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Work of the Practice Review Committee

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IT IS a pleasure to be here tonight to talk about a subject of great importance to the accounting profession, and one of great interest to me personally.

Lately there has been considerable criticism of the accounting profession—criticism by some segments of industry, by financial analysts, and by members of the profession itself. Most of these critics have deplored the lack of uniformity in accounting practices and resulting lack of comparability in financial statements; some have assailed financial reports for not disclosing sufficient information. It has also been asserted by some that the accounting profession is not meeting its responsibility to the public.

Actually, the situation is not as bleak as these critics make it sound. There is room for improvement, true, and the profession is aware of this need. Such awareness was evident in the decision to the Accounting Principles Board in 1959, when one of the stated objectives was the "continuing effort to determine appropriate practice and to narrow the areas of difference and inconsistency in practice." Another step that is evidence of the continuing struggle for improvement was the creation in 1962 by the AICPA of its practice review committee "to encourage compliance with generally accepted accounting principles and auditing standards and to eliminate, insofar as possible, substandard reporting practices through education and persuasion rather than by disciplinary action."

THE PROBLEM OF SUBSTANDARD REPORTING

Over the years, business managements and professional accountants have performed well in meeting their responsibilities to investors and to the public. Continuous progress has been made over the past thirty years. This is evident in a comparison of financial reports with those of three decades ago.

Most members of our profession possess a high level of competence, and their work attests to this. Nevertheless, there is a small minority of accountants whose competence and performance are not up to the desired standards—and it is the work of these CPAs that raises the question of substandard reports. Furthermore, departures from acceptable standards are noted from time to time in the reports of all accountants.

Such reports create problems. One problem is the widespread publicity given to some substandard reports; these may be isolated instances, but unfortunately they are the ones that become embedded in the public's mind. Another problem relates to the tendency of other companies to seek the same questionable reporting treatment from their independent auditors. Many of you are probably familiar with the argument: But XYZ Company is doing it this way, why can't we? Those of you who have been exposed to this question probably know how difficult it is to provide the client with a satisfactory answer.

THE PROGRAM OF SELF-DISCIPLINE

The concept of a practice review committee is not revolutionary; rather, it is an evolutionary step in the development of a well-organized program of self-discipline which is vital to the progress of any profession. The AICPA from its inception has acknowledged the need for such a program. The major steps in this self-disciplinary system were the establishment of generally accepted auditing standards, the issuance of statements on accounting principles and the adoption of a code of professional ethics. This was followed by the organization of a consultation service to assist members with difficult technical problems, the establishment of staff training and professional development programs, and, more recently, by the organization of the practice review committee.

A significant development affecting our profession at the present time is the increasing circulation of corporate reports and resultant greater reliance upon accountants' opinions. This is due importantly to the growing number of small private investors, but it is also true that bankers and credit grantors, financial analysts, and members of the business public are placing increasing reliance on audited financial statements.

THE NEED FOR A PROGRAM OF PRACTICE REVIEW

What is the implication of this trend for the accounting profession? It seems to me that we should devote increasing attention to the preparation of financial statements and to our auditor's report. This is the final product of our work—the only product that is being exposed to the public—and accordingly we will be judged by its quality.

Management has the primary responsibility for financial reports, but the CPA has the secondary responsibility for examining the statements and rendering his opinion on the fairness of their presentation. In this he has a great deal of influence on the accounting principles and reporting practices followed by management. In many cases this influence becomes effective when management seeks the auditor's advice on accounting matters. In other cases this influence becomes effective when management adopts a practice recommended by the auditor in order to avoid a qualified report.

The CPA has both the responsibility and the authority for taking any exceptions required in his report. According to the fourth standard of reporting, the auditor's 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."

In numerous cases brought to our attention, however, reports are so worded as to make it difficult, if not impossible, to comprehend clearly the scope of the examination and the responsibility assumed by the independent auditor. In other cases the financial statements seem to deviate from generally accepted accounting principles and yet these statements are accompanied by an unqualified opinion. In still other cases the scope of the examination would appear to require a qualification, disclaimer, or adverse opinion, but the accompanying opinion does not meet such requirements. One of the basic reasons for the creation of the practice review committee was the elimination of such shortcomings in financial reports.

