to the firm's attest, tax and MAS services to SEC clients
- Reporting annually to the audit committee or board of directors of each SEC client on the total fees received from the client for MAS and a description of the services

- Reporting to QCIC within 30 days of being served with any litigation or regulatory proceeding relating to alleged audit deficiencies in the audit of an SEC client

Peer Review Committee

15 CPA firms are required to create a system of quality control, in accordance with promulgated standards, that is appropriate for their size, the nature and complexity of their practice, and other factors. The peer review process was established to evaluate whether:

- A firm's quality control system for its accounting and auditing practice appropriately addresses each element of quality control
- The quality control policies and procedures are adequately documented and communicated to professional personnel
- Personnel are complying with the policies and procedures
- The firm is complying with the SECPS membership requirements

16 Independent peer reviewers, that is, other audit firms, examine each firm's quality control system every three years. The peer reviewers examine both the design of the system and compliance with it, including a review of internal firm documents and selected audit reports and working papers. At the completion of the peer review, the peer reviewers issue a report on the effectiveness of the design of and compliance with the system. The report, similar to that rendered at the completion of an audit, may be unmodified, modified or adverse. The report also may refer to a separate letter of comments that enumerates deficiencies in the system of quality control that were noted during the peer review. (When the report is unmodified, it states that none of the deficiencies are of such significance as to result in a modified report.) The reviewed firm is required to submit a letter of response to the Peer Review Committee (PRC) describing the actions taken, or to be taken, by the firm to correct the deficiencies.

17 The peer review report and, if applicable, the letter of comments and letter of response (collectively, the peer review reports), together with the peer review working papers, are submitted to the POB staff or the SECPS staff for review. The POB staff performs an in-depth review of the peer review working papers and related peer review reports for those firms, including all of the largest firms, that meet its risk-based criteria. The POB staff provides oversight on all other peer reviews. The SECPS staff reviews the peer review working papers and related reports for those peer reviews that the POB staff does not review. Collectively, the SECPS and POB staffs then present the reports to the PRC (comprising representatives from 18 member firms) for acceptance. On acceptance, the peer review reports are placed in a public file at the AICPA.

18 When necessary, the PRC imposes corrective measures on member firms to make certain that quality control deficiencies are corrected. Those corrective measures and the number of times they were imposed during the SECPS's fiscal year ended June 30, 1999, and since the inception of the peer review process are as follows[4]:

Action	Year Ended June 30, 1999	Since Inception
Accelerated peer review	1	54
Employment of an outside consultant to perform preissuance reviews of financial statements or other specified procedures	11	110
Oversight by the peer reviewers or a PRC member to monitor progress made by the firm in implementing corrective actions	11	220
Oversight of the firm's internal monitoring program	32	402
Changes made to the firm's quality control document or other guidance materials	1	44
Continuing professional education in specified areas	4	62*

* Since July 1, 1988; data for prior years are no longer available.

19 The POB oversees the entire peer review process, including reviewing the qualifications of peer reviewers. Further, under the provisions of an access agreement between the POB and the Office of the Chief Accountant (OCA) of the SEC, the peer review working papers and related reports (masked to protect the confidentiality of individual registrants) are made available for review and oversight by the OCA staff.

Quality Control Inquiry Committee

20 Shortly after the SECPS instituted the peer review process, its member firms and the SEC sought a means to address issues of alleged audit failures that occurred during the three-year period between a firm's peer reviews. The result was the Special Investigations Committee, later renamed QCIC, which consists of approximately 12 representatives of member firms, most of whom are retired.

21 Member firms are required to report to QCIC, within 30 days of being served, all matters of alleged audit failures involving SEC clients arising from litigation or regulatory investigations, including criminal indictments. The QCIC process begins almost immediately after a matter is reported; it is not deferred while litigation or regulatory proceedings are in process. The allegations are investigated by QCIC members and staff to determine whether there are deficiencies in the reporting firm's system of quality control, its compliance with the system, or the professional standards relevant to the matters in the case. QCIC does not make any determinations concerning the guilt, innocence or liability of the reporting firm.

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[4] Public Oversight Board, *Annual Report 1999.*

22 The activities of QCIC take place in four distinct phases. Each case added to its agenda might require QCIC to employ the procedures in one or more phases. The phases and the related procedures are as follows:

Phase No. 1 – Analysis of allegations

23 Read the complaint against the firm, relevant financial statements and any other publicly available relevant materials. After evaluating the information, proceed to Phase No. 2 unless the case file can be closed because, after analysis, QCIC considers the complaint to be frivolous. A frivolous complaint is characterized by, among other things:

- Allegations that do not relate to a period in which the auditor was associated with the entity's financial statements
- Allegations that are so general in nature that they do not raise serious implications concerning the adequacy of the firm's system of quality control or its compliance with that system
- Allegations that ignore relevant and adequate disclosures made in the financial statements or information contained in the auditor's report
- Allegations that do not relate to matters that are encompassed by existing generally accepted accounting principles (GAAP) or generally accepted auditing standards (GAAS), or that clearly misstate their requirements

Phase No. 2 – General inquiries

24 Discuss the issues addressed by the allegations that have quality control implications with representatives of the firm. Based on those discussions, proceed to Phase No. 3 unless the case file can be closed because one or more of the following conditions exist:

- The relevant aspects of the firm's system of quality control are considered adequate based on QCIC's review of the firm's relevant guidance materials and established firm auditing or quality control policies and procedures
- The complaint stems from a business failure, not an audit failure
- Nothing more than minor changes in quality control were necessary, and the firm has taken appropriate corrective measures and has satisfied QCIC that those changes are effective

Phase No. 3 – In-depth inquiries

25 Discuss with firm personnel who are familiar with the subject engagement the quality control policies and procedures and compliance with them; review firm technical manuals, guidance materials and inspection reports; or read certain audit documentation having a bearing on the issues addressed by the allegations. Based on those procedures, proceed to Phase No. 4 unless the case file can be closed because the responses to QCIC's inquiries provide a reasonable basis to conclude that the firm's quality control policies and procedures are adequate and were complied with.

Phase No. 4 – Special review

26 A special review is ordered whenever QCIC, based on its evaluation of responses to in-depth inquiries, is not satisfied that the firm's quality control system provides the firm with reasonable assurance of performing audit engagements in compliance with professional standards, whether for the firm as a whole, an office or a specific industry. The scope of a special review is directly related to the extent of the possible quality control deficiencies and any corrective actions that may be needed.

27 From July 1, 1981, through June 30, 2000, QCIC has opened 866 cases (see Table 2 to this appendix).

28 Before 1998, the AICPA Ethics Division would open a case file on the AICPA members on the engagement concurrent with QCIC opening a case file. The Ethics Division, as a matter of fairness to an AICPA member and at the member's request, would defer its investigation until the litigation or regulatory proceeding had been completed, which often was many years after the allegation had been made. Even when the QCIC investigation resulted in a determination that the allegation was frivolous, the Ethics Division would expend considerable time and resources (albeit many years later) to reach a similar conclusion.

29 In 1998, in an attempt to eliminate this waste of time and resources, the SECPS Executive Committee and the Professional Ethics Executive Committee (PEEC) entered into a Memorandum of Understanding (MOU) whereby QCIC would assign a rating to each case at the conclusion of its investigation, ranging from a "1" to a "4." The ratings and related recommendations are:

1. QCIC deems the case to be frivolous and recommends that no actions be taken by the PEEC with respect to the engagement personnel.
2. QCIC determines that no engagement personnel issues of significance are involved in the case and recommends that no actions be taken by the PEEC with respect to the engagement personnel.
3. QCIC believes that there may be engagement personnel issues of significance, and recommends that the PEEC determine whether or not to open an investigation of certain engagement personnel.
4. QCIC recommends that the PEEC open an investigation of certain engagement personnel.

30 Since the inception of the MOU, which was made retroactive to those cases closed by QCIC at its December 1997 meeting, a total of 125 cases have been rated, the results of which are:

Rating	No. of cases
1	12
2	64
3	38
4	11

31 As of August 2000, the PEEC has reviewed 36 of the cases rated as "3" and opened a case file on 28 of those matters. Noteworthy is the fact that the PEEC did not open a case file on 84 of the 125 cases, which allows it to devote additional time and resources to those cases that merit its scrutiny. In addition, QCIC has referred 25 current or former client personnel who are members of the AICPA to the PEEC.

32 The following table presents QCIC's actions related to member firms, professional standards and individuals for the SECPS fiscal year ended June 30, 1999, and since the inception of QCIC[5]:

	Year Ended June 30, 1999	Since Inception
Actions related to firms		
Either a special review was made, the firm's regularly scheduled peer review was expanded or other relevant work was inspected	2	72
The firm took appropriate corrective measures that were responsive to the implications of the specific case	6	133
Actions related to standards[6]		
Appropriate AICPA technical bodies were asked to consider the need for changes in, or guidance on, professional standards	3	49
PITF was asked to consider the issuance of a Practice Alert	2	23
Actions related to individuals		
The case was referred to the AICPA Professional Ethics Division with a recommendation for investigation into the work of specific individuals	14	46

[5] Public Oversight Board, *Annual Report 1999*.

[6] During its analysis of cases, QCIC is cognizant of the need to identify matters for which it believes the profession would benefit from additional or more specific standards or guidance. It refers these matters to the appropriate standard setters or the PITF for inclusion in a Practice Alert.

33 The POB oversees the QCIC process through its participation in all aspects of QCIC's analysis, investigation and closing of each matter. Further, the SEC staff reviews the Closed Case Summary prepared by the QCIC staff, together with the POB's oversight files for each matter.

SEC Regulations Committee

34 The SEC Regulations Committee acts as the primary liaison between the profession and the SEC on technical matters relating to SEC rules and regulations. It provides input to the SEC on accounting and auditing matters, as well as relevant guidance to AICPA members.

35 The SECPS Regulations Committee consists of representatives from SECPS member firms, academia and industry.

Professional Issues Task Force

36 The PITF was created by the SECPS Executive Committee to accumulate and consider practice issues that present potential audit concerns for practitioners from numerous sources, including QCIC, the PRC and the POB.

37 The PITF disseminates its information through non-authoritative Practice Alerts, which are published in the version of *The CPA Letter* that is distributed to AICPA members in public accounting firms. The Practice Alerts also are available on the AICPA's website. The PITF also refers matters that may require a reconsideration or reinterpretation of existing standards to appropriate standard-setting bodies.

38 The PITF consists of representatives from a number of SECPS committees, the ASB, PEEC and the legal departments of audit firms.

Firm Policies and Procedures

39 Audit firms establish, maintain and enforce firm-wide quality control policies and procedures. These measures are 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. Although invisible to the public, internal monitoring of audit quality is considered by many to be the most pervasive and productive of all types of regulation. The principal components of internal monitoring include periodic inspection procedures, determination of any corrective actions to be taken and improvements to be made in the quality control system, vigorous internal challenges regarding client acceptance and continuance decisions, independent preissuance reviews of audit engagements, and continuous updating of guidance and training materials and their dissemination to professional personnel. Enlightened self-interest has led firms to emphasize the importance of quality control and to discipline professionals who depart significantly from firm policies and professional standards.

Standard-Setting Bodies

40 Professional standards form the basis for measuring performance. The standard-setting bodies in the accounting profession include:

Financial Accounting Standards Board

41 The federal securities laws give the SEC statutory authority for establishing accounting standards. In meeting this statutory responsibility, the SEC historically has looked to the standard-setting bodies designated by the profession to provide leadership in establishing accounting principles. Since 1973, that body has been the FASB.

42 The FASB, as part of the Financial Accounting Foundation (FAF), is a not-for-profit organization supported by contributions from accounting firms, corporations and other entities that are interested in accounting issues. The FASB consists of seven full-time members who are selected and approved by the FAF; the FASB establishes its agenda through discussions with parties interested in financial accounting.[7] The FASB's deliberations are open to the public and its standards are subject to public exposure prior to issuance. The FASB maintains a dialogue with the SEC regarding its deliberations and activities.

43 In order to provide timely guidance to financial statement preparers, auditors and users on emerging issues that affect financial reporting, the FASB established the Emerging Issues Task Force (EITF). The EITF identifies emerging accounting issues and publishes its "consensus" in authoritative releases. The short time frame in which the EITF is expected to respond to the need for guidance does not permit preissuance public exposure of its pronouncements. The Chief Accountant of the SEC, who has the right to the floor, attends the EITF meetings as "the SEC Observer."

44 The Accounting Standards Executive Committee (AcSEC) of the AICPA promulgates GAAP on certain industry issues and other matters (e.g., software revenue recognition), under the FASB's oversight. Most AcSEC pronouncements are exposed for comment prior to issuance.

Auditing Standards Board

45 After the highly publicized McKesson-Robbins audit failure in 1939, the AICPA established the predecessor committee to the ASB to promulgate GAAS. The ASB is

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[7] The FAF established the Financial Accounting Standards Advisory Council (FASAC) to advise the FASB on issues related to projects on the FASB's agenda, possible new agenda items, project priorities, procedural matters that may require the attention of the FASB, and other matters as requested by the FASB chairman.

funded by the AICPA through members' dues. Its pronouncements, which include quality control standards as well as GAAS, are subject to public exposure and comment. Like the FASB, the ASB maintains a dialogue with the SEC regarding its activities and deliberations. The ASB's pronouncements are applicable to audits of all entities, not just to audits of public companies; however, certain Statements on Auditing Standards (SASs) are applicable primarily to public company engagements (e.g., SAS No. 71, *Interim Financial Information*).

46 The ASB consists of 15 members, with representatives from audit firms, academia and government (either state or federal government entities). The AICPA Board of Directors approves the membership of the ASB.

AICPA Ethics Division

47 After the creation of the SEC, the AICPA adopted certain auditor independence rules that were necessitated by the SEC's requirement for audits by independent accountants. Subsequently, the AICPA formed its Ethics Division, which, through the PEEC, is responsible for changes to and determining compliance with the profession's Code of Professional Conduct. Unlike the SEC, the Ethics Division does not have subpoena power and its disciplinary authority extends only to individual AICPA members. As previously noted, its disciplinary process is deferred while litigation or regulatory proceedings are in process.

Independence Standards Board

48 The ISB was established in 1997 by the SEC and the AICPA for the purpose of assuming responsibility from the SEC for establishing standards for auditor independence with respect to audits of public companies. The ISB is funded by the SECPS, but it is an autonomous body with responsibility for hiring and supervising its staff, establishing its budget and, with input from the SEC, determining its agenda.

49 The ISB consists of eight members, of whom four are public members and four are from the accounting profession. Three of the accounting profession members, who are nominated by the SECPS Executive Committee, are representatives of SECPS member firms, and the fourth is the President of the AICPA or his or her designee. The public members are responsible for nominating their successors. The SECPS-nominated ISB members must be approved by the AICPA Board of Directors.

50 In accordance with SEC Financial Reporting Release No. 50 issued in December 1997, standards issued by the ISB will be deemed by the SEC to have "substantial authority" regarding matters of auditor independence with respect to audits of public companies; however, ISB standards that are less restrictive than existing SEC or AICPA rules will not be effective until the SEC or the AICPA amends or revokes its rules. (The

PEEC retains responsibility for all other matters contained in the Code of Professional Conduct, including the rules relating to independence for audits of all other entities.)[8]

[8] In May 2000, the PEEC stated that it would view any pronouncement issued by the ISB as authoritative for *any* engagement requiring independence unless and until the PEEC announces that it will not view that pronouncement as authoritative. Accordingly, if an AICPA independence standard is more restrictive, in whole or in part, than an ISB pronouncement, the PEEC will not consider a member's independence to be impaired as a result of his or her non-compliance with the more restrictive AICPA standard until members are given notice of the PEEC's rejection of the ISB's less restrictive pronouncement.

