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The Role of the Practice Review Committee

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Accounting has had dynamic growth and progress in the past quarter century. Today there are over 100,000 CPAs in the United States as compared with 22,000 only 25 years ago. The CPA has expanded his services in the fields of auditing and taxation and has naturally filled a gap in the area of management advisory services.

But growth adds complexities to our work, and the profession has recognized that its members and prospective members should be well prepared to cope with these problems. Today's students of accounting receive a comprehensive education, including a broad liberal curriculum designed to serve as a foundation for intellectual fulfillment in our society. Those of us in practice today are presented with numerous opportunities to continue our education through the professional development programs established by the American Institute of Certified Public Accountants, our state societies, and the other accounting organizations. These programs, besides providing information on current techniques, serve as a basis for our individual professional growth.

Although these educational efforts have improved the technical competence of the accountant, the profession vigorously engages in a comprehensive program of self-discipline. Probably no other profession is so self-critical.

The membership has established for itself a code of professional ethics. If a CPA violates the Code, he subjects himself to disciplinary action by the ethics committee through the trial board.

The profession has established the auditing standards under which it operates. It does not feel you must or should be content with these rules as circumstances or conditions develop that would call for their review and revision.

The Accounting Principles Board, the senior technical committee for the certified public accountant, has been charged with an objective of making a "continuing effort to determine appropriate practice and narrow the areas of difference and inconsistency in practice." You are aware of some of the Board's recent accomplishments in this regard. During 1966 the Board issued pronouncements on such topics as Accounting for the Cost of Pension Plans and Reporting the Results of Operations. It also issued an Omnibus Opinion covering such topics as consolidated financial statements, poolings of interest, convertible debt, and liquidation preference of preferred stock. Very shortly, the Board expects to issue an opinion on Accounting for Income Taxes and another Omnibus Opinion covering certain accounting principles; the latter would cover either matters not discussed in previous pronouncements and not believed to warrant a separate Opinion or matters needing clarification. Before long thereafter, the Board also expects to issue an opinion on Financial Statements Restated for Price-Level Changes, and another on Conglomerates. The long-range plans of the Board are even more ambitious.

The Committee on Auditing Procedure is another of the senior technical committees of the AICPA's committee structure. Periodically it issues statements on auditing matters and in this regard covers a broad spectrum of accounting practice; it has an important influence upon the members of the profession.

Most accountants are familiar with the publication *Statements on Auditing Procedure No. 33,* published in 1963 by the Committee on Auditing Procedure. This statement is a consolidation of the substantive matters of earlier pronouncements and, in general, states the responsibilities and functions of the independent auditor and the generally accepted auditing standards as approved and adopted by the members of the Institute. There are three classes of standards: those of a general nature, the standards of field work, and the standards of reporting. We will see later how important the application of these standards is to the work of the Practice Review Committee.

The Committee on Auditing Procedure acts as a clearing house for a number of other Institute committees that publish audit guides on such topics as Nonprofit Organizations, Statistical Sampling, and Governmental, Brokerage, Insurance, and Bank Accounting.

These committees and services the CPA has established I mention only to demonstrate to you that the accounting profession has recognized the changing aspects of today's dynamic business society.

But, to paraphrase the New Testament, what does it profit a profession to have all the technical principles and services available, if some members issue substandard reports?

THE SCOPE OF THE WORK OF PRACTICE REVIEW COMMITTEE

In 1962 the Council, the governing body of the American Institute of Certified Public Accountants, adopted a resolution creating the Committee on Practice Review, whose duty is

> ... to review specific audit reports and opinions which on their face appear to involve deviations from accepted standards; and to communicate with the accountant or accounting firm who signed the report or opinion under consideration and to provide such accountant or accounting firm with the committee's questions or views with respect to the report or opinion and related financial statements.

In October 1964 the Committee received an additional charge by the Council in the Special Bulletin *Disclosure of Departures from Opinions of the Accounting Principles Board.* At that time, Council instructed the Committee to "give its attention to this area and to specifically report to Council the extent of deviations from these recommendations."