THE SCOPE OF THE PRACTICE REVIEW COMMITTEE

In discussing the operation of the practice review committee I should like to draw your attention to the pamphlet *Practice Review—The Role of the Practice Review Committee,* published by the AICPA in 1963. This booklet gives an excellent description of the part played by the committee in the accounting profession, its methods, and its procedures.

Under the terms of the 1962 resolution creating the Committee on Practice Review, "the duty of this committee 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 views or questions with respect to the report or opinion and the related financial statements."

The committee's function is purely educational, not punitive, in nature. Communication with the accountant whose report is under consideration—to point out the nature of the deviation—is vital to attain the educational objective. In addition, there are numerous cases where additional information supplied by the accountant is of great help to the committee in forming its conclusions.

Confidential handling is an essential element in the review of reports by the practice review committee. The submitting source receives only a reply that the case submitted will be processed. The name of the accountant and his client is known only to members of the Institute staff who work with the committee. All communication with the accountant is handled by members of the Institute staff, who delete all identifying material from the report before it is forwarded to the committee for review. The committee's views are made known only to members of the Institute staff and the accountant concerned. The practice review committee does not refer any cases to the ethics committee. Such confidential procedure, it is hoped, will encourage the submission of reports.

The Institute's committee is concerned mainly with published reports, although it processes whatever reports are submitted to it. Most unpublished reports are submitted by our clients to banks and other credit grantors, but so far it has been difficult to obtain substandard reports from banks, with identification of the auditor concerned. Banks are hesitant to forward such reports to the committee, because of legal problems as well as practical aspects of relations with the customer and with the particular accountant. Another stumbling block is the attitude of many bankers: For their own enlightenment as well as for handling the matter with the accountant, they want to be informed directly of the conclusions reached by the practice review committee. A number of state societies are working on a solution to this problem of receiving substandard reports from bankers.

SOURCES OF INFORMATION

Anyone may submit to the practice review committee a report that appears to contain deviations from accepted standards. Members of our profession, the staff of our professional societies, governmental agencies, and various other organizations in direct contact with financial reports are encouraged to submit reports for review.

Judging from the cases we have reviewed to date, it appears that the major reasons for substandard reporting practices are the lack of information on the part of practitioners and inadvertent errors rather than intentional departure from generally accepted standards. As do all other professions, our profession also has its percentage, though small it may be, of people who do not keep abreast of professional developments. These practitioners are not meeting their responsibility as stated in Chapter 1 of *Statement on Auditing Procedure No. 33:* "The independent auditor also has a responsibility to his profession, the responsibility to comply with the standards accepted by his fellow practitioners."

Each accountant has a duty to his contemporaries that pertains to such matters as ethics, conduct, and furtherance of the profession's affairs. The noncompliance by some CPAs with generally accepted standards stains the entire profession. It is the duty of all of us, therefore, not only to maintain and improve our own level of performance, but also to raise the level of performance of those few who are responsible for substandard reports—and, of course, one way of meeting this duty is to establish practice review committees in all states, and to submit to these committees substandard reports that come to our attention.

METHOD OF OPERATION

Briefly, the practice review committee of the Institute operates as follows once a report is submitted:

> A form letter is sent to the person submitting a report for consideration by the committee, thanking that person for referral of the report. This letter is sent by a member of the Institute's staff, who deletes all identifying material from the report before processing.
>
> If the staff member considers that the report meets acceptable standards, he submits it to the chairman for concurrence. If the chairman agrees, the case is closed.
>
> If the report appears deficient, a letter is sent to the reporting auditor, asking pertinent questions and requesting additional data. This letter is sent after the report has been reviewed and the questions raised have been approved by a member of the committee.
>
> Upon receipt of the auditor's reply, a letter is drafted stating the conclusions of the practice review committee, after considering all data available.
>
> This draft of the final conclusion letter, with copies of the entire report and correspondence, with all identifying material deleted, is sent to the full committee for approval.

Six of the nine members of the practice review committee must approve this letter before it is issued to the reporting auditor.