CURRENT GOVERNANCE STRUCTURE

TABLE 1

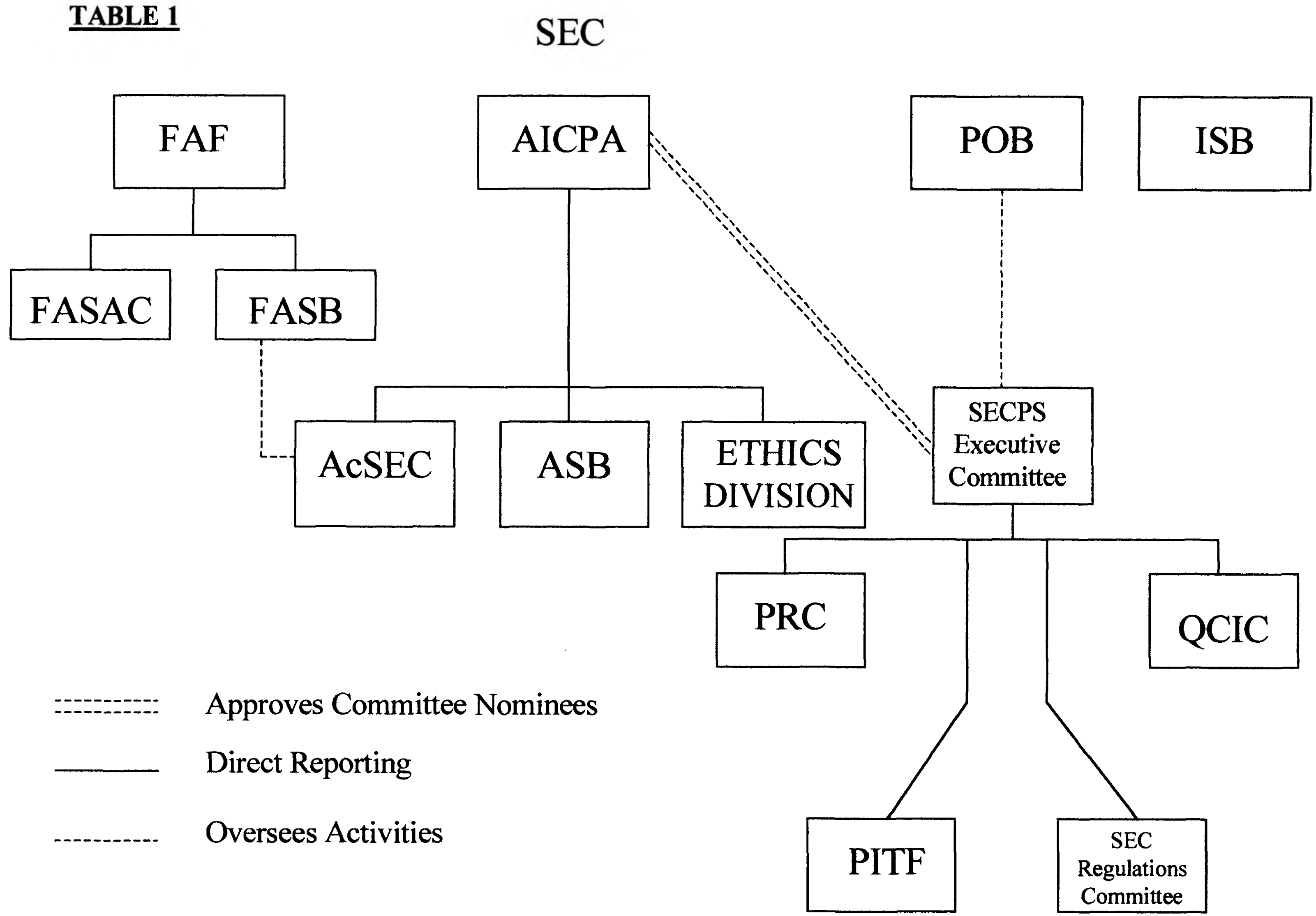

TABLE 2

Quality Control Inquiry Committee
Number of Cases Reported to QCIC by Year

Year Ended June 30,	Number of Cases
1982	20
1983	34
1984	27
1985	47
1986	44
1987	44
1988	42
1989	53
1990	56
1991	44
1992	55
1993	59
1994	61
1995	51
1996	33
1997	37
1998	53
1999	48
2000	58
Total	866

APPENDIX D – PRIOR CONSIDERATIONS OF NON-AUDIT SERVICES

1 In its 1957 annual report, the SEC voiced one of the earliest concerns about the breadth of services that auditors provide and whether an auditor could become so closely identified with the client that the auditor would make decisions that should be made by management. In 1959, the SEC's Chief Accountant commented on the possibility of an auditor's becoming so deeply involved in performing managerial services for a client that the auditor would lose the objectivity needed for an audit.[1]

2 In 1961, two educators studied non-audit services and concluded that management and tax services tended to cloud the appearance of independence.[2] They recommended that the audit function be sharply separated from other services provided by a firm. The AICPA's Committee on Professional Ethics issued Opinion No. 12 in 1963, reasserting a 1947 statement by AICPA Council that independence is an attitude of mind. However, the committee recognized that maintaining public confidence required avoiding relationships that might have the *appearance* of a conflict of interest. Opinion No. 12 added that there is no ethical prohibition against a CPA's performing management advisory services (MAS) for an audit client "so long as he does not make management decisions or take positions which might impair objectivity."

3 Opinion No. 12 was followed by a spate of articles and studies on whether auditors can appropriately perform MAS for audit clients.[3] Most expressed concerns about the appearance of a conflict. In an address to the AICPA at its 1966 annual meeting, the chairman of the SEC chided the profession over certain types of non-audit services – such as executive recruitment – that he believed raised independence questions.[4] (Following the Metcalf Subcommittee report in 1977,[5] the SECPS adopted a rule prohibiting members from providing executive recruitment services to SEC clients.) At the same time, the chairman sought to distinguish "management services" related to financial processes or to information and control systems, which he felt raised no serious threat to independence, from other types of services.

4 In 1966, an AICPA committee began a study of auditors' scope of services and issued its report in 1969.[6] The committee found no evidence that non-audit services impair

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[1] Andrew Barr, *Accounting – Changing Patterns: The Impact of Regulatory Agencies*, address presented in Chicago, November 11, 1959.

[2] R. Mautz and H. Sharaf, *The Philosophy of Auditing* (American Accounting Association, 1961).

[3] For example, A. Schulte, "Compatibility of Management Consulting and Auditing," *Accounting Review* (July 1965); A. Briloff, "Old Myths and New Realities in Accountancy," *Accounting Review* (July 1966); and J. Carey and W. Doherty, "The Concept of Independence – Review and Restatement," *Journal of Accountancy* (January 1966).

[4] Manuel F. Cohen, address before AICPA annual meeting, October 5, 1966.

[5] Subcommittee on Reports, Accounting and Management, Committee on Government Affairs, United States Senate, 95th Congress, 1st Session, *Improving the Accountability of Publicly Owned Corporations and Their Auditors* (Committee Print 1977) (Senate Report).

[6] AICPA Ad Hoc Committee on Independence, "Final Report," *Journal of Accountancy* (December 1969).

independence *in fact*, but found that some users believed that such services created an *appearance* of lack of independence.

5 There have been a variety of studies and investigations since then. In 1974, the AICPA formed an independent commission (the Cohen Commission) to study several aspects of the accounting profession and published its findings in 1978.[7] The Cohen Commission recommended, among other things, that the board of directors (or its audit committee) consider all services provided to the company by the auditor, and that the auditor fully inform the board of all such services and their relationship, or lack thereof, to the audit function. That same year, the SECPS adopted that disclosure recommendation as a membership requirement.

6 Shortly after the Cohen Commission was formed, the United States Senate, through the Subcommittee on Reports, Accounting and Management (Metcalf Subcommittee) of the Committee on Governmental Operations, launched a broad-scale inquiry of the accounting profession, including a review of the nature of services furnished by accounting firms.[8] The resulting staff report (*The Accounting Establishment*), published in 1977, generally concluded that MAS furnished to audit clients created a conflict of interest. After holding hearings on the staff report, the Metcalf Subcommittee concluded that the only MAS it believed appropriate to provide to public audit clients were "certain computer and systems analyses...necessary for improving internal control procedures of corporations."[9] The Metcalf Subcommittee also concluded that certain types of services, such as executive recruitment, marketing analysis, plant layout, product analysis and actuarial services, should not be provided to audit clients.

7 The profession reacted promptly to the Metcalf and Moss subcommittee reports by undertaking a new program of self-regulation, including forming the SECPS, introducing required peer reviews and establishing the Public Oversight Board to oversee the SECPS and peer reviews. The SECPS adopted criteria for scope of services and specified that an auditor may not provide the following services to a public audit client: psychological testing, public opinion polls, merger and acquisition assistance for a finder's fee, executive recruitment, and actuarial services to insurance companies.

8 Over the years the SECPS has instituted several disclosure requirements related to non-audit services. As noted above, SECPS members must report annually to the audit committee of each SEC client the amounts and nature of MAS rendered. Also, each member's annual report to the SECPS must include MAS fee data for SEC clients, indicating the number of clients by ranges of such fees as a percentage of audit fees (i.e., the number of clients for which MAS fees were 0% of audit fees, 1-25% of audit fees, 26-50%, 51-100%, and over 100%).

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[7] Commission on Auditors' Responsibilities, *Report, Conclusions, and Recommendations* (1978).

[8] Although not focused on non-audit services, in 1978 a House subcommittee (the Moss Subcommittee) also looked into the role of the SEC in establishing accounting principles and overseeing the profession.

[9] Senate Report (see note 5).

9 Further, Standard No. 1 of the Independence Standards Board (ISB), issued in January 1999, requires auditors (1) to disclose, annually in writing, all relationships between the auditor and the audit client that may reasonably be thought to bear on independence and (2) to confirm their independence. The auditor also must meet with the audit committee to discuss the auditor's independence.[10] The SEC issued a complementary rule in December 1999 that, among other things, requires that proxy statements include reports by audit committees that state whether the committee has received the disclosures required by Standard No. 1 and discussed the auditors' independence with them.[11]

10 In 1978, the SEC adopted requirements that certain disclosures related to non-audit services be made in the annual proxy statements of public companies.[12] The disclosures included the percentage relationship of fees for all non-audit services to the audit fee, the percentage relationship of the fee for each non-audit service to the audit fee (describing the service if more than 3%), and whether the audit committee or board had approved the services and considered the possible effects on independence. The SEC described the disclosure requirements as an interim step and stated it would not propose any rules limiting scope of services but would await the conclusions of a study by the POB.

11 The POB concluded an extensive study on the issue in 1979.[13] The POB studied the history of concerns over scope of services and held public hearings, noting that with one exception there were few uniform views. The exception was that almost all agreed that providing MAS was perceived by some persons as creating a situation in which an auditor's independence is impaired. In its report, the POB reviewed the concerns but also balanced them with the many benefits that appeared to accrue from MAS, even citing a comment letter from a former Chief Accountant of the SEC.[14] The former Chief Accountant related some of his own positive experiences, including those as a staff accountant, to illustrate the benefits that he believed MAS brought to the audit process.

12 The POB found it difficult to assess the effects of MAS on independence:

> From the voluminous record before the Board, it is apparent that documented evidence of MAS abuses or impairment of independence through the use of MAS is virtually nonexistent.[a] Many concerned persons point to a feeling that "it doesn't look right" or a speculation that some services "might" or "could" impair independence, but no one can counter the demonstrated benefits of MAS with some proof that specific practices lead to actual impairment....

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[10] In Practice Alert 99-1, *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.

[11] *Audit Committee Disclosure* (Release No. 34-42266), December 22, 1999.

[12] *Disclosure of Relationships with Independent Public Accountants* (Accounting Series Release [ASR] No. 250, June 29, 1978).

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

[14] Letter from John C. Burton, p. 17 of POB scope of services report (see note 13).

...[T]he absence of any known cases, while comforting, does not serve to prove conclusively that independence has not been, or will not be, impaired due to the furnishing of MAS to audit clients.

...[T]he problem ... is not so much lack of independence in fact as the appearance of lack of independence.[15]

[a] Specific evidence of loss of independence through MAS, a so-called smoking gun, is not likely to be available even if there is such a loss.

13 The POB concluded that no rules should be imposed to prohibit specific services. In light of the disclosure requirements of ASR No. 250 and the SECPS membership rules, the POB believed it better to rely on public disclosure, supplemented by the admonition to auditors to exercise restraint and judgment before venturing into new MAS areas. The POB also concluded that:

There are many potential benefits to be realized by permitting auditors to perform MAS for audit clients that should not be denied to such clients without a strong showing of actual or potential detriment....

[M]andatory limitations on scope of services should be predicated only on the determination that certain services, or the role of the firm performing certain services, will impair a member's independence in rendering an opinion on the fairness of a client's financial statements or present a strong likelihood of doing so.[16]

14 In ASR No. 264 the SEC responded to the POB's report, stating that the report "did not adequately sensitize the profession and its clients to the potential effects on the independence of accountants of performance of non-audit services for audit clients," and invited comments on factors the Commission identified as important to an evaluation of whether non-audit services could impair independence.[17] In 1981, the SEC rescinded ASR No. 264,[18] followed almost immediately by the SECPS's adopting the aforementioned requirement for member firms to disclose the extent of MAS fees and activity in their annual reports to the SECPS. The SEC repealed ASR No. 250 in 1982, citing the new SECPS disclosure requirements and having concluded that the disclosure required by ASR No. 250 "was not generally of sufficient utility to investors to justify continuation."[19]

15 In 1986, the POB, having noticed that non-audit services had continued to proliferate despite its admonition that the firms exercise self-restraint and judgment before venturing into new areas of MAS, commissioned a survey of attitudes of various groups toward

[15] POB scope of services report, pp. 33-36 (see note 13).
[16] POB scope of services report, pp. 4-5 (see note 13).
[17] *Scope of Services by Independent Accountants* (ASR No. 264), June 14, 1979.
[18] *Relationships Between Registrants and Independent Accountants* (ASR No. 296), August 20, 1981.
[19] *Relationships Between Registrants and Independent Accountants* (ASR No. 304), January 28, 1982.

non-audit services and independence.[20] The POB issued the survey without comment, but reaffirmed that it knew of no instance in which it could be demonstrated that MAS had interfered with auditor independence. The survey results indicated continued concerns that MAS could impair auditor objectivity and independence.