This charge was effective for 1966 and subsequent reports. To date the Practice Review Committee has had no undisclosed departures from APB Opinions to report to Council.

In its principal activity of reviewing substandard reports, the committee's function is purely educational, not punitive. The hope is to eliminate substandard reporting practices and to attain compliance with generally accepted auditing standards through education and persuasion rather than by disciplinary action.

We have attempted to stress the educational function of the committee by reviewing the reports in a confidential manner. The submitting source receives a reply from the Institute, acknowledging the receipt of the report and informing him that the report will be considered by the committee. He is not informed of the conclusions or ultimate disposition of the case. Only the Director of Technical Services of the AICPA and his staff know the name of the accountant and his client. The members of the Practice Review Committee receive copies of the report from the Institute, with all names and other identifying material deleted. The committee's questions and conclusions are communicated by the Institute's staff only to the accountant concerned. The cases are never submitted to the Ethics Committee, and members of the Practice Review Committee are not eligible to serve on the Ethics Committee, and vice versa.

Sources of Information

The Practice Review Committee will accept, from practically any source, reports that appear to deviate from generally accepted accounting principles or auditing standards. We have made a special effort to invite members of the profession, banking societies, governmental agencies, and other organizations having occasion to review reports, to submit accountants' reports that appear to deviate from accepted standards.

Some cases are submitted by the staff of the Institute itself as a result of their review of several hundred corporate reports used in the publication of the annual study *Accounting Trends and Techniques.*

But, essentially, the Practice Review Committee relies on each of you. Every accountant has a duty not only to maintain and improve his own level of performance, but also to raise the level of performance of those few who reflect adversely upon the entire profession through the issuance of substandard reports. One method of fulfilling this responsibility is to submit to the Practice Review Committee any substandard reports that may come to your attention. Submission of a report is *not* tantamount to bringing a charge against the reporting accountant, since there is no disciplinary action and all correspondence is handled in a highly confidential manner.

Method of Operation

Once a report is submitted to the Institute, the committee follows a set operation designed to preserve the confidential relationship, while allowing for a most thorough review. Briefly, let me outline the procedures we follow:

First, a member of the Institute's staff sends a form letter to the person who submitted the report, thanking him for referring it and explaining that the committee's conclusions are communicated only to the accountant who signed the report.

Second, the Director of Technical Services of the AICPA and his staff, after determining that the accountant is an Institute member, reviews the entire report. If they feel that it is not substandard, they submit it to the Committee chairman for his concurrence. If the Chairman agrees, the case is closed. If the report appears to be deficient, a letter is prepared asking pertinent questions and requesting additional information of the reporting auditor. This letter is cleared with two members of the committee prior to mailing.

Third, upon receipt of the auditor's reply or after a reasonable period of time, the conclusions to the case are drafted, after consideration of all available data. This conclusion letter is sent to the entire committee, with copies of the report and related correspondence with all identifying material deleted.

Finally, after at least six of the nine committee members approve the letter, it is issued to the reporting auditor.

The committee feels that to be educationally effective, it is important to refer to the specific published accounting and auditing standards appearing to have been violated. Lack of information on the part of the reporting auditor seems to be a cause of many of the deficiencies. The conclusions of the committee have greater impact on the auditors when appropriate pronouncements of the profession are indicated. In certain cases, the committee will suggest reading various technical accounting publications.

The committee utilizes certain widely distributed AICPA publications as its guidelines in reviewing the reports submitted. Basically, the committee uses the accounting research bulletins, the opinions of the Accounting Principles Board, the statements on auditing procedure, and, when appropriate, industry audit guides.

If the accepted principles or standards have not been discussed by the Institute's technical committees, but have been firmly established in practice, the committee will express its conclusions regarding the apparent deviation, even though it may not be able to enumerate Institute pronouncements.

The Practice Review Committee does not establish accounting principles or reporting standards, nor does it attempt to resolve the controversial areas of practice. These are the responsibilities of the Accounting Principles Board and the Committee on Auditing Procedure. From time to time, however, the Practice Review Committee refers unresolved problem areas to these two technical committees for their consideration.