In the issuance of the final conclusion letter, the practice review committee generally refers to the specific published accounting and auditing standards appearing to have been violated. This is important from the educational viewpoint, and aims at the cause of many deficiences: lack of information on the part of the auditor. By pointing out pertinent pronouncements of the accounting profession, the auditor, we feel, will be influenced to a greater extent by the conclusions of the committee. In some cases the accountant is given a list of technical accounting literature, with the suggestion that it be carefully read.

The basic literature used as guidelines by the committee includes the statements on auditing procedure, the accounting research bulletins, opinions of the Accounting Principles Board, and the generally accepted auditing standards adopted by the AICPA, especially as they are explained in *Statement on Auditing Procedure No. 33.*

The committee also encounters violations of sound accounting principles and practices not covered by specific Institute literature, but which have been firmly established through accepted practice. The committee also expresses its conclusions on such cases, even though it may not be able to recite Institute pronouncements.

For the information of the membership generally, the committee intends to widen its educational mission by publishing a booklet of examples of frequent deviations from accepted standards. Such a publication, of course, would be prepared in such manner as to make identification of the auditor or his client impossible. The staff of the Institute and a subcommittee of the practice review committee are currently engaged in preparing a draft, publication of which is tentatively scheduled for this Fall.

EXAMPLES OF DEVIATIONS FROM ACCEPTED STANDARDS

To date the committee has reviewed 125 reports containing deviations from accepted practice, of which 88 cases have been completed. To indicate to you the types of deviations we have noticed most frequently in the first sixty cases, I have summarized them according to the standards of reporting 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."

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When generally accepted accounting principles are not applied in the presentation of financial statements, the auditor is required to so state in his opinion. We have reviewed eight reports which contained deviations from generally accepted accounting principles, with inappropriate opinions being expressed thereon.

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

Statement on Auditing Procedure No. 33 describes certain phrases to be used in given circumstances to indicate the presence or lack of consistency. Nevertheless, we have processed twelve cases where no consistency phrase was used, or its wording was inappropriate. In addition, we have processed three cases that involved changes in accounting principles, but no consistency qualification was expressed by the auditor.

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

The committee has observed various violations of this reporting standard, the most frequent ones relating to inadequate information regarding the following:

Terms of long-term liabilities

Basis of carrying value of marketable securities

Basis of valuation of inventories

Capital stock—number of shares issued and outstanding, par values, etc.

Mergers and equity in unconsolidated subsidiaries

Change in capital surplus accounts

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."

This, perhaps, is the most important reporting standard. Unfortunately, it is also the one violated most frequently.

The committee has processed seven cases where the standard short-form report was not used and alternative wording was not acceptable; six cases where receivables were not confirmed, or inventory-taking was not observed, and an inappropriate opinion was rendered by the auditor; five cases where the notes to financial statements contained an explanation of the scope of the auditor's examination; four cases where the qualified opinion was not clear concerning the nature and effect of the qualification; five cases where the auditor did not meet the requirements of the long-form report.

In addition to the matters cited above, the committee has noticed a number of published reports that are issued by the client without the auditor's knowledge or authorization. In the cases under review these reports were not published in their complete form. The auditor's report was modified, or the financial statements were modified or omitted entirely, or the auditor's name was associated with such financial statements without his opinion. This points out the importance of discussing with the client the auditor's responsibility regarding financial statements to be published.

The list above is by no means complete, but it serves to indicate the types of deviations that occur frequently.

THE ROLE OF THE STATE SOCIETIES

The Institute has advised all state societies of the scope of its committee and of efforts in various states to improve the quality of reporting at the local level. State societies have been urged to establish practice review committees and to call on the Institute for any assistance that may be required. In particular, coöperation with bankers and other credit grantors is encouraged in order to raise the quality of unpublished reports.

At the present time only about one-half of the state societies have active programs or are in the process of activating programs. The type of program established by the different states varies; some have set-ups similar to that of the Institute; others have coöperated with bankers or bankers' representatives to design a report-review system.