16 Shortly thereafter, the Treadway Commission concluded that the audit committee should oversee management's judgments relating to the independence of accountants by reviewing management's plans for engaging its auditors to perform MAS, considering both the types of services that might be rendered and the projected fees.[21]

17 In March 1994, in response to a Congressional request, the Office of the Chief Accountant (OCA) of the SEC reexamined the existing independence rules and considered whether any changes were needed. The OCA acknowledged the continuing increase of non-audit service offerings by firms and undertook to continue to be alert to the development of problems of auditor independence, but concluded that:

> ... the extensive systems of independence requirements issued by the Commission and the AICPA, coupled with the Commission's active enforcement program, provide to investors reasonable safeguards against loss due to the conduct of audits by accountants that lack independence from their audit clients. The enactment of detailed legislation or the promulgation of additional rules is not necessary.[22]

18 The POB continued to analyze "extended audit services" such as internal audit outsourcing and to monitor the firms' expansion of non-audit services. The POB had concluded that extended audit services need not impair independence if they were properly and carefully structured. The POB suggested that the profession consider whether the Code of Professional Conduct provides an adequate framework and guidance for addressing in a timely manner the implications of new service lines, and organizational structures to provide them, on the traditional concepts of independence.[23]

19 In response, the AICPA has issued or revised several ethics interpretations and ethics rulings, including:

- Interpretation 101-3, *Performance of Other Services* – lists many activities that would be considered to impair independence

- Interpretation 101-13, *Extended Audit Services* – discusses circumstances in which internal audit outsourcing and similar services would or would not

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[20] *Public Perceptions of Management Advisory Services Performed by CPA Firms for Audit Clients*, a research report prepared for the POB by Survey Division, Audits & Surveys, Inc., November 1986.
[21] *Report of the National Commission on Fraudulent Financial Reporting*, October 1987.
[22] SEC, *Staff Report on Auditor Independence*, March 1994.
[23] POB, *Annual Report 1994-1995*. A task force of the SECPS Executive Committee studied the issue of non-audit services. Although no report was issued, its findings were submitted to the then newly formed Independence Standards Board.

impair independence

- Interpretation 101-14, *The Effect of Alternative Practice Structures on the Applicability of Independence Rules* – discusses the extent to which independence rules apply to certain persons outside the "traditional" auditing firm

- Interpretation 102-2, *Conflicts of Interest* – offers guidance when a conflict occurs and on activities that should cause a CPA to consider whether others could view the relationship as impairing objectivity

- Interpretation 102-6, *Professional Services Involving Client Advocacy* – discusses tax, consulting or other engagements that involve acting as an advocate for the client

20 In a 1996 report to Congress,[24] the GAO stated that it believed that measures that would limit auditor services are outweighed by the value of traditional consulting services, but added that concerns over independence would grow as firms moved to provide new services that go beyond traditional services. The GAO also urged the profession to be attentive to independence concerns in considering new services.

21 Since then the shifting mix of practice has been a continuing source of concern and has been noted frequently by the SEC. The Chief Accountant of the SEC recently asserted, "These firms no longer advertise themselves as auditing firms, but as one-stop financial services firms that offer a full range of services."[25]

22 Recently, the success of the firms' consulting practices, the explosive growth in technology, and regulators' concerns over auditor independence have converged and resulted in the Big 5 firms exploring new business strategies for the future. These strategies, which have attracted attention from the regulators with respect to the issue of auditor independence, include:

- Restructuring and separating consulting practices from accounting and tax services

- Fully or partially divesting the restructured practices

- Planning public offerings of the consulting practices to obtain capital

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[24] United States General Accounting Office Report to the Ranking Minority Member, Committee on Commerce, House of Representatives, *The Accounting Profession – Major Issues: Progress and Concerns,* September 1996.
[25] Lynn E. Turner, *Shifting Paradigms in Self-Regulation*, address to the Securities Regulation Institute, January 27, 2000.

23 Some other firms have sold their non-attest practices to other financial services firms and have a variety of alliances with those firms (see Appendix B).

24 The agenda of the Independence Standards Board includes alternative practice structures, as well as appraisal and valuation services, outsourcing engagements and legal services for public audit clients. (Currently, there are certain independence restrictions on the performance by audit firms of legal services for SEC audit clients.) In July 2000, the ISB indicated that it would defer action regarding non-audit services pending the outcome of the SEC's rule-making proposals on independence (see Chapter 5).

APPENDIX E – QUASI PEER REVIEW PROCESS

1 The Panel's primary purpose was to examine whether the audit processes of the large firm members of the SECPS adequately serve and protect the interests of investors. The major element in this examination was the Quasi Peer Review (QPR) process. The QPR process was designed to make a comprehensive review of public company audits performed by the eight largest firms, to evaluate the way independent audits are performed and to assess the effects of recent trends in auditing on the public interest. The QPR process, which occurred during the summer and fall of 1999, gathered empirical data on the quality of a selected sample of SEC audit engagements with 1998 and 1999 year ends. In considering the effectiveness of the audits, the QPR:

- Evaluated the quality of work performed in specific key areas, including risk assessments, reviews of controls, and documentation
- Assessed whether the individuals who performed and reviewed the work had the necessary knowledge, skills and experience
- Determined whether the work was performed and reviewed on a timely basis
- Considered the adequacy of existing professional standards

Recommendations for improving audit effectiveness were developed from the Panel's QPR findings.

QPR COMPARED WITH SECPS PEER REVIEW

2 While there were numerous similarities between the QPRs and SECPS peer reviews, there also were numerous differences. The differences included:

- In-depth interviews in the QPRs of engagement personnel at all levels
- Focusing the QPRs on specific identified areas, such as the risk assessments, the linkage of the risk assessments to tests of controls and substantive tests, and whether the people who performed the work had the necessary knowledge and skills, rather than on an overall assessment of the engagement (i.e., an overall assessment of conformity with generally accepted accounting principles and compliance with generally accepted auditing standards)
- More in-depth, subjective examinations in the QPRs of the areas reviewed
- Having a member of the Panel staff conduct an extensive debriefing session with the QPR reviewer at the conclusion of each engagement review
- Holding focus group meetings in the QPRs of managers and seniors in each office reviewed
- Not preparing "matter sheets" in the QPRs that describe the deficiencies noted by the reviewers
- Not preparing reports or letters of comments on individual offices or firms in the QPRs

3 During the Panel's development of the QPR, various constituencies, including the SEC, the POB, practitioners, the Panel and the Panel staff, identified specific areas that directly affect the overall effectiveness of an audit. The Panel determined that the QPR should focus on these specific areas. The QPRs examined these areas in more depth than the SECPS peer reviews typically do. These areas included:

- Risk assessments, including engagement risk, fraud risk, inherent risk and control risk
- Controls, especially those related to information technology
- Linkage of risk assessments to tests of controls and substantive tests
- Substantive procedures, including substantive analytical procedures, in selected areas
- Completion of the audit, including the resolution of issues, non-standard entries, final analytical review and waived adjustments
- Communications with audit committees
- Revenue recognition, asset impairments, and merger-related and restructuring reserves

4 The QPR reviewers sought to obtain an in-depth understanding of the engagement teams' thought processes in the areas reviewed. The QPR reviewers used in-depth interviews and reviews of working papers to obtain this understanding. All instances in which the QPR reviewers disagreed with the quality or sufficiency of the engagement teams' work were referred to the firms for appropriate follow-up.

5 Matter sheets, reports and letters of comments were not prepared during the QPRs to increase openness and candor and reduce the reviewees' defensiveness. The goal of the QPR was not to assess and report on specific offices or firms; rather, the purpose was to assess and report on the overall effectiveness of public company audits performed by the large firms. In order to elicit frank responses and full cooperation from those reviewed, the Panel agreed to hold the specific engagement results in confidence. Accordingly, the results of the QPR have been summarized on an overall basis that combines the results of all offices and firms.

QPR SCOPE

6 All the companies whose audits were reviewed were SEC registrants. The reviews covered the eight largest accounting firms in the United States, namely, the Big 5 firms of Arthur Andersen LLP, Deloitte & Touche LLP, Ernst & Young LLP, KPMG LLP and PricewaterhouseCoopers LLP, as well as the three next largest firms, BDO Seidman, LLP, Grant Thornton LLP and McGladrey & Pullen, LLP.

7 To facilitate the selection of the individual offices to be reviewed, the Panel staff requested these firms to provide detailed demographic information by office.[1] The staff selected the offices to be reviewed to achieve diversity in their size, geographic location, clients and risk characteristics. For each of the Big 5 firms, the Panel staff selected four offices. The Panel staff selected only two or three offices for each of the other three firms because of their smaller size. In all, audit engagements at 28 offices were reviewed.

8 The selected offices then were requested to provide detailed demographic information about each SEC registrant audited by the office, as well as information regarding certain office-wide quality control and risk matters.[2] The Panel staff used this data, as well as other information,[3] to determine the specific engagements to be reviewed. The engagements were chosen to achieve a diverse sample of engagements in terms of size, industry and engagement characteristics.[4] For the Big 5 firms, the Panel staff generally selected five engagements per office, resulting in approximately 20 engagements reviewed for each firm. For the other three firms, the Panel staff selected approximately 10 engagements per firm to review. Overall, the staff selected 130 engagements, of which results were tabulated for 126 engagements representing 320,790 audit hours. The other four engagements were used to pilot test the QPR process. Based on the pilot tests, the staff made certain modifications to the QPR questionnaire to improve the effectiveness of the QPR process. The Panel members exercised oversight throughout the selection process.

QPR PROCESS

9 The firms' regular peer reviewers (from another audit firm) conducted the 28 office reviews under the close supervision of the Panel staff, including at least one senior member of the Panel staff. Virtually all the reviewers were partners with relevant industry and SEC experience.

Training

10 Before the QPRs were performed, the Panel staff conducted a training session for the eight firms' QPR coordinators and the review team captains from the reviewing firms. One member of the POB, a Panel member, and members of the staffs of the AICPA, SEC, POB and SECPS also attended the one-day session.

11 At the beginning of the review in each office, the reviewers and reviewees attended an orientation session conducted by the Panel staff. The purpose of these training and orientation sessions was to explain the purpose and objectives of the QPRs, how they

[1] See Table 1, Demographics Considered in Office Selection.
[2] See Table 2, Demographics Considered in Engagement Selection.
[3] Other information included the "Top 50" restructuring charges, in-process research and development charges, merger charges, and write-downs in 1998; information regarding the fastest growing companies; and the SEC's "hot topics."
[4] See Table 3, Industries of Reviewed Engagements, Table 4, Audit Hours of Reviewed Engagements, and Table 5, Engagement Characteristics of Reviewed Engagements.

differed from the SECPS peer reviews and how the Panel would use the results of the reviews.

Office Reviews

12 Each office review was approximately one week long and consisted of:

- An interview of the partner-in-charge of the office's audit practice
- Discussions with groups of audit seniors and managers (referred to as "the focus groups")
- Engagement reviews comprising interviews of engagement personnel, reviews of selected working papers and completion of the QPR questionnaire
- Interviews of the consulting partners responsible for the delivery of non-audit services, if any, on the engagements reviewed
- An exit conference with office management

13 Panel members attended most of the office reviews, participated in the focus groups and interviews, and observed the engagement reviews.

Interview of the Partner-in-Charge

14 The interview of the partner-in-charge of the office's audit practice focused on the adequacy of the professional development of auditors, the overall "tone at the top" in the office, and the performance measures used by the office in evaluating, compensating and promoting audit personnel. The partner's views on audit effectiveness and governance of the profession also were obtained. The QPR team captain conducted the interview, which was attended by a member of the Panel staff, and in many instances by one or more Panel members.

Focus Groups

15 The objective of the focus group discussions was to provide the Panel with added insight from audit seniors and managers about matters that they viewed favorably and matters that they believed needed improvement or would require changes in the future. There were two focus group meetings in most offices, one comprising five to eight senior managers and managers, and another comprising a similar number of seniors. At some of the smaller offices, one combined focus group meeting of managers and seniors was held. The focus group participants generally were not assigned to the engagements being reviewed. The sessions, which were conducted by the Panel staff, addressed such topics as the environment, auditors' knowledge and skills, and audit methodology. In many instances, one or more Panel members attended the sessions.

Engagement Reviews

16 The engagement reviewers began the review process by reviewing information from the prior year's audit and making their own preliminary risk assessments before interviewing the engagement partner, concurring partner, manager, senior and selected staff. Then they reviewed selected working papers based on the information obtained. The reviewers documented their observations and findings by completing a detailed questionnaire that included basic and supplemental sections. Panel members and staff participated in some of the interviews.

The Basic Questionnaire

17 The basic questionnaire included 426 data gathering, evaluative, best practice and improvement questions, as well as space for the reviewer's comments. The questionnaire was designed to elicit narrative responses from the reviewers to help identify best practices and areas for improvement and to eliminate the "check the box" mentality that can occur when questionnaires are used to gather information. The data gathering and evaluative questions were organized in a manner that was consistent with the audit risk model. Panel members reviewed and commented on the questionnaire before it was issued.

18 The questionnaire covered the following areas at the financial statement level:

- Engagement risk assessment and linkage to the inherent risk and control environment assessments
- Inherent risk and control environment assessments
- Fraud risk assessment

19 The reviewers generally selected three high-risk areas for review as well as one material area that the engagement team had assessed as having "low" or "moderate" (i.e., not high) risk. For these areas, the reviewers evaluated the:

- Inherent risk assessment
- Internal control risk assessment and evaluation
- Linkage of risk assessments (inherent, control and fraud risks) to substantive tests
- Design and performance of substantive tests

20 In order to obtain data regarding other important areas that affect audit effectiveness, the questionnaire required the reviewers to consider:

- Completing the audit
    - Resolution of issues
    - Non-standard entries

- Final analytical review

- Relations with the audit committee
- Personnel assigned to the engagement and changes in the engagement in recent years

21 The reviewers had to make numerous subjective evaluations when completing the questionnaire. These judgments related to the quality of the audit work performed, the knowledge and skills of those who performed the work, and whether the reviewer agreed with the engagement team's decisions. The reviewer's judgments on these matters were not limited to the engagement team's compliance with firm policies or professional standards, since the purpose of the QPRs was to address change and identify potential improvements.

The Supplemental Sections

22 The reviewers completed the following supplements to the basic questionnaire when they were applicable:

- Fraud risk assessment – misappropriation of assets
- Use of internal audit
- Revenue recognition
- Merger-related and restructuring reserves
- Impairment of long-lived assets and long-lived assets to be disposed of
- Going concern/severe liquidity
- Multi-location audits
- Non-audit services
- Former firm personnel in client management

23 Also, the reviewers described the audit approach in each of the four key areas and completed a supplemental questionnaire on the use of analytical procedures as substantive procedures in five additional areas that the reviewers selected with guidance from the Panel staff.

Debriefing Sessions

24 At the end of each engagement review, the reviewer met with a Panel staff member to communicate the reviewer's findings and evaluation of the engagement, with emphasis on the:

- Appropriateness of the risk assessments
- Level, general business and industry experience/expertise, knowledge and skills of those who performed and reviewed the work

- Nature, timing and extent of the partner's involvement in the engagement
- Nature and extent of the controls testing and substantive procedures performed, including the use of analytical procedures as substantive procedures
- Adequacy of documentation in the areas reviewed

Panel members attended some of these sessions.

QPR Exit Conferences

25 An office exit conference was held at the completion of the QPR process in most offices to summarize the results of the review. The conferences were conducted by the QPR team captain and generally were attended by the office's accounting and auditing leaders, a Panel staff member and, in some offices, a Panel member.

26 An overall exit conference was conducted with most of the firms to summarize and discuss the firm's overall QPR results. The firm's accounting and auditing leaders generally attended the meeting, which focused on the scope of the QPR and the best practices and areas for improvement noted during the review.