Examples of Deviations

The committee's review of a case is somewhat limited because only the audit report and supplemental information furnished by the auditor are examined. Accordingly, its attention is directed primarily to the standards of reporting rather than to the general standards and the standards of field work.

Since its inception, the Committee on Practice Review has processed over 200 reports containing deviations from accepted practice. Many of these reports contain several violations; others, only one. Allow me to summarize these deviations for you according to the standards that have been violated.

The first standard of reporting states: "The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting."

The committee has found approximately 40 violations of this standard. Several reports do not refer to generally accepted accounting principles. Other reports stated that the statements were presented in accordance with GAAP, when in fact they were not. Here are some examples of these deviations:

Assets written up to reflect appraisal values
Writeoff of an intercompany receivable to capital surplus
Including deferred income in stockholders' equity
Lack of provision for such items as a decrease in inventory value, or loss on an investment
Lack of provision for deferred taxes when the circumstances were such as to warrant a provision
Failure to follow accepted accounting for stock dividends

The second standard of reporting states: "The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period."

The committee has encountered over 30 cases where the consistency phrase was omitted or its wording was inappropriate. In several cases the words "applied on a consistent basis" were used in reports encompassing only the current year, when the phrase "applied on a basis consistent with that of the preceding year" would have been appropriate to reflect the comparability of financial statements. Additionally, the committee has processed a number of cases including a change in accounting principles during the period without a consistency qualification. We have also noted financial statements where the prior year's statements had not been restated to reflect a pooling of interest and where a consistency exception was not included in the auditor's opinion.

The third standard of reporting states: "Informative disclosures in financial statements are to be regarded as reasonably adequate unless otherwise stated in the report."

This appears to be the most frequently violated standard. The committee has noted over 100 deviations.

Many reporting auditors felt that immateriality justified the omission of disclosure of certain items. The most frequent violations of the informative disclosure standard turned upon the omission of information regarding the following:

Carrying basis of fixed assets
Carrying value of marketable securities
Basis of valuation of inventories
Changes in capital surplus accounts
Par value and number of shares of capital stock issued and outstanding
Terms of long-term liabilities
Policy of consolidation
Restrictive covenants
Overly condensed statements
Failure to explain a tax provision disproportionate to pre-tax income

The fourth standard of reporting states: "The report shall either contain an expression of an opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an over-all opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking."

Approximately 100 violations of this standard have been encountered. There appear to be an increasing number of reports that have been published in various forms by the client, such as in newspaper advertisements and fund-raising campaign brochures, that have associated the auditor's name with the financial data; frequently his report has been omitted and often the mention of the auditor's name has been without his consent. The committee has stressed to these auditors the importance of reviewing all published reports before their release. In all cases, the auditors have informed the committee that their clients have readily agreed to submit all future releases for clearance before issuance.

The standard short-form report has been accepted by the profession for many years. It provides reasonable uniformity in the manner of expressing an opinion and avoids any misleading inferences by readers. The committee has found, however, numerous reports where the standard short-form report was not used and the alternative wording was not appropriate. For example, in some reports the scope paragraph states that there was an examination of the books and records. Since the opinion relates to the statements, not to the books and records, the committee has pointed out the desirability of referring to the examination of the financial statements in the scope paragraph. I should add that the committee would not process a report solely because of this point.

The committee has reviewed a number of unpublished reports where the auditor has indicated in the footnotes the scope of his examination and his comments on the financial statements. The financial statements and the notes thereto are the representations and responsibility of the management of the company, although the independent auditors may assist in drafting them and may insist on changes if they do not fairly deal with the matters under consideration.

Among the reporting deficiencies found in the expression of an opinion are:

Omission of scope paragraph
Opinion failing to refer to either generally accepted accounting principles or consistency
Qualified opinion not clear about the nature and effect of qualification
Failure to meet the necessary requirements in reporting on unaudited financial statements
Titles of statements mentioned in auditor's report differing from titles used in the financial statements

Two areas of reporting give auditors continuing problems:

- The difficulty of giving meaningful piecemeal opinions following a disclaimer. I have reservations regarding the desirability of disclaimers. I have always felt that the alternatives should be (a) an appropriately worded qualification or (b) an adverse opinion.