The Institute, in leaving the area of unpublished reports largely to the states, is aware of the difficulty in reaching the authors of such substandard reports. Above I mentioned the legal and economic obstacles to disclosures of financial statements by banks. Other reasons are found in the highly confidential nature of the audit, which sometimes prohibits the auditor from discussing his problems with others; the reluctance of some practitioners to seek assistance; the reluctance of clients to allow a substandard report to be brought to the attention of a professional committee.

To overcome such reluctance requires a broad educational program. We have consultation services and professional development programs, but we must urge wider use of them. Coöperation between management and independent auditors is needed on a full scale, since both have common objectives and joint responsibilities in financial reporting. Business must be made aware of the valuable service performed by the practice review committee in improving financial reports.

In order to overcome reluctance on the part of bankers to disclose the auditor's identity, some state societies have adopted practice review committees that receive reports from a bank and return their comments to the bank. Communication between the bank and the committee is handled by an intermediary representative who deletes all identifying material. The bank, upon receipt of the committee's comments, may or may not discuss them with the auditor concerned. Publication of the cases studied may be made either by the state society or by the bankers' association, or by both of them in coöperation.

The concern of the Institute's committee over such programs was expressed in its 1964 mid-year report to 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.

In the formation of a practice review program, it is important to realize that the emphasis of the Institute's committee is on education. Its primary function is to communicate directly with the auditor concerned rather than have somebody else communicate with him.

I should also like to point out that there are legal problems encountered in any type of practice review program. Regardless of the type of practice review program adopted, I strongly recommend that each state society consult with its legal counsel regarding its proposed plan of operation and the wording of letters to members and others.

While it is the present policy of the Institute's committee to deal mainly with published reports, and to let state societies handle unpublished reports, it is the committee's long-range objective to develop a coördinated program on a national scale for coöperation between the Institute and the state societies to eliminate all substandard reporting, published and unpublished.

CONTRIBUTION OF THE PRACTICE REVIEW COMMITTEE TO THE STATUS OF THE ACCOUNTING PROFESSION

Competence in the performance of all functions is one of the hallmarks of any profession, and as a profession we must strive to attain the highest possible level. I think we would agree that the practice review committee may make a valuable contribution to the accounting profession by raising the level of competence of practitioners.

In recent years the professional accountant and his work have become more conspicuously exposed to the public, especially the business public. With increasing exposure, and resulting criticism, of financial reports, I think it is obvious that an effort of this kind reflects great credit on the accounting profession, since it provides tangible evidence of the profession's continued determination to discipline itself and to encourage compliance with the highest standards.

The importance of competent performance can be seen from the following passage from John L. Carey's book *The CPA Plans for the Future:*

> The future of the accounting profession will be determined not only by the opportunities which confront it, but by the intellectual capacity, knowledge and skills of its members.

Another contribution by the practice review program to the progress of the profession is the referral of problem areas to the Accounting Principles Board or to the committee on auditing procedure. The practice review committee deals only with established reporting standards and accounting principles. It does not try to establish such standards or choose preferred methods if alternatives exist—such questions are referred to the appropriate organizations. To date several problems have been forwarded to the Accounting Principles Board or the Committee on Auditing Procedure. The practice review committee, through its review of substandard reports, is in an ideal position to point out recurring deficiencies in reporting practices.

The well-established status of the practice review committee, despite its relatively recent formation, is evident in the Special Bulletin on Disclosure of Departures from Opinions of Accounting Principles Board, issued last October. Paragraph 9 of that Bulletin reads:

> The failure to disclose a material departure from an Accounting

Principles Board Opinion is deemed to be substandard reporting. The Practice Review Committee should be instructed to give its attention to this area and to specifically report to Council the extent of deviations from these recommendations.

CONCLUSION

In conclusion, let me urge you again to give your support to the practice review program. One of the greatest opportunities for raising the general level of our profession lies in the improvement in the quality of our reports. The practice review committee has assumed the leadership in the campaign against substandard reporting through educational measures, but it can only succeed if it has the support of all members of the profession: support by referral to it of any known examples of substandard reporting; support from all CPAs through their continued reviews of guideline literature issued by the profession; support by demonstrating high standards of performance so that others, perhaps less competent, will be influenced to contribute their part to this campaign. By giving such support you will not only enhance the standing of the profession, but you will also enhance your own standing in your community.