TABLE 1

Demographics Considered in Office Selection

To facilitate the selection of the individual offices to be reviewed, the Panel staff requested the eight firms to provide the following information by office:

- Audit engagement hours for the most recent 12-month period
- Number of audit partners
- Number of other audit personnel
- Average hours per audit partner
- Ratio of other audit personnel to audit partners
- Number of SEC engagements
- Number of IPOs effective since December 31, 1997
- Number of new SEC clients for which the firm's first report covered a period ending after November 30, 1997, with separate identification of the number of clients for which the predecessor auditors had resigned or reported a disagreement
- Number of SEC engagements with management consulting fees that exceeded the audit fees
- Number of SEC engagements considered "high risk"
- Number of cases reported to the Quality Control Inquiry Committee since January 1, 1997
- Number of restatements issued since December 31, 1997 (both SEC and non-SEC clients)
- Number of withdrawals of opinion since December 31, 1997 (both SEC and non-SEC clients)
- "Top five" industries by audit hours

TABLE 2

Demographics Considered in Engagement Selection

The selected offices were requested to provide detailed information by SEC registrant including:

- Engagement hours, industry, revenues, percentage of assets used in foreign operations and percentage of revenues from foreign operations
- Whether the following characteristics were present:
  - Significant derivative financial instruments
  - Going concern issues
  - Revenue recognition issues
  - In-process research and development (IPR&D) charges
  - Restructuring charges
  - Significant use of electronic data interchange (EDI)
  - Internal audit outsourcing services provided by the firm
  - IPO effective since December 31, 1997
  - The firm's first report covered a period ending after November 30, 1997
  - The firm's first report covered a period ending after November 30, 1997 and the predecessor auditors had resigned or reported a disagreement
  - The management consulting fees exceeded the audit fees
  - The client is considered "high risk"
  - A reproposal within the past three years
  - A partner or manager had left the firm to become the client's chairperson, CEO, COO, CFO or controller within the past three years

In addition, the selected offices were asked to list any:

- Cases reported to the Quality Control Inquiry Committee since January 1, 1997
- Restatements issued since December 31, 1997 (both SEC and non-SEC clients)
- Withdrawals of opinion since December 31, 1997 (both SEC and non-SEC clients)

TABLE 3

Industries of Reviewed Engagements

Industry	Number of Engagements
Manufacturing	28
High technology	25
Financial services	17
Telecommunications	14
Consumer business	12
Health care	8
Real estate	8
Utilities	8
Gaming	2
Transportation	2
Aerospace & defense	1
Travel	1
Total engagements	126

TABLE 4

Audit Hours of Reviewed Engagements

Audit Hours	Number of Engagements	% of Total Engagements
0 – 500	18	14%
501 – 1000	27	21%
1001 – 2000	38	31%
2001 – 3000	15	12%
3001 – 4000	10	8%
4001 – 5000	4	3%
More than 5000	14	11%
Total engagements	126	100%

TABLE 5

Engagement Characteristics of Reviewed Engagements

Engagement Characteristics	% of Total Engagements
Initial audits	15%
IPO within the past 3 years	25%
Predecessor auditors resigned or declined to stand for re-election	6%
Client classified as "high risk"	44%
Reproposal within the last 3 years	6%
Restated financial statements in the past 3 years	11%
Significant use of EDI	13%
Foreign operations	44%
Work of a specialist used	33%
Significant work referred to an affiliated firm	24%
Significant work referred to an unaffiliated firm	4%
Significant work referred to other U.S. offices	12%
Internal audit was given significant audit consideration	16%
Restructuring charges or reserves	29%
Impairment of long-lived assets	28%
Going concern issues	39%
Revenue recognition issues	27%
Merger-related charges or reserves	20%
In-process R&D write-offs	6%
Significant use of derivatives	7%
Significant audit adjustments	29%
Significant disagreements with management	0%
Services other than audit or tax provided	29%
Former partner or manager of the firm in position of client chairperson, CEO, CFO, COO or controller	13%
Communications about fraud or illegal acts	8%
Communications about reportable conditions	12%

APPENDIX F – ANALYSIS OF SEC ACCOUNTING AND AUDITING ENFORCEMENT RELEASES

SCOPE AND METHODOLOGY

1 The Panel studied recent SEC Accounting and Auditing Enforcement Releases (AAERs) to supplement the Quasi Peer Reviews and held discussions with the SEC staff regarding the apparent causes of actual or alleged instances of fraudulent financial reporting and audit failures. The Panel's objective was to obtain additional insights regarding the characteristics that frequently were present in these matters, as well as insights regarding the auditors' work that either resulted in detecting or not detecting material misstatements. The Panel used those insights to identify lessons that might be useful in improving audit effectiveness and in helping to develop some of the recommendations in this report, especially in Chapters 2 through 4.

Scope

2 The study, which was conducted by Professor Thomas Weirich of Central Michigan University, covered the AAERs issued from approximately July 1, 1997, through December 31, 1999, involving the Big 5 firms or their clients. The Panel limited the study to the Big 5 firms and their clients because the Big 5 firms audit the most SEC registrants and because most of the Panel's efforts have focused on the effectiveness of their audits. The study included 96 AAERs involving 38 different matters.

Methodology

3 After reading the AAERs, Professor Weirich met with members of the staff of the Office of the Chief Accountant of the SEC to discuss each case. The discussions focused on:

- The root causes of or contributing factors to an effective or ineffective audit
- The auditors' actions, including what they did right and what they did wrong
- Any implications for the audit risk model
- The steps that could or should have been taken to prevent or detect the alleged financial reporting or audit failure
- The systemic and quality control implications
- The penalties (if any) the SEC assessed against the auditors
- The client personnel involved
- The client personnel's apparent motivations for materially misstating the financial statements
- The methods the client personnel apparently used to misstate the financial statements

4 The SEC staff answered questions using the information contained in the SEC's non-public enforcement files. Professor Weirich did not have access to those files. To help structure his discussions with the SEC staff, Professor Weirich developed a questionnaire that members of the Panel and its staff reviewed. After his meetings with the SEC staff, Professor Weirich prepared a written summary of the key elements of each case, including the auditors' actions during the audit, if those actions were known.

5 Subsequently, the Panel's staff director met for a total of five full days with Professor Weirich and members of the SEC staff to review and discuss each of the cases, spending more than an hour on average on each case.

6 Two significant limitations of this study were:

- While the SEC staff routinely examines the auditors' involvement in each case, the SEC's files generally did not contain much or any information about the auditors' work unless the auditors were named in the AAER, which happened in seven of the 38 cases.
- Professor Weirich did not have direct personal access to the SEC's files because they contain non-public information. Instead, he had to rely on the SEC staff's responses to his questions.

FINDINGS

Overview

7 The SEC named the auditors in seven of the 38 cases, and may name the auditors in others where the SEC has not completed its investigations. In those cases where no actions were brought against the auditors, the reasons included: there was insufficient evidence to support an action against the auditors, only unaudited interim financial statements were misstated, and the auditors discovered the misstatements. For instance, in 12 of the 38 situations, the auditors discovered the fraudulent activities, reported them to the audit committee and resigned or required restatements, or both.

8 There appeared to be substantial variations in the quality of the audits. At one extreme, the auditors appeared to have performed extremely thorough audits under the leadership of heavily involved, highly skeptical partners and managers who were able to ferret out well-concealed, massive, collusive frauds. At the other extreme, inexperienced auditors appeared to have been virtually unsupervised, overlooked seemingly obvious "red flags" and failed to follow up adequately on exceptions noted during their audit tests.

Accounts Frequently Misstated

9 Most of the misstatements involved relatively routine transactions and accounts rather than complex judgmental areas and more esoteric transactions and accounts, such as derivatives or other complex financial instruments, restructuring reserves, business combinations or in-process research and development charges.

10 The most frequently misstated transactions and accounts were:

Revenue and accounts receivable	26	cases (out of 38)
Expenses	13	
Cost of sales and inventory	9	
Sales discounts/returns and allowances	8	
Property, plant and equipment	7	
Accounts payable and accrued liabilities	5	
Securities valuations	3	

11 These findings are consistent with those of the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in its research study, *Fraudulent Financial Reporting: 1987–1997, An Analysis of U.S. Public Companies.*

Common Techniques for Overstating Revenue

12 As indicated above, approximately 70% of the cases in the study involved the overstatement of revenue—either premature revenue recognition or fictitious revenue. The most frequent techniques for overstating revenue were:

- Recognizing revenue contrary to agreements with customers, including:
    - Recognizing revenue on consignment sales
    - Recognizing revenue despite having entered into side agreements
    - Recognizing revenue on conditional sales to related parties
    - Recognizing revenue on bill and hold transactions
    - Inflating invoices in kickback schemes
    - Recognizing revenue when the risks and rewards of ownership had not passed to the customer
    - Recognizing revenue on shipments not ordered by customers
    - Recognizing revenue on non-qualifying barter transactions

- Manipulating cut-off, including:
    - Recording revenue on shipments after year end by backdating shipping documents

    - Delaying the recognition of returns

- Generating fictitious transactions, including:

    - Recognizing fictitious revenue with false journal entries
    - Recognizing fictitious revenue on shipments of mock products or obsolete inventory
    - Recognizing fictitious revenue on shipments to public or company warehouses

13 In many instances the entity used more than one of the preceding techniques to overstate revenue. Many of these techniques are similar to those identified in the COSO report.

Other Factors Associated with Materially Misstated Financial Statements

14 During the study, Professor Weirich noted:

- Numerous instances where entities used information technology to facilitate material frauds, such as by making inappropriate modifications to computer programs, recording hundreds of small non-standard entries rather than a few large ones, or "freezing the date" in the computer system
- Numerous instances where non-standard entries were used to conceal misstatements
- A few instances of materially misstated financial statements resulting from the misappropriation of assets
- Several instances where the entity's inherent risk apparently increased as a result of significant changes in the entity's business (e.g., the loss of one or more major customers or the existence of a new competitor with a better, cheaper product), and the auditors apparently were not aware of these changes or did not accurately assess how they increased inherent risk
- Numerous instances where management had overridden controls, including controls over aging accounts receivable, recording shipments, changing computer programs and classifying disbursements. Because the auditors seem to have been unaware that management was overriding controls, they apparently assessed control risk and fraud risk as considerably lower than they actually were.
- Several instances of material fraud, either fraudulent financial reporting or misappropriation of assets, at relatively small divisions or subsidiaries. In some of these instances, the auditors apparently had not visited the locations in several years even though the entities did not have any internal auditors, controls at the locations were weak, or competition for the locations' products had increased substantially, thereby increasing the risk at the locations.

- Numerous instances where the auditors' substantive procedures apparently were not adequate to detect material misstatements. Examples included:

  - Inadequate (small) sample sizes[1]
  - Not adequately following up on exceptions noted on, or fax responses to, confirmations
  - Not adequately testing the following: the approval process for sales, sales or inventory cut-offs,[2] charges to asset accounts, or the valuation of securities or property, plant and equipment
  - Not controlling the confirmation process or not confirming the terms of large or unusual sales transactions, especially those that occurred at year end
  - Not ascertaining whether the financial statements agreed or reconciled with the accounting records
  - Over-relying on management's representations (i.e., not obtaining sufficient evidence to corroborate or refute management's representations, such as management's explanations for unusual fluctuations noted when performing analytical procedures)
  - Not testing the accuracy of computer-prepared schedules

- Various instances where the auditors apparently were not aware of, or did not pay sufficient attention to, such factors as negative cash flows, extended sales terms, customers taking longer than usual to pay, increased product returns, or very large percentages of sales being recorded at the end of periods
- A very limited number of situations where the external auditors may not have tested, supervised and reviewed the internal auditors' work as thoroughly as would have been desirable
- Some instances where the personnel assigned to audit certain areas, such as receivables and inventories, did not appear to have sufficient training and experience or to be adequately supervised

In many of these situations, the auditors appeared to have demonstrated a lack of sufficient professional skepticism.

15 Professor Weirich also noted that the entities with the most sophisticated frauds often were very concerned about concealing them from the auditors and ensuring that "the numbers and the relationships among them would '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." In these circumstances, key ratios such as the accounts receivable

[1] In several situations, cut-off tests were limited to examining the documentation for a very small number of transactions.
[2] See note 1.

and inventory turnover ratios and the gross margin percentages presumably met the auditors' expectations rather than raising questions that might have revealed the fraud.

16 In a limited number of instances, succumbing to time pressures may have contributed to the auditors' failure to detect material misstatements, while in others, the auditors' resistance to time pressures may have facilitated their detection of the misstatements.

Fraud Participants and Incentives for Committing Fraud

17 In most of the 38 cases, one or more members of top management were involved in or aware of the activities that resulted in the materially misstated financial statements. For example, the CFO apparently was involved in almost two-thirds of the cases, the CEO in almost one-half, and the controller in almost one-half. In some situations, numerous lower-level personnel (such as accounting clerks, district sales managers, or personnel in the IT department who reprogrammed the computer to conceal the fraud) also were involved in or at least aware of the activities.

18 In still other situations, top management apparently was unaware that the overall financial statements were materially misstated, since the fraud was perpetrated at a subsidiary or division where the personnel apparently were trying to either "make the numbers" or cover up their misappropriations of assets. Finally, in a few situations, third parties were involved in attempting to conceal the fraud, such as by sending false confirmation responses to the auditors.

19 In five situations, one or more of the members of management involved in the misstatements had been with the audit firm, in three situations as partners, prior to joining the company.

20 The personnel involved in making the misstatements are reported to have cited various incentives for participating, including:

- Meeting analysts' expectations
- Meeting corporate earnings targets
- Raising additional capital
- Complying with financial covenants for loans or lines of credit
- Reporting favorable results for an IPO
- Earning bonus awards or stock options
- Satisfying NASDAQ listing requirements
- Funding personal expenses

APPENDIX G – FOCUS GROUPS

1 Eleven focus group sessions were conducted to obtain information on topics relevant to financial reporting and audit effectiveness. An independent professional facilitator and a Panel staff member led the sessions, which lasted about three hours. At least one Panel member attended almost every session. (These sessions were in addition to those held in conjunction with the Quasi Peer Reviews.) The groups included:

- Practicing professionals from the eight large firms – A total of eight sessions were held in New York, Atlanta, Chicago and San Francisco. Each included one individual from each of the eight large firms that participated in the Panel's project. All of the participants at each session had the same level of experience. The eight sessions covered a cross-section of experience levels, as follows:

	Years of Experience	Number of Meetings	Number of Participants
Staff	1-2	1	8
In-charge	3-5	3	24
Managers/Supervisors	5-11	2	16
Experienced managers	11-14	1	8
Partners	12+	1	8

- Chief financial officers and controllers – One session of financial executives of SEC registrants. All were members of the Financial Executives Institute. The companies represented were:

  Bethlehem Steel Corporation
  General Electric Company
  ITT Corporation
  Tenneco Inc.
  Union Carbide Corporation

- Internal audit executives – One session of executives, mostly from SEC registrants. All were members of the Institute of Internal Auditors. The companies represented were:

  Asea Brown Boveri Inc.
  Bell Atlantic Corporation
  International Business Machines Corporation
  Lucent Technologies Inc.
  Praxair, Inc.
  Readers Digest Association Inc.
  Texaco Inc.

Pitney Bowes Inc.