- A second problem area relates to negative assurance. The Practice Review Committee has requested the Committee on Auditing Procedure to consider broadening the use of negative assurance reporting to cover merger and purchase situations and possibly other limited areas.

PRACTICE REVIEW COMMITTEES OF THE STATE SOCIETIES

All the state societies are aware of the activity of the Institute's Practice Review Committee, and they have been encouraged to establish programs of their own. Over half the state societies have now initiated some type of program. The scope of their work and their methods of operation vary among states. Many have patterned themselves after the Institute Committee.

In general the state societies deal with the unpublished reports. For various reasons, however, it has been difficult for the committees to obtain these reports. Some practitioners are reluctant to submit reports encountered by them since, without warrant, they feel they are pressing charges against another member, and bankers are fearful that by submitting a report for review they may develop adverse relations between the bank, the client, and the auditor. Banks are also fearful of the legal implications of referring accountants' reports for review.

Some states have adopted a policy of reviewing reports that have been submitted by banks and returning their comments to the bank. The bank may or may not discuss the committee's comments with the auditor. This type of program is of great concern to the Institute's committee, and this concern has been expressed to the Council of the AICPA:

> Under this procedure, the reporting auditor is never in communication with the practice review committee to express his views or to give background information on the items in question, and except by chance he will not receive the review comments of the accountants' committee. The Institute's committee on practice review suggests that this type of program may pose legal liability problems, first, as to accountants' responsibility from the viewpoint of the reporting auditor and, second, as to libel from the standpoint of the society's practice review committee, and further believes that, while the procedure may be educational to specific bankers and to a lesser extent to accountants generally, it is unlikely to be helpful, educationally or otherwise, to the reporting auditor.

Some state societies have gone beyond reviewing the reports alone. Upon request of the reporting auditor and with the approval of the client, members of the committee conduct a post-audit review of the working papers. This type of program undoubtedly has great educational value to the auditor. It brings to his attention new techniques and methods that might be applied for a more efficient and comprehensive examination and is helpful to him in resolving problems. These reviews also give the committee a basis for judging the compliance of the members of the profession with the general standards and the standards of field work.

Any practice review program must be well planned. The Institute strongly urges all state societies, when forming such committees, to discuss the scope, operations, and objectives of the program with legal counsel.

The long-range goal is to develop a co-ordinated program between the Institute and the state societies for mutual co-operation in eliminating, through education, any and all substandard reports.

NEED FOR CONTINUED EFFORT IN DEVELOPMENT OF AUDITING AND REPORTING PRACTICES

We are all much aware of the current criticism of the accounting profession in the financial press by some members of industry, education, government, and even members of the profession itself. Much of the criticism stems from a misunderstanding of what accounting does and what the accountant's responsibilities are, rather than from the principles and practices under which the accountant operates.

In today's climate, our profession's attention is being focused on accounting principles, and rightly so, although I believe that too much emphasis has been placed on uniformity. This can be as undesirable a goal as promoting unsound accounting principles. A uniform treatment may not take into consideration the variable conditions and circumstances that exist in reality in today's business society.

We must take into consideration the type of industry, economic conditions, and management policies that accompany the method employed.

But there is other criticism justifiably placed against the profession because of substandard reporting by a few of our members. It is but a small minority of accountants whose standards of performance are not comparable to the standards of the profession. These few accountants, however, detract from the entire profession, for the reports with which they are associated are receiving a more extensive distribution than ever before.

My experience on the Practice Review Committee leads me to the conclusion that our membership is not giving adequate attention to auditing procedures and reporting practices. These are the areas, to a much greater extent than accounting principles, that are involving accountants in serious problems often resulting in legal action against the auditor.

We should increase our attention to the preparation of financial statements and the auditors' reports. This is our finished product—so to speak. This is the product that is exposed to the public and, accordingly, this is what is used by the public in judging our work.