- Partners from smaller firms – one session of eight partners experienced in conducting peer reviews of smaller firms.[1] The firms represented were:

    Barnes, Dennig & Co.
    Cherry, Bekaert & Holland, LLP
    Hanson, Barnett & Maxwell
    Hevia, Beagles & Company, P.A.
    Larson, Allen, Weishair & Co. LLP
    Urbach Kahn & Werlin P.C.
    Virchow, Krause & Company, LLP
    Weaver and Tidwell LLP

2 Different topics were emphasized depending on the experience and background of the participants. The topics were identified by the Panel and included the following:

- *The value of an audit* – as seen by management, audit committees, investors, other users and auditors
- *The audit environment* – governance of firms and the profession, messages about audit quality, personnel issues (recruiting, turnover, salaries), personnel performance measures, fee competition and earnings management
- *Audit methodology* – understanding the client's business and risks, internal control, detailed audit tests and the effects of technology on audits
- *Fraud* – auditors' responsibilities and abilities to detect material financial statement frauds
- *Knowledge and skills of audit professionals* – self-development, technology skills, technical and industry knowledge, and on-the-job learning
- *Professional standards* – individual accounting and auditing standards, and standard setting
- *Audit committees* – roles, responsibilities and relationships with auditors
- *Practice economics* – practice development and growth, profitability, fee competition and time pressures on engagement teams
- *Auditor independence* – the effects of non-audit services on auditor independence
- *The SEC* – its role and responsibilities; relationships with the SEC staff

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[1] See Appendix K for additional information.

APPENDIX H – SURVEY

1 The Panel's project contemplated gathering information from key audiences using a variety of means. Early in the project the Panel decided to seek information about a wide range of issues from a number of sources through a mail survey, "Request for Opinions on Issues of Audit Effectiveness Addressed to Thought Leaders and Key Stakeholders." The survey was issued on September 1, 1999.

2 The survey was not intended to be an opinion poll. Rather, the Panel encouraged each respondent to give free-form responses to as many of the questions as possible from that person's unique perspective. The Panel also informed all potential respondents that their responses would be held in confidence and would not be available for public inspection.

CONSTITUENCIES RESPONDING

3 The intent of the Panel was to seek the views of many constituencies. Toward that end, the Panel addressed the survey to a number of selected individuals and organizations. Among the constituencies surveyed were preparers and users of financial statements, auditors, regulators, academicians, lawyers and analysts. While the list of those initially selected was broad, the Panel did not limit responses to those on the list. Rather the views of everyone interested in the Panel's project were welcomed. The survey questionnaire was included on the websites of the AICPA and the SEC for anyone to obtain and answer.

4 An analysis of the constituencies included in the Panel's original mailing and the constituencies responding follows:

Constituency	Original Mailing*	Responses*
Accounting firm personnel	46	15
CPA organizations or personnel	157	18
Legal firm personnel	36	2
Governmental organizations	80	9
Management organizations	16	4
Corporate management	15	7
Investment management or analysts	88	7
Public interest organizations	56	9
Academia	43	19
Totals	537	90

* Some individuals or organizations could fit into more than one category.

SURVEY QUESTIONNAIRE

5 The survey was designed to provoke thought by setting forth points of view in a number of areas, with related questions for respondents to address as they saw fit. The areas explored in the survey were:

1. The Business Environment
2. Responsibilities for Detecting Financial Statement Fraud
3. The Audit Risk Model
4. Breadth of Auditors' Involvement
5. Audit Committees and Auditors' Communications
6. The Auditing Profession
7. The Business of Auditing
   - i) The effects of competition
   - ii) Scope of services offered by audit firms
   - iii) Organizational structures
   - iv) Litigation
8. Regulation and Self-Regulation
   - i) Roles and responsibilities
   - ii) Auditing standards
   - iii) The AICPA and audit firms
9. Costs, Benefits and Other Issues

A copy of the survey questionnaire is included at the end of this appendix.

ANALYSIS OF SURVEY RESPONSES

6 The Panel reviewed all of the survey responses. The details of each response were related to the applicable question or questions in the survey. Matters appearing to be of common interest and common themes were identified and discussed. In general, the Panel addressed:

- Key substantive observations made in response to each of the survey's questions
- Specific recommendations for Panel action or non-action
- Comments about the Panel's project, process and scope
- Specific ideas for enhancing audit effectiveness, including incentives and disincentives
- Other ideas for enhancing investor protection, not necessarily directly involving auditing or auditors
- Cost–benefit considerations and recommendations

7 The information that the Panel received from the survey was valuable in its deliberations and in formulating many of its recommendations. The Panel expresses its appreciation to all respondents for their efforts and the quality of their responses.

COPY OF THE QUESTIONNAIRE

8 A copy of the survey questionnaire is reproduced below.

C. The Questionnaire

Each section of the questionnaire begins with an introductory paragraph, setting out some points of view that you may or may not agree with, and that are not necessarily representative of the views of the Panel. Please feel free to consider these points of view in forming your responses to the questions that follow, or set them aside, as you see fit. They are merely meant to provoke thought.

1. The Business Environment

Auditors operate in an environment of increasing complexity, accelerating change and intense business competition. There is significant merger and acquisition activity, newer and more complex financial transactions and instruments to hedge or mitigate risks, and more intangible or "soft" assets on corporate balance sheets than ever before. Businesses often change strategic directions giving rise to restructuring activities with corresponding reserves set aside to cover the anticipated costs of those activities. Accounting standards address many of these areas, but they often are subject to varying interpretation. In preparing financial reports, management must rely far more on making informed judgments and estimates about the effects of future events and transactions.

Core Questions

- Are auditors devoting sufficient attention to the areas where management discretion and judgment are required in financial reporting? If not, please explain why you believe this.

- To what extent do analysts' earnings estimates influence management's judgments in preparing financial statements, and what are the effects on the auditor? If you see any effects, please elaborate on their importance.

- Do accounting standards issued in recent years help or hinder auditors in meeting the needs of users of financial statements? If they hinder auditors, how do they do so and what should be done?

Extended Question

- Analysts' earnings per share estimates establish expectations (sometimes to the penny) in the marketplace for companies to achieve. Can audits ever be expected to be this exact? If not, what should be done, if anything, to deal with this situation?

2. Responsibilities for Detecting Financial Statement Fraud

Under current auditing standards, auditors have the responsibility to assess fraud risks and obtain reasonable assurance that the financial statements are free of material misstatement, whether caused by error or fraud. This is not the same as saying that audited financial statements are a "guarantee" that fraud has not taken place. Investors clearly place some responsibility for the detection of fraud in the hands of auditors, but the extent of these responsibilities often is unclear to many of those involved in the financial reporting process.

Core Questions

- Are auditors' responsibilities with respect to the detection of deliberate misstatements of earnings appropriate? Please explain your view.

- What are users' views of those responsibilities and are they realistic? Please feel free to elaborate on differing views of various types of users, such as individual investors and institutional investors.

- What, if anything, should be done to change these views, or to change auditors' responsibilities for detecting fraud?

3. The Audit Risk Model

Audits are conducted using an "Audit Risk Model" that requires auditors to use their judgment in assessing risks and then in deciding what procedures to apply. The model allows auditors to take the client's business, financial and other circumstances into account in selecting their audit approach. This model can be applied differently by different audit firms, so long as they comply with "generally accepted auditing standards."

Core Questions

- Is this model, where auditors are encouraged to use their judgment in selecting their audit approach based on the individual company's nature and circumstances, appropriate? Please elaborate on your point of view.

- What are the best safeguards to make sure that auditors exercise this judgment in ways that protect shareholders and other investors?

Extended Questions

- Does this model allow too much chance that errors in auditors' judgments will result in problems for investors?

- Does the model require auditors to explore in sufficient detail the accounting policies and procedures that individual companies use?

- Does the model meet the expectations of the investment community in constraining inappropriate management behavior, especially in judgmental areas?

- Is this model equally appropriate in all industries, or are there some where a different approach might be needed?

- Are auditors sufficiently equipped to deal with the growing role of information technology? What incremental skills are needed?

- Do auditors exert the right balance between efficiency and timeliness on the one hand and thoroughness on the other? Do you have any observations about the level of experience of auditors assigned to engagements, how they are supervised and their work reviewed, or the nature and extent of the audit documentation that they retain in their working papers?

4. Breadth of Auditors' Involvement

Some argue that, in light of increased business complexity, technology, new financial instruments, and other developments, auditors do not pay enough attention to business systems, management processes, unique industry factors and operational matters. According to these observers, auditors place too much emphasis on historical financial information and not enough on the current and future risks of managing the business and on the entity's communications with investors. Others believe that it would be impractical or inappropriate for auditors to focus more attention on these matters.

Core Question

- Do you believe auditors should be more involved in and familiar with their clients' business and operational matters and ongoing communications with the investment community? Please explain why you feel the way that you do.

Extended Questions

- Should auditors be more or less involved with:

  - internal controls

    - interim financial statements
    - forecasts
    - management's discussion and analysis
    - non-financial data
- Should auditors be required to report on such matters? If so, which matters and why?
- Would greater involvement in these areas improve the value of the independent audit?
- Would the costs of greater involvement outweigh the benefits?

5. Audit Committees and Auditors' Communications

A significant part of the debate about audit effectiveness has focused on the current and future roles of audit committees, including their roles in enhancing communications among themselves, the board, management, shareholders, and the auditors. Some believe that a stronger role for audit committees may be a necessary and helpful way of improving the effectiveness of audits. (The Panel does not intend to duplicate the work of the Blue Ribbon Committee on the Effectiveness of Audit Committees.)

Core Questions

- Do you believe auditors currently communicate effectively with:
    - management
    - audit committees
    - boards of directors
    - stockholders (feel free to elaborate on institutional versus individual investors)

Extended Questions

- Do you have any suggestions for improving the effectiveness of auditors' communications?
- Should auditors do more to assist audit or other committees of a board of directors?
- Are audit committees effective in promoting quality audits? How can audit committees be more effective in that regard? Do audit committees do enough to seek out auditors' opinions and input?

6. The Auditing Profession

Some have sensed that it is becoming more difficult to attract and retain young people in auditing as a career. Others believe that this has long been a challenge and that things are not so different today.

Core Questions

- Do you believe that the quality of new recruits into auditing has been declining in recent years, and if so, is this having an effect on the quality of audits?
- Are the opportunities and rewards in the auditing profession sufficient to attract and retain high quality entrants? (Please separate the question of attracting versus retaining as you see fit.) If not, what more should be done to attract and retain more high quality individuals over the long term?
- What are your views on audit personnel taking jobs with clients?

7. The Business of Auditing

i) The effects of competition

Audit firms operate in a highly competitive environment, and there is a debate about the effects of that competition on the quality of audits. While the largest five firms audit the preponderance of publicly held companies, changes in audit firms by publicly held companies are relatively infrequent. Some believe that competition improves the quality of audits while others argue that emphasis on competition weakens their quality.

Core Questions

- What are your views about the effects of competition and pricing on the quality of audits?
- How do you see time and budget pressures affecting the quality of audits?

ii) Scope of services offered by audit firms

Some believe that audit firms are placing less emphasis on audit work and more emphasis on other services they provide, thus weakening the quality of audits. Others assert that non-audit work either has no effect, or actually helps audit firms perform better audits by keeping their skills and understanding of business more up to date.

Core Questions

- What are your impressions of the importance (stature, compensation, advancement, investments, etc.) audit firms place on audit work relative to the other services they offer, and how, if at all, does this affect the quality of audits?

- Do you believe non-audit services offered to audit clients affect the independence or perceived independence of auditors? If so, how do they do so and what should be done about this?

- Do firms properly balance the importance of high quality, independent audits with

  - The goal of practice growth and firm success?
  - The goal of client retention?
  - The goal of enhancing relationships with clients?

- Do firms place sufficient importance on professional qualifications, accounting and auditing training, specialized skills, experience and integrity of auditors?

iii) Organizational structures

Over the past decade, audit firms have diversified into a variety of services either by internal expansion or by acquisition. Furthermore, some non-audit organizations have acquired audit firms or parts of them.

Core Questions

- What are the effects of the following on the quality of audits:

  - non-audit organizations acquiring audit firms or parts of them?

  - audit firms broadening their range of non-audit services through acquisition or by internal expansion?

- Are current organizational structures appropriate to promote quality audits?

iv) Litigation

Some believe that litigation or the threat of litigation has a salutary effect on the quality of audits. Others assert that litigation has unreasonably driven up costs for audit firms, and combined with downward pressures on prices, may have weakened audit quality.

Core Questions

- What are your thoughts on the effects of litigation on the quality of audits?
- Will recent changes in federal or state laws affect the quality of audits? In what way?
- Are more changes to securities or other laws needed? If so, what changes?

8. Regulation and Self-Regulation

i) Roles and responsibilities

Currently, there is a wide array of practices in place to enhance audit quality, including oversight by regulatory bodies, self-regulation by professional associations, and policies and practices within each audit firm.

Core Questions

- Do you think that there is the right balance between regulation and self-regulation, insofar as enhancing audit quality is concerned?
- What changes, if any, would you suggest in the approaches taken by regulatory bodies, self-regulatory bodies, and individual firms to enhance audit quality?

ii) Auditing standards

Auditing standards are established by the Auditing Standards Board of the AICPA, a 15-member board comprising representatives from each of the five largest audit firms, eight other audit firms, a member of the academic community and a member from government. The SEC oversees the activities of the ASB.

Core Question

- Do "generally accepted auditing standards" and the way they are formulated meet the needs of the investment community? If not, what changes would be useful?

iii) The AICPA and audit firms

The AICPA exists to serve the accounting profession's interests in a variety of ways, including speaking on behalf of the profession on topical issues. Audit firms, of course, speak on their own behalf and promote their own individual capabilities.

Core Question

- What would you like to see the AICPA and individual firms do to enhance the public's trust and confidence in the auditing profession?

9. Costs, Benefits and Other Issues

Actions to improve the effectiveness of audits in protecting investors' interests need to be justified in terms of their costs versus the benefits to be derived from them.

Core Question

- What recommendations would you like to see the Panel make, and how do you assess their costs and benefits?

****

The foregoing questions are intended to cover key issues relating to audit effectiveness. The Panel invites respondents to provide comments on issues that may not be addressed or adequately covered by this questionnaire. You may draw on personal experiences or observations, as you deem appropriate.

APPENDIX I – OCTOBER 1999 PUBLIC HEARINGS

1 The Panel conducted public hearings in October 1999 to gather information directly from leaders of all constituencies of the financial reporting process – investors, regulators, auditors, preparers, analysts, plaintiffs' and defendants' bars, standard setters and educators. Leaders of almost 30 organizations were invited to testify at the hearings, and most agreed to participate. Participants were asked to express their views on the current effectiveness of audits in protecting investors' interests. Each participant made a presentation lasting 15–20 minutes, followed by questions from Panel members.

2 The following organizations were represented at the hearings[1]:

American Accounting Association
American Bar Association, Committee on Law and Accounting
American Institute of Certified Public Accountants
Arthur Andersen LLP
BDO Seidman, LLP
Bear Stearns & Co.
Deloitte & Touche LLP
Ernst & Young LLP
Financial Accounting Standards Board
Financial Executives Institute
Grant Thornton LLP
KPMG LLP
McGladrey & Pullen, LLP
Milberg Weiss Bershad Hynes & Lerach
National Association of State Boards of Accountancy
New York Society of Security Analysts
PricewaterhouseCoopers LLP
Public Oversight Board
Securities and Exchange Commission
SEC Practice Section
Ten Eyck Associates
Wharton School of the University of Pennsylvania
Willkie Farr & Gallagher

3 The speakers were forceful and straightforward in their remarks, and responded candidly to Panel members' questions. The Panel considered the information it received to have been very valuable in its deliberations and is grateful to the speakers for their outstanding participation.

[1] See Exhibit 3 to this report for a timetable of the presentations at the October 1999 hearings.

4 The views expressed by the speakers are referred to in the "Findings" sections of this report. Among the areas of recurring comments by the speakers were:

Governance of the profession
Financial statement and reporting models
Non-audit services
Recruiting new people to the profession
Auditing revenue recognition
Auditing reserves
Auditors' involvement in interim periods
The "rate" of audit failures
Encouraging employees to disclose fraud
Earnings management
Audit myths, including audits as loss leaders
Alternative practice structures
Risk-based audit model
Effects of globalization
The relationship between the SEC and audit firms

APPENDIX J – FIRM MATERIALS/MEETINGS WITH FIRMS

1 At the outset of the project, representatives of the Panel met with some of the leaders of the accounting and auditing practices of the eight largest firms. These meetings generally included the partners responsible for the firms' U.S. accounting and auditing practice and for activities related to professional education; risk management, including client acceptance and continuance; professional standards; internal consultation; and methodology development and implementation. The objective of these several-hour meetings was to obtain the firms' views on the accounting and auditing environment and the issues the Panel should consider, including:

- *Expectations of auditors*, including by management, audit committees, boards of directors, shareholders, other users and auditors
- *Personnel*, including recruiting and the availability of quality people, knowledge and skills, performance measures and employee turnover
- *Audit methodologies*, including the risk-based model, the effects of technology, and auditors' responsibilities for detecting fraud
- *Accounting and auditing standards*, including the processes for developing and implementing them, and ideas about necessary changes
- *Governance issues*, including, in particular, the roles of the SEC, AICPA and POB
- *Independence matters*, including the effects, if any, of non-audit services performed by auditors

2 The partners also provided the Panel with in-depth information and explanations about changes in their audit methodologies and tools and related firm policies.

3 Separately, the firms provided additional information and statistics on a variety of topics for the Panel's use in developing its findings and recommendations. The topics included:

- Audit policies, procedures, guidance materials and practice aids
- Risk management – client acceptance and continuance
- Professional development activities, including instructor-led and self-study course catalogs and selected course content, coaching and mentoring programs, and average training hours per auditor by experience level
- Performance measurement and evaluation policies and procedures and related measurement tools
- Reward and incentive compensation programs for employees at each experience level
- Marketing publications designed to attract new audit clients or promote

additional services to existing audit clients

- Internal messages to staff, particularly relating to the importance of performing quality audit work, and external messages to clients and potential clients concerning audit quality
- Statistical data covering five-year trends in hiring, employee retention and employee work load and scheduling
- Success stories – examples of situations where audits uncovered material errors or fraud before the issuance of financial statements or where the auditor took a strong stand against overly aggressive accounting or client-imposed time pressures

APPENDIX K – SMALLER FIRMS

1 Over 80% of the audits of domestic SEC registrants are performed by the eight largest U.S.-based audit firms.[1] As a result, the Panel concentrated primarily on those firms and their audit methodologies. However, the Panel recognizes the important role that smaller firms that audit the remaining public entities play in our capital markets. (See also "Other Firms" in Appendix B.) Accordingly, the Panel staff reviewed and analyzed Practitioners Publishing Company's "Guide to Risk-Based Audits" and "Guide to Audits of Small Businesses," since these publications represent the core methodologies that a large number of smaller firms use.

2 In addition, the Panel staff met with a group of eight professionals experienced in conducting peer reviews of smaller firms (see Appendix G). These individuals are partners in firms ranging from fewer than 10 to more than 600 professionals, and in the aggregate they conducted nearly 100 peer reviews in 1999.

3 The discussions with these peer reviewers included a broad range of topics similar to the topics covered in meetings with the larger firms and in other focus groups, but from the perspective of the smaller firms. Substantial time was devoted to client acceptance and continuance policies and procedures; technical industry and specialist support for engagement teams, such as in the area of information technology; and the unique challenges these firms face as a result of changing technology and audit methodologies.

[1] Provided by SECPS staff.

APPENDIX L – MEETINGS WITH REGULATORS AND PROFESSIONAL BODIES

1 The Panel chairman, the staff director and other members of the Panel and its staff had numerous meetings with regulators, primarily the SEC, and various private-sector professional bodies involved in the governance of the profession or their representatives. During these meetings, the Panel representatives reported on the Panel's activities and progress and discussed various issues and other matters of mutual interest to assist the Panel in gathering information and formulating its recommendations.

2 The groups the Panel or its staff met with and the number of meetings are:

Organization	Number of Meetings
Securities and Exchange Commission and its staff	18
SECPS Quality Control Inquiry Committee	8
Public Oversight Board	8
SECPS Peer Review Committee	6
Independence Standards Board and its staff	5
Auditing Standards Board and its staff	5
SECPS Executive Committee	5
SECPS Peer Review Process Task Force	4
SECPS Planning Subcommittee	4
CEOs of the Big 5 firms	2
Audit Issues Task Force	2
Committee on Corporate Reporting of the Financial Executives Institute	1
International Organization of Securities Commissions	1
Professional Ethics Executive Committee staf	1
International Auditing Standards Subcommittee of the Auditing Standards Board	1
International Auditing Practices Committee	1

APPENDIX M – PANEL MEETINGS

1 The Panel met 13 times for a total of 21 days. Portions of five meetings were open to the public, including representatives of the SEC, the press, the AICPA, the SEC Practice Section and the eight firms that participated in the Panel's project.

2 During its meetings, the Panel met with representatives of the AICPA and/or the SEC Practice Section (four times), the Public Oversight Board (four times), the SEC (twice) and the Independence Standards Board (once). The Panel heard presentations by representatives of some of those organizations on such topics as governance of the profession, including the feasibility of a Self-Disciplinary Organization; the supply and demand for entry-level accountants; and the results of the Independence Standards Board's research project that surveyed various constituencies on their perceptions of auditor independence and objectivity.[1]

[1] Earnscliffe Research & Communications, *Report to the United States Independence Standards Board - Research into Perceptions of Auditor Independence and Objectivity*, November 1999.

APPENDIX N – JULY 2000 PUBLIC HEARINGS

1 The Panel conducted public hearings in July 2000 to obtain views about its recommendations in the Exposure Draft of its report. Leaders of almost 20 organizations testified at the hearings. Each participant made a presentation of approximately 15 minutes, followed by questions from Panel members.

2 The following organizations were represented at the hearings[1]:

American Institute of Certified Public Accountants
Arthur Andersen LLP
Auditing Practices Board (UK)
Canadian Institute of Chartered Accountants
Colorado State Board of Accountancy
Deloitte & Touche LLP
Ernst & Young LLP
Institute of Internal Auditors
KPMG LLP
National Association of State Boards of Accountancy
New York State Board of Accountancy
New York State Society of Certified Public Accountants
PricewaterhouseCoopers LLP
Securities and Exchange Commission
Texas State Board of Accountancy
Washington State Board of Accountancy

The following individuals also testified at the hearings:

Richard Antle, Professor, Yale School of Management
Thomas Craig, Professor, Illinois State University

3 The speakers were forceful and straightforward in their remarks, and responded candidly to Panel members' questions. The Panel considered the comments it received in completing its report and is appreciative of the speakers' participation.

[1] See Exhibit 5 to this report for a timetable of the presentations at the July 2000 hearings.

4 Some of the areas of recurring comments by the speakers were:

Governance of the profession, including the POB's proposed charter
Audit risk model
Non-audit services
Role of the state boards of accountancy
International aspects of the profession, including cooperation in standard setting
Forward-looking recommendations
Prioritization of recommendations
Management's responsibility for prevention and detection of fraud
Management reporting on internal control
Forensic-type auditing
Linkage between the Panel's findings and its recommendations

APPENDIX O – SIGNIFICANT CHANGES FROM THE EXPOSURE DRAFT

1 On May 31, 2000, the Panel issued the Exposure Draft of its *Report and Recommendations*. The Panel received comments on the Exposure Draft from participants at public hearings (see Appendix N) and from 42 individuals and organizations that submitted letters of comment. The Panel analyzed all the comments, deliberated again many of its recommendations and made a number of changes to its report. This appendix describes the most significant modifications. In addition, the final report includes updated information, clarifications and editorial improvements that are not described below.

Executive Overview

2 Significant changes made elsewhere in the report are reflected in "Recommendations."

Chapter 1 – Introduction

3 The discussion of "Benefits and Costs" has been expanded. Also, changes made elsewhere in the report are reflected in "The Panel's Approach to the Project" and in "Chapters Containing Findings and Recommendations."

Chapter 2 – Improving the Conduct of Audits

4 Several commentators noted that not all the recommendations seemed to be supported by the findings from the Quasi Peer Reviews (QPRs). The Panel added an explanation that its recommendations spring from a variety of sources (not solely the QPRs), and are intended not merely to suggest improvements resulting from perceived deficiencies, but also to foster wider use of "best practices" that the Panel identified (paragraphs 2.20 – 2.21).

5 Also, some questioned whether the Panel's call for more definitive auditing standards meant that the Panel was suggesting that auditors use more checklists and rely less on their judgment. The Panel has clarified that its intention was that better guidance be developed to help auditors enhance their professional judgment, not that more checklists be designed, and has added an example of definitive guidance in an existing standard (paragraphs 2.23 – 2.24).

6 The recommendations to the Auditing Standards Board (ASB) for "Multi-location Audits" and "Assessing Control Risk" have been expanded to include additional consideration of the control environment in determining audit scope.

7 The recommendations to the ASB regarding "Analytical Procedures" now include developing guidance for relying on and documenting management's explanations.

8 In "Going Concern Considerations," the Panel has noted in its recommendation to the Financial Accounting Standards Board that an international accounting standard addresses the subject of going concern, and that an international auditing standard references that accounting standard.

9 In "Communicating with Audit Committees," the Panel has deleted the recommendations in the Exposure Draft addressed to the ASB, since they are substantially covered by existing guidance.

10 A recommendation has been added to "Establishing Auditing Standards" that the POB review the ASB's prioritization, timetable and process for addressing the Panel's recommendations. The Panel also has offered observations to the POB and ASB on this activity.

Chapter 3 – Earnings Management and Fraud

11 Changes to this chapter include:

- A new section, "Consideration of Exposure Draft Comments on the Forensic-type Phase"

- A notation that all the audits reviewed in the QPRs were subject to SAS No. 82 (note 27 to Chapter 3)

- Clarifying references to the goal of "zero defects" (paragraph 3.27)

- Clarifications to the recommendation that the ASB develop a forensic-type audit phase, including an expanded discussion of the degree of additional audit effort in this phase, the use of the word "forensic," the neutral concept of professional skepticism, the use of internal auditors, high-risk areas and procedural guidance for interim periods

- An extension by one year of the timetable that the Panel believes is reasonable for strengthening standards in this area

- An additional recommendation to audit committees requiring management to acknowledge in writing that it has the primary responsibility for preventing and detecting fraud

Chapter 4 – Audit Firms

12 A brief discussion of "Collegiate Education" has been added to "Professional Development." The recommendations to audit firms under "Professional Leadership – The Tone at the Top" and "Personnel Management" have been expanded (but not changed).

Chapter 5 – Auditor Independence

13 "The Panel's Process" in "Non-audit Services" has been updated for the SEC's June 2000 independence proposals, and a footnote reference to the Independence Standards Board's conceptual framework project has been added.

Chapter 6 – Governance of the Auditing Profession

14 In "Proposed System of Governance," the recommendations in the Exposure Draft have been substantially reorganized for clarity. In some cases, those to whom the recommendations are addressed have been changed to better direct the recommendations to the parties most capable of implementing them.

15 The Panel has recommended that the POB, SEC, AICPA, SECPS and major firms promptly agree to a charter for the POB, noting that there are two matters in the August 22, 2000, draft charter that are still under negotiation. Upon the successful conclusion of those negotiations, the Panel believes the charter will result in a major step forward in the governance of the profession (paragraph 6.26).

16 The Panel expanded its recommendation regarding the POB's oversight of the profession's activities to include the standard-setting activities of the AICPA's Professional Ethics Executive Committee that relate to audits of public companies (paragraph 6.23).

17 A recommendation has been added that the POB and state boards of accountancy determine how best to facilitate communications between them (paragraph 6.28).

Chapter 7 – International

18 "The Goal of Transparency" has been clarified to emphasize that the cooperative efforts of all those involved in the financial-reporting and capital-raising processes are required to achieve the goal. The Panel has added a concluding recommendation that the ASB and the International Auditing Practices Committee initiate a formal collaborative effort to harmonize auditing standards and achieve their global acceptance.

Chapter 8 – Looking Ahead

19 "The Information Demand" and "The Best People" have been expanded to acknowledge the potential for changes to the current accounting model and other challenges in today's "new economy."

Appendices

20 Appendices N (July 2000 Public Hearings) and O (Significant Changes from the Exposure Draft) have been added.

Exhibit 1

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE CHIEF ACCOUNTANT

September 28, 1998

Mr. A.A. Sommer
Chairman
Public Oversight Board
One Station Place
Stamford, Connecticut 06902

Dear Al:

I am writing to you today to ask that the Public Oversight Board ("POB") examine whether recent changes in the audit process serve and protect the interests of investors. Perhaps the best way to approach such an examination is to convene a "blue ribbon" panel of investors, auditors, audit committee members, corporate executives, former regulators, and others with a keen understanding of the audit function. The panel could study the issues outlined below, invite public comments, and possibly hold public hearings.

As you are well aware, the Commission and the accounting profession have a long history of assuring that financial information reaching the marketplace is credible, relevant, and reliable. The foundation for this unique relationship was laid when Congress stated in the securities laws that issuers could access the public capital markets only if their financial statements are audited by independent accountants. This statutory franchise placed the accounting profession on a pedestal and charged the profession with the critical responsibility of enhancing investors' confidence in the financial information they receive.

Almost since its inception, the Commission has looked to the profession to take the lead in setting auditing standards. The Commission has overseen and participated in that standard setting process and, when necessary, enforced adherence to those standards. As a result of our efforts and the efforts of dedicated accountants serving in both management positions in public companies and in the auditing profession, investors have come to rely on the accuracy of financial statements when making investment decisions.

Recently, however, the combination of changes in the audit process and high profile financial frauds have raised questions about the efficacy of the audit process. For example, many auditors have changed their audit procedures to use a risk assessment model that places increased reliance on analytical procedures, while decreasing the use of substantive audit procedures, such as confirmations with debtors and detailed testing of transactions, account balances, and the activity in those accounts. This restructuring of the audit process has come at a time when the press has reported several frauds involving materially and in some cases hugely misstated financial statements that appear to have gone undetected by auditors.

Some auditors assert that the changes to their processes are responsive to the increased use of information technology in financial reporting and accounting. Other market participants, however, may believe that the profession is abandoning the techniques that, in the past, made the financial statement audit a valuable tool for the protection for investors.

The primary focus of our concern, therefore, is whether today's audit model, with its emphasis on risk assessments and analyses instead of more intensive fact checking and verification of the numbers, can continue to assure investors that appropriate steps have been taken to provide them with reliable financial information. A review of this issue may involve a top to bottom examination of the "re-engineered" audit function, including, among many other things, the training of auditors, how audits are planned and supervised, whether firms' quality controls address all necessary elements in the new audit process, and whether the apparent decrease in audit documentation will impact the efficacy of peer reviews and other evaluations of audits.

As you know Al, before becoming Chief Accountant, I served as the Chief Financial Officer for a large technology company. Serving in that role drove home the reality that in order for an auditor to understand and appreciate fully the way management evaluates business risks and makes financial decisions, that auditor must have considerable business and professional experience. I am concerned that a substantial majority of the individuals performing audit work today, although some of the brightest graduates from our universities, do not have that experience. As the bulk of the audit work involves ongoing assessments of operations and associated risks, and how those risks might impact the reported results, this lack of practical business experience may have significant detrimental effects on the quality of audits. An inquiry into if, when, and how auditors bring partner-level and in-depth industry experience to bear in the audit process, therefore, would appear to be essential to an understanding of whether that process is continuing to protect investors.

Other questions might include whether the current audit model allows the auditor to de-emphasize or eliminate audit procedures that would have uncovered material financial statement misstatements, and whether there is a set of minimum detail-testing audit procedures that the auditor should not be permitted to eliminate under any new audit model or audit re-engineering.

As you know, our suggestion for a panel to review the new audit process is not an alarmist call to arms, but an effort to be proactive in making sure that all participants in the process work together to assure the continued protection of investors. As we discussed, I understand the POB will need to consider this request at its next Board meeting, along with the accompanying logistical questions. I would be happy to respond to any further questions the Board and its staff might have on this very important project.

Al, I appreciate your and the POB's continued efforts on behalf of investors and I look forward to working with you in addressing the concerns identified in this letter, as well as other questions that may arise. I also look forward to discussing plans for forming and staffing the "blue ribbon" panel, and I am of course available to discuss these issues at your convenience.

Sincerely,

Lynn Turner

Lynn E. Turner
Chief Accountant

cc: Barry Melancon, President, American Institute of Certified Public Accountants
Deborah Lambert, Chair, Auditing Standards Board
Thomas Ray, Director, Audit and Attest Standards, American Institute of Certified Public Accountants

Exhibit 2

PUBLIC OVERSIGHT BOARD

PANEL ON AUDIT EFFECTIVENESS

One Station Place
Stamford, CT 06902
(203) 353-5370
Fax (203) 353-5311

January 6, 1999

The Public Oversight Board
One Station Place
Stamford, CT 06902

Members of the POB:

We are pleased to submit this letter outlining how we propose to address a project to examine whether the audit processes of large-firm members of the SECPS adequately serve and protect the interests of investors. Such a project was requested by Mr. Lynn E. Turner, Chief Accountant of the Securities and Exchange Commission, by letter of September 28, 1998 to Mr. A. A. Sommer, Jr., Chairman of the POB.

The purpose of the project is to make a comprehensive review and evaluation of the way independent audits are performed and assess the effects of recent trends in auditing on the public interest. The project will include, among other things, evaluating the adequacy of the professional development of auditors, how audits are planned and supervised, whether firms' quality control systems encompass the necessary elements and guidance, and whether audit documentation is appropriate. It also will consider the overall "tone at the top" and performance measures used by firms in evaluating audit personnel. Furthermore, the project will include assessing the need for possible changes in professional standards and the profession's self-regulatory process. In carrying out the project, we will consider users' expectations about auditors' responsibilities and the relationship between audit and non-audit services.

We anticipate that, as part of this undertaking, we will gather information and consider guidance materials recently issued or currently under development by the large-firm members of the SECPS and the AICPA. For example, the *Horizons* project of the Auditing Standards Board, we understand, contemplates evaluating the efficacy of the auditing standard relating to the detection of fraud and assessing the impact of audit reengineering on standards.

We envision that the project will be carried out in phases as described in the work program prepared by the Panel's staff members, culminating in a report that will be issued by the Panel. The report will identify the process undertaken, the resultant findings, and the basis for recommendations made to accounting firms, the AICPA, the Securities and Exchange Commission, audit committees, and managements.

Very truly yours,

Shaun F. O'Malley
Chair

Exhibit 3

Panel on Audit Effectiveness
Public Hearings October 7/8, 1999
Timetable

	Thursday, October 7	Friday, October 8
9:00 – 9:15	Opening Remarks, Shaun O'Malley	Opening Remarks, Shaun O'Malley
9:15 – 9:45	Arthur Levitt, Harvey Goldschmid, Lynn Turner, SEC	Michael Young, Willkie Farr & Gallagher
9:45 – 10:15	SEC, continued	Karen Pincus, AAA
10:15 – 10:30	Break	Break
10:30 – 11:00	Richard Rowe, Dan Goldwasser, Samuel Gunther, ABA Committee on Law and Accounting	Steve Samek, Joe Berardino, Greg Jonas, Arthur Andersen
11:00 – 11:30	Ed Jenkins, FASB	David Costello, NASBA
11:30 – Noon	Barry Melancon, AICPA	Jim Copeland, Deloitte & Touche
Noon – 1:00	Lunch Break	Lunch Break
1:00 – 1:30	Mike Conway, SECPS	Patricia McConnell, Bear Stearns
1:30 – 2:00	David Bershad, Milberg Weiss Bershad Hynes & Lerach	Dennis Nally, Bob Herz, PricewaterhouseCoopers
2:00 – 2:30	Phil Livingston, FEI	Steve Percoco, Lark Research Inc.
2:30 – 3:00	Peter Knutson, The Wharton School	Bob Herdman, Ernst & Young
3:00 – 3:15	Break	Break
3:15 – 3:45	Dom Esposito, Grant Thornton (on behalf of Grant Thornton, BDO Seidman, and McGladrey & Pullen)	Don Kirk, POB
3:45 – 4:15	Ernest Ten Eyck, Ten Eyck Associates	Closing Remarks, Shaun O'Malley
4:15 – 4:45	Bob Elliott, KPMG	
4:45 – 5:00	Closing Remarks, Shaun O'Malley	

Exhibit 4

Report of the
Peer Review Process Task Force
Executive Committee
SEC Practice Section of the AICPA
January 25, 2000

Purpose

The Peer Review Process Task Force (Task Force) was formed by the Executive Committee of the SEC Practice Section of the American Institute of CPAs (SECPS) in March 1999 for the purpose of determining ways of improving the effectiveness of peer reviews conducted under the SECPS peer review program. The formation of the Task Force and the need to reexamine the peer review program was encouraged by the SECPS Peer Review Committee (PRC), the Public Oversight Board (POB), and the staff of the Securities and Exchange Commission (SEC). These groups seek:

- enhancements in the reporting of the results of peer reviews;
- improvements in the effectiveness of peer reviews, for example by emphasizing the timely identification and testing of emerging issues and higher-risk areas during peer reviews;
- comprehensive governance and oversight of the peer review process; and
- peer reviews performed by appropriately qualified and trained reviewers.

Task Force Deliberations

A list of the Task Force members is attached. The members have the following affiliations:

- SECPS Executive Committee
- SECPS Peer Review Committee
- SECPS SEC Regulations Committee
- AICPA Peer Review Board
- AICPA Auditing Standards Board
- Nasdaq

Also participating in the deliberations of the Task Force was a member of the POB, staff of the POB, and staff of the POB's Panel on Audit Effectiveness. Additionally, members of the Task Force met individually with several groups who are users of peer review reports, but were not directly represented in the deliberations of the Task Force, to obtain feedback from them regarding the peer review program. These meetings included representatives from the SECPS Quality Control Inquiry Committee, the U.S. Department of Labor, several State boards of accountancy, and several State CPA societies who administer the AICPA's Peer Review Program applicable to non-SECPS member firms.

Background and Objectives of the SECPS Peer Review Program

The origins of the profession's programs for voluntary self-regulation date back to 1977. Since then these programs have been continuously reviewed and enhanced with the changing practice environment and market conditions. Currently, SECPS member firms must have their quality control systems reviewed by independent peers once every three years. These reviews are system and compliance oriented with the objectives of evaluating whether:

- The reviewed firm's system of quality control for its accounting and auditing practice has been designed to meet the requirements of the quality control standards established by the AICPA.

- The reviewed firm's quality control policies and procedures were being complied with to provide the firm with reasonable assurance of conforming with professional standards.

- The reviewed firm was complying with the membership requirements of the SECPS in all material respects.

In a peer review, an independent team of CPAs, typically a firm-on-firm review, reviews the firm's stated quality control policies and procedures to determine whether they meet the elements of quality control set forth in professional standards. Then the review team tests whether the firm's personnel have consistently applied these policies and procedures by looking at specific engagements and compliance with firm-wide quality control systems, for example systems pertaining to independence, client acceptance, and professional development. The review team's conclusions are documented in a written report—which may be unmodified, modified or adverse—and, when appropriate, a letter of comments addressing matters that require action by the reviewed firm. The reviewed firm then responds to the letter of comments in writing, stating what corrective actions it intends to take.

The PRC establishes and maintains review standards. At regular meetings and through report evaluation task forces, the PRC considers each peer review, evaluates the reviewer's competence and performance, and examines every report, letter of comments, and accompanying response from the reviewed firm that states its corrective action plan before it is finalized. In its deliberations, the PRC may also question the peer review team or require the team to revisit the reviewed firm to perform additional procedures. The POB staff plays a key role in overseeing the performance of peer reviews working closely with peer review teams and the PRC. The working papers prepared on all peer reviews performed under the SECPS program are reviewed by the SECPS staff or POB staff.

Based on the nature of the peer review results, the PRC may require remedial measures beyond those contemplated in the reviewed firm's letter of response and require active monitoring of the firm's follow-up to assure that corrections are made. On some occasions, the PRC requires an accelerated follow-up peer review.

Once the PRC accepts them, peer review reports, letters of comments, and reviewed firms' responses are maintained in a file available to the public.

The SEC also oversees the SECPS peer review program and makes its own evaluation of the adequacy of the program and the POB's oversight of it. After the PRC accepts reports on the peer reviews of member firms with one or more SEC clients, the POB arranges with the SEC staff to review the POB's oversight files and the peer reviewer's working papers for a sample of the reviews based on the SEC access to working papers protocol set forth in the peer review standards. The SEC reports on its evaluation of the peer review program in its annual report to Congress.

Comments and Recommendations

After evaluating the current peer review program and obtaining feedback from various user groups, the Task Force reaffirmed the previously stated objectives of the peer review program. The structure for administering, conducting, and overseeing peer reviews should continue to strive for improvements in the performance of member firms' accounting and auditing practices and provide a means for fostering remedial actions when necessary. The Task Force also concluded that it is in the public's, and the profession's, interest to continue to have peer reviewers express opinions on the design of quality control systems and a firm's compliance with those quality control systems.

However, the Task Force identified four areas of the current peer review program that it believes should be improved. The four areas are: Reporting, Process, Governance and Oversight, and Qualifications and Training of Reviewers. The Task Force believes improvements in these areas will enhance the effectiveness of future peer reviews.

Reporting

Overview

Currently, individuals can request (either orally or in writing) the contents of the SECPS's public file which includes a member firm's three most recent annual reports, their most recent peer review report and, if applicable, the letter of comments and letter of response issued pursuant to their most recent peer review report, and the PRC's acceptance letter of such peer review. In addition, any actions required to be taken by the reviewed firm as a condition of acceptance of its peer review report are included in the firm's acceptance letter. Peer review reports and letters of comments are prepared based on the Standards for Performing and Reporting on Peer Reviews established by the PRC. Other communications regarding the results of peer reviews that are not available to the public are made orally at exit conferences with firm management and in Summary Review Memoranda[1] presented to the PRC[2] (and available to the POB and SEC).

The Task Force believes that in order to best serve the public interest, the future peer review reporting model must be more transparent and better facilitate the communication of matters identified during peer reviews that should be addressed by reviewed firms and the profession. More transparent reporting would inform users of peer review reports and letters of comments about the conduct of peer reviews and expand the disclosure about the findings pertaining to the reviewed firms' quality control systems and compliance with those systems. The reporting model also should provide for the communication of best practices, constructive suggestions that go beyond professional standards, and matters for the attention of standards setters. To accomplish this, peer reviewers and reviewed firms should consider the PRC as the "audit committee" so that they have appropriate information to perform their functions effectively. Additionally, the future reporting model should provide appropriate access to information for the SEC staff to assess the effectiveness of the peer review program.

Recommendations

1. The SECPS should:

    a. Continue to maintain a file that provides for public access to peer review reports, letters of comments, and the firms' responses to the letters of comments. We understand the SECPS is in the process of developing a system for including the documents contained in the public file on the Internet. The Task Force supports efforts to make the public file more accessible.

    b. Study whether there are key quantitative and qualitative performance indicators that would be useful to users of SECPS member firms' annual reports or peer review reports. Such information might include, for example, the number of audits performed during the year compared to key qualitative indicators that are relevant, objective, and measurable.

2. The PRC should make changes to the Standards for Performing and Reporting on Peer Reviews for the following:

    a. Revise the standard peer review report to more fully describe the peer review process and matters relevant to the specific peer review.

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[1] The Standards for Performing and Reporting on Peer Reviews require that a Summary Review Memorandum be prepared on each peer review. The memorandum describes the planning of the review, the scope of the work performed, the findings and conclusions supporting the report and letter of comments issued, and the comments communicated to firm management during the exit conference that were not deemed of sufficient significance to include in the letter of comments.

[2] The Summary Review Memorandum is presented to the PRC for firms with 30 or more SEC clients or in instances where it is necessary for consideration by the PRC in accepting the applicable peer review report.

b. Peer review reports should be addressed to the reviewed firm and the PRC to emphasize that peer reviewers and reviewed firms should consider the PRC as the "audit committee."

c. Require a Summary Observations Memorandum be prepared on all peer reviews that describes the peer reviewer's observations regarding best practices, constructive suggestions that go beyond professional standards, and matters for the attention of standards setters. The Summary Observations Memorandum should be submitted to the PRC along with the other documents that are required to be submitted (all of which are available to the POB). To encourage candid communications, the Summary Observations Memoranda prepared on peer reviews each year should not be made available for public distribution, but should be used as a basis for preparing the PRC annual report described in Recommendation 4 c. The SEC staff should have access to the PRC annual report and, in its oversight role, should have access to the Summary Observations Memoranda on a no-name basis.

Process

Overview

As previously indicated, the PRC establishes and maintains the Standards for Performing and Reporting on Peer Reviews. Although there are approximately 1,300 SECPS member firms of various sizes and types of practices, the peer review standards are common to all member firms and do not provide for these differences. The Task Force believes the peer review process needs to recognize that not all firms are the same and adapt the peer review procedures accordingly. The peer reviews of larger, more complex firms with extensive quality control systems and internal inspection programs[3] should have more frequent peer review involvement and eliminate redundancies with internal inspection programs. Further, the Task Force believes the peer review process needs to place greater emphasis on ascertaining auditor performance versus evaluating documentation to determine compliance with quality control systems and professional standards.

Recommendations

3. The PRC should make changes to the Standards for Performing and Reporting on Peer Reviews for the following:

a. There should be a prescribed differentiation of the SECPS member firms, based on the effectiveness and objectivity of the firms' internal inspection programs. Tier A firms should be those that do not have an internal inspection program that meets specifically defined

[3] The larger, more complex firms have established extensive internal inspection programs. These programs are designed to annually evaluate the adequacy of the firm's quality control policies and procedures, its personnel's understanding of those policies and procedures, and the extent of its personnel's compliance with them. The inspection procedures performed are similar to those performed during tri-annual peer reviews. Such procedures place significant emphasis on reviewing engagements performed by a cross section of the firm's accounting and auditing personnel.

criteria for a Tier B firm. Tier B firms should be those firms that have an effective internal inspection program that meets specifically defined criteria. The effectiveness of a reviewed firm's internal inspection program should be determined by the peer reviewer. The PRC, with the POB's oversight, should concur with the classification of firms.

b. The peer reviews of Tier A firms should be systems and compliance oriented but place greater emphasis on the reviews of engagements, while the peer reviews of Tier B firms should involve reviews of engagements but place greater emphasis on systems and compliance.

c. Tier B firms should be required to engage their peer reviewers to annually perform certain limited review procedures, in addition to the peer review performed on a tri-annual basis. The procedures performed by the peer reviewer on an annual basis should include: (1) follow-up on actions taken by the reviewed firm in response to the letter of comments, if any, and Summary Observations Memorandum from the most recent peer review, the Recommendations Letter (described below), if any, from the most recent annual limited procedures engagement, and the findings of the prior year internal inspection program; (2) review the design of any significant changes in the reviewed firm's system of quality control for its accounting and auditing practice; (3) review changes to the firm's policies and procedures designed to implement significant new professional standards; (4) review the plan for and results of the reviewed firm's internal inspection program, including determining whether it included consideration of emerging issues and higher-risk areas, and determine whether the reviewed firm has taken appropriate actions with respect to any engagements with material findings noted in the inspection program; and (5) if considered appropriate, prepare a Recommendations Letter communicating to the reviewed firm any observations and recommendations resulting from the limited procedures engagement. The Recommendations Letter would be sent to the PRC for informational purposes. However, if the peer reviewer determines that the firm has not taken appropriate actions with respect to material findings, the peer reviewer should refer such circumstances to the PRC for further consideration. Additionally, the POB should conduct oversight of the annual limited procedures engagement.

d. The tri-annual peer review for Tier B firms should be integrated with the reviewed firm's internal inspection program in that year and focus on emerging issues and higher-risk areas, while relying on the internal inspection program (with some testing by the peer reviewer) to review routine and compliance areas. The reviewed firm's internal inspection program should become an integral part of the peer review in that the peer reviewer should review and approve inspection review procedures, review materials and questionnaires, and office and engagement selections made for the inspection program, and form joint teams of internal inspectors and peer reviewers for certain reviewed offices. The objectives of this more integrated involvement are to provide the peer reviewer with more direct, ongoing knowledge of the effectiveness of the firm's quality control systems and inspection program. Also, if the internal inspection program is determined to be effective, this approach allows the peer reviewer to perform less routine and compliance review procedures and focus primary attention on the areas of higher-risk and emerging issues. For example, in some instances, peer reviewers might review on a surprise basis only those portions of engagements pertaining to emerging issues and higher-risk areas.

e. The review materials and questionnaires should be revised to generate more qualitative, subjective, and judgmental considerations and findings by peer reviewers. The qualitative considerations by the peer reviewer should include in-depth interviews of the engagement team at all experience levels with respect to the approach taken in areas of higher-risk and emerging issues to provide a basis for judgmentally evaluating whether the engagement team possessed the necessary experience and appropriate information to adequately and timely plan and perform the audit procedures. Peer reviewers also should conduct focus group sessions with professional personnel at various levels in the organization in order to obtain candid feedback regarding critical matters pertaining to the accounting and auditing practice. The qualitative, subjective, and judgmental findings from these procedures should result in observations and recommendations regarding best practices, constructive suggestions that go beyond professional standards, and matters for the attention of standards setters to be included in the Summary Observations Memorandum in addition to potential findings for the letter of comments.

Governance and Oversight

Overview

The PRC is responsible for administering the SECPS peer review program by establishing standards for conducting and reporting on the results of peer reviews. The PRC also works closely with the POB in its oversight role. Although the AICPA Code of Professional Conduct does not specifically consider relationships between reviewers, reviewed firms, and clients of reviewed firms, the concepts concerning independence, integrity, and objectivity embodied in the Code are critically important to the peer review program. Likewise, oversight of the peer review program by the POB, and the SEC, makes the process both more effective and more credible.

The Task Force concluded that the overall structure for administering and overseeing the peer review program is primarily sound. However, the Task Force believes the effectiveness of future peer reviews would be improved with additional measures to promote peer reviewer independence and objectivity; changes to current protocols among the PRC, POB, SEC, and peer reviewers; and with greater depth in the POB's oversight of the performance of peer reviews.

The Statements on Quality Control Standards (SQCS) issued by the Auditing Standards Board (ASB) provide that firms have a system of quality control for their accounting and auditing practice and broadly describes elements of quality control and other matters essential to the effective design, implementation, and maintenance of the system. These standards, as well as generally accepted accounting, auditing, and independence standards and SEC rules and regulations in areas where such rules and regulations are pertinent, form the foundation of the systems oriented approach to conducting peer reviews. The Task

Force believes that one of the root causes of some recent criticisms of the peer review process relates to the lack of specificity of the SQCS.

Recommendations

4. The PRC should:

   a. Make changes to the Standards for Performing and Reporting on Peer Reviews for the following:

      i. Limit the peer review team captains for the reviews of Tier B firms to two consecutive reviews of the same firm and a total of three consecutive reviews as an engagement team member[4]. The primary purpose for limiting the team captain's total years of service is to enhance the benefit of the fresh-look obtained by rotating the peer review team captain.

      ii. Require that peer review team captains for the reviews of Tier B firms participate in a meeting (exit conference) with the SEC staff and POB staff when the SEC staff reviews the firm's peer review working papers. The purpose of such a meeting is to timely discuss significant matters considered by the SEC staff during their oversight.

   b. Prepare an annual report for the profession, standard setters (such as the ASB and FASB), regulators (such as the SEC), and others (such as the Professional Issues Task Force and SECPS Quality Control Inquiry Committee) that describes significant matters noted during peer reviews conducted during the year. Such report should highlight matters noted in letters of comments, Summary Review Memoranda, and Summary Observations Memoranda. The primary purpose of the annual report would be to facilitate the timely identification of matters that require the attention of the profession, standard setters, regulators, and others.

   c. Determine a more formal means of identifying emerging issues and higher-risk areas in a timely manner, and providing frequent updates or supplements to the review materials and questionnaires used to perform peer reviews. The PRC should regularly seek formal input from the ASB, Professional Issues Task Force, SECPS Quality Control Inquiry Committee, POB, SEC staff, and others as to emerging issues and higher-risk areas that should receive focused attention by peer reviewers. The PRC, through a standing committee, task force, SECPS staff or otherwise, should prepare revisions or supplements to its review materials and questionnaires and timely distribute them to peer reviewers. We understand the SECPS is in the process of developing a system for including the review materials and questionnaires on the Internet. The Task Force

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4 Team captains are currently limited to three consecutive reviews of the same firm with no limit on the total years of service on the engagement team.

supports efforts to make these materials easier to keep current and more accessible to peer reviewers.

d. Study the cost versus benefit of more frequent peer reviewer involvement for Tier A firms in order to improve the effectiveness of the peer review process for these firms. More frequent peer reviewer involvement might include limited review procedures similar to those described in Recommendation 3 c for Tier B firms.

e. Establish a more formal means for continuously pursuing better approaches to performing peer reviews. Such means might include, for example, periodically conducting focus group sessions with experienced peer reviewers and users of peer review reports or having a limited number of experienced peer reviewers experiment with different review techniques on some peer reviews.

5. The POB should:

a. Perform an in-depth review of its current approaches to overseeing the performance of peer reviews with the goal of identifying ways of gaining more timely and deeper involvement by the staff and Board. Guidelines for enhancing such approaches should include the following:

i. The nature, timing, and extent of the POB staff's oversight role should vary based on an assessment of such factors as size, complexity, and risk profile of the firm's accounting and auditing practice.

ii. The POB staff's oversight of the performance of peer reviews should be timely and include the scope of the review, evaluation and resolution of issues identified during the review, and communications of the results of the review. The scope of the review includes consideration of the number of and specific engagements and offices to be reviewed; the significant accounting, auditing, and independence areas to be emphasized during the review; and the approach to integrating the firm's internal inspection program.

iii. The POB staff's oversight of the performance of peer reviews should be more timely and extensive for Tier B firms. More timely involvement would include, for example, increasing beyond its current level the oversight of the work of peer reviewers as it is being performed rather than reviewing the work once it is completed. More extensive involvement would include, for example, participation with a peer reviewer in some interviews of audit engagement team members and in focus group sessions with office personnel.

b. Consider establishing a process for obtaining additional expertise to assist the POB staff, when necessary, in formulating the staff's views on significant matters that occasionally arise during the performance of peer reviews. The purpose of establishing such a process would be to provide a means of drawing on experienced professionals and subject matter experts to assist in evaluating matters where significant differences of professional judgment exist between the peer reviewers, reviewed firm, and/or POB staff.

6. The Task Force understands the ASB is planning a project to improve the SQCS. The Task Force believes that an expansion of the standards to include more specific guidance is an important element to achieving continuous improvement and strongly supports the ASB's efforts.

Qualifications and Training of Reviewers

Overview

The Standards for Performing and Reporting on Peer Reviews describes the qualifications and training requirements for peer reviewers. The Task Force believes the standards appropriately address the essential requirements of the peer review team such as confidentiality; independence, integrity and objectivity; competence; organization of the review team; and qualifications for individuals who serve as reviewers and of the reviewing firm. However, the Task Force also believes that the current training courses and approach to training peer review team captains and reviewers needs to be enhanced. There are currently two courses offered by the AICPA to peer reviewers, How to Conduct a Peer Review Under the AICPA Practice-Monitoring Programs ("How to Course") and the Advanced Training Course for Reviewers: Current Issues in Practice Monitoring ("Advanced Course"). Individuals who want to participate as a team captain on a peer review are required to attend a training course at least once every five years. The courses are developed by authors contracted with by the AICPA and are offered through various State CPA societies.

Almost all peer reviews are firm-on-firm peer reviews. However, in a few instances, Committee Appointed Review Teams (CARTs) are formed to perform the review. CARTs are typically formed for reviews of small firms so that the review team has appropriate specialized skills. For example, a CART may have a team captain from one firm and a reviewer from another firm in order to have a review team member who is knowledgeable in a particular specialized industry. Currently, the PRC establishes the fee schedule for CARTs. The Task Force believes a market driven fee arrangement between the CART and the firm being reviewed would result in more qualified reviewers willing to participate on a CART.

Recommendations

7. The PRC should:

   a. Establish a standing task force that will oversee the peer review training programs to ensure that the training programs and methods of delivering them meet the needs of the peer review program. The task force should address the following:

i. The content and method of delivering peer review training courses to ensure that the training is relevant and timely. To determine the content of training programs, considerations should be given to the competencies required to perform effective peer reviews. Such competencies would include interviewing skills, diagnostic skills, knowledge of the peer review process, as well as, knowledge of generally accepted accounting, auditing, and independence standards and SEC rules and regulations in areas where such rules and regulations are pertinent to the engagements being reviewed. Also, alternative training methods should be considered such as via the Internet, CD-ROM, or tele-conferencing.

ii. The process for identifying and selecting course instructors and for monitoring the instructor's performance should be formalized.

iii. Consideration should be given to developing more continuous training programs for team captains.

b. Develop a system for evaluating the performance of team captains. Such a system might include a written evaluation of the team captain's performance by the SECPS technical reviewer and, when applicable, POB staff for each peer review. The results of such evaluations could then be summarized on a periodic basis to identify team captains who are not performing at an acceptable level so that appropriate actions can be considered by the PRC.

c. Discontinue setting rates for peer reviews conducted by CARTs. Fees for participating in a CART review should be established by the firm being reviewed and the members of the review team.

Attachment

Task Force Members and Other Participants
Peer Review Process Task Force
Executive Committee
SEC Practice Section of the AICPA

Task Force Members		
Richard L. Miller, Chair	Ernst & Young LLP	SECPS Peer Review Committee
Edmund Coulson	Ernst & Young LLP	SECPS SEC Regulations Committee
George Diacont	Nasdaq	
Bradley R. Gabosch	Arthur Andersen LLP	SECPS Peer Review Committee
Daniel J. Hevia	Hevia, Beagles & Company	SECPS Peer Review Committee
Wayne A. Kolins	BDO Seidman LLP	SECPS Executive Committee
Deborah D. Lambert	Johnson, Lambert & Co.	Chair, Auditing Standards Board
Dale P. Lien	McGladrey & Pullen LLP	SECPS Peer Review Committee
Anthony D. Lynn	Davis, Lynn & Moots P.C.	AICPA Peer Review Board
Guy W. Moore, Jr.	Deloitte & Touche LLP	SECPS Peer Review Committee
Edward F. Smith	KPMG LLP	SECPS Peer Review Committee
David J. Steiner	Ehrhardt, Keefe, Steiner & Hottman PC	SECPS Peer Review Committee
W. Ronald Walton	PricewaterhouseCoopers LLP	Chair, SECPS Peer Review Committee
Other Participants		
Michael A. Conway	KPMG LLP	Chair, SECPS Executive Committee
Donald J. Kirk	Public Oversight Board	Board member
Jerry D. Sullivan	Public Oversight Board	Executive Director
Charles J. Evers	Public Oversight Board	Technical Director
Thomas M. Stemlar	Public Oversight Board	Staff, Panel on Audit Effectiveness
AICPA Staff		
Susan S. Coffey	Vice President - Self Regulation & SECPS	
David Brumbeloe	Director - SECPS	
Sheri Fabian	Senior Technical Manager, SECPS	
Dean Beddow	Technical Manager, Peer Review	
Al Perazzo	Technical Manager, SECPS	

Exhibit 5

Panel on Audit Effectiveness
Public Hearings on Exposure Draft of
Report and Recommendations
Timetable

	<u>Monday, July 10</u>
9:30 – 9:40	Opening Remarks, Shaun O'Malley
9:40 – 10:30	Arthur Levitt, Lynn Turner, SEC
10:30 – 10:45	Break
10:45 – 11:15	Daniel Dustin, New York State Board of Accountancy
11:15 – 11:45	Steve Samek, Joe Berardino, Greg Jonas, Arthur Andersen
11:45 – 12:15	K. Michael Conaway, William Treacy, Texas State Board of Accountancy
12:15 – 1:15	Lunch Break
1:15 – 1:45	Jim Turley, Bob Herdman, Ernst & Young
1:45 – 2:15	Thomas Sadler, Washington State Board of Accountancy
2:15 – 2:45	Ian Plaistowe, Jon Grant, The Auditing Practices Board (UK)
2:45 – 3:15	Jim Schiro, Ken Sicchitano, PricewaterhouseCoopers
3:15 – 3:30	Break
3:30 – 4:00	David Costello, Dennis Spackman, NASBA
4:00 – 4:30	Thomas Craig, Professor, Illinois State University
4:30 – 5:00	Jim Copeland, John Fogarty, Deloitte & Touche

	<u>Tuesday, July 11</u>
9:00 – 9:15	Opening Remarks, Shaun O'Malley
9:15 – 10:15	Barry Melancon, Dan Jones, Jim Gerson, AICPA
10:15 – 10:30	Break
10:30 – 11:00	Mike Conway, KPMG
11:00 – 11:30	Andrew Wingate, Diana Hillier, Canadian Institute of Chartered Accountants
11:30 – Noon	William Bishop, Bill Duane, Institute of Internal Auditors
Noon – 1:00	Lunch Break
1:00 – 1:30	Larry Gelfond, Colorado State Board of Accountancy
1:30 – 2:00	Rick Antle, Professor, Yale School of Management
2:00 – 2:30	Gerard Sokolski, William Stocker, Julian Jacoby, New York State Society of Certified Public Accountants
2:30 – 2:45	Closing Remarks, Shaun O'Malley