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# **The Road to Reform**

**A White Paper From  
The Public Oversight Board  
On  
Legislation to Create a New Private Sector  
Regulatory Structure for the Accounting Profession**

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## **Introduction**

On January 20, 2002, the Public Oversight Board (POB) – created in 1977 to oversee the voluntary self-regulatory structure for the accounting profession in the United States – voted to terminate its existence not later than March 31, 2002. For the POB, this action was taken as a matter of conscience and principle.

In a report prepared for the Senate Committee on Governmental Affairs in August 1980, the Securities and Exchange Commission (SEC) pointed out that for a self-regulatory program for the accounting profession to be successful, strong leadership from the POB is essential. The POB, wrote the SEC, “should serve as the conscience and critic of the self-regulatory effort.” The POB’s charter makes it clear that it is independent and the purpose of its oversight activities is “to represent the public interest on all matters that may affect public confidence in the integrity, reliability and credibility of the audit process.”

At the time the POB was created, there were concerns that it might not be the right solution. John C. Burton, a distinguished professor of accounting at Columbia University and the chief accountant at the SEC in 1977, warned in congressional testimony in 1978 that “it is highly doubtful that a part-time group [POB] can either in fact or perception” provide an effective substitute for statutory regulation.

Meanwhile, Harold M. Williams, who was chairman of the SEC at the time the current self-regulatory system was being created in the late 1970s, warned in a speech in January 1978, that “[t]he effectiveness and credibility of the Public Oversight Board depends on its independence, including its willingness to be critical when called for and its ability to make public its conclusions, recommendations, and criticisms.” Chairman Williams also made the point that an effective POB could only be effective “if it is not impeded in performing its functions and responsibilities.”

Following its decision to terminate, the POB decided to prepare this paper to outline its proposals to create a new regulatory structure for the accounting profession. These proposals stem from the POB’s extensive experience with the profession’s voluntary self-regulatory system, its knowledge of problems that confront that system, and its insights on the need for change. The primary purpose of this paper is to present the case for legislative action creating an independent regulatory organization in the private sector.

The POB felt it would be helpful to provide a brief history of how the current regulatory structure came into being; to discuss problems affecting the present regulatory structure; to provide the POB’s views on enforcement, discipline, and several other issues facing the profession; and to discuss the POB’s decision to terminate.

## **Executive Summary**

Over the past two years, the POB has faced increasing obstacles that have impeded its ability to carry out its oversight functions. As a consequence, the POB feels it must perform its role as “conscience and critic” because events of recent months have demonstrated that the warnings of Dr. Burton and Chairman Williams have come to pass.

Three events are noteworthy in how the POB has been frustrated in its ability to effectively carry out its responsibilities.

- On May 3, 2000, the SEC Practice Section (SECPS) – an organization within the American Institute of Certified Public Accountants (AICPA) – took the unprecedented step of notifying the POB that it would refuse to pay for special reviews of public accounting firms. The special reviews in question had been sought by the SEC to determine whether the firms had complied with SEC and professional independence standards. The decision of the SECPS to deny funding to the POB was a serious blow to independent oversight of the accounting profession. Melvin Laird, the former congressman and Secretary of Defense, who served on the POB longer than any other member, said that this was “the worst incident in my 17 years” on the POB.
- Following the decision to cut off funding of the POB’s special reviews requested by the SEC, the largest accounting firms – the Big 5 – agreed with the SEC that the POB should instead conduct more limited independence reviews of the large firms. Despite this agreement, the next 21 months were marked by delay and lack of progress. The POB, in the end, was unable to conduct the reviews.
- For years, the POB had carried out its oversight responsibilities under a set of bylaws adopted after it was created in 1977. The POB felt that a formal charter would improve the independence of the Board, and a charter was one of the primary recommendations in 2000 of the Panel on Audit Effectiveness, created by the POB at the request of the SEC. However, objections from the AICPA and the Big 5 caused negotiations to drag on for more than a year. Ultimately, a new charter took effect in February 2001.

When the POB voted to terminate its existence, the lack of progress in connection with the independence reviews and the frustrations that stemmed from the funding cut off and slow negotiations over the new charter all played a role. But the precipitating factor was the decision of the SEC to develop a new regulatory structure in private talks with the AICPA and the Big 5 firms, with no consultation with the POB. The SEC did not consult with the POB even though the POB had been established by the AICPA, in consultation with the SEC, to protect the public interest.

When the POB initially learned of these talks, it asked to be included in the process and was promised that it would be consulted. That consultation never took place. In the end, the POB was simply informed – on the day of the announcement of the proposed new structure – that there was no continued role for the POB in this structure, rendering it a “lame duck.” The POB determined that it could not effectively oversee the activities of the accounting profession

under the circumstances, and that it would mislead the public to appear to do so. Furthermore, the POB was concerned that if it were to continue during an interim period before a new governance structure was in place, it would leave the impression that the POB approved of the SEC proposal, which it did not. Thus, as a matter of principle, it voted to terminate its existence.

The Public Oversight Board strongly believes that a new regulatory structure for the accounting profession is essential and that, to be effective, it must be based on the foundation of federal legislation.

The Board recommends that Congress create a new Independent Institute of Accountancy – the IIA – and center all regulation under its auspices. A seven-member board would run the Institute totally independent of the AICPA, the Big 5, and other firms. The chair and vice chair would be full time employees of the Institute; five other members would serve on a part time basis. All would be appointed by a panel composed of the chair of the SEC, the chair of the Federal Reserve Board and the Secretary of the Treasury. Once named, the chair of the IIA would join these three in naming other members of the board. Members of the IIA board could be removed only by a two-thirds vote of the board itself.

The SEC would have oversight of the IIA, and the SEC's Office of the Chief Accountant would be the liaison to the IIA.

Important functions of the Institute would include:

- The IIA would exercise oversight for all standard setting for accounting, auditing, and independence, and their interpretation. Accounting standards are just as important as auditing and independence standards. For this reason, the POB believes the Financial Accounting Standards Board (FASB) should be brought under the umbrella of the IIA, which would take responsibility for its oversight and funding.
- Firm-on-firm peer review would be discontinued for firms that audit more than 100 public corporations each year. In its place, IIA employees would conduct comprehensive and thorough yearly reviews of the annual internal inspections of such firms. Unlike peer review, no activities of a firm would be off limits to Institute reviewers and the process would produce informative public reports. Substantial staff resources to conduct these reviews will be needed.

In addition to the reviews, IIA employees would conduct special reviews, when warranted. Similar to those the SEC originally asked the POB to undertake, these reviews would take a systemic, in-depth look at a firm's systems, policies, procedures, and operations. If necessary, such special reviews would delve into questions affecting the firm's compliance with applicable professional standards. As with the yearly reviews, reports of these special reviews would be public.

- An Office of Enforcement and Discipline within the IIA would have full authority to investigate allegations of wrongdoing by public accounting firms and their personnel. The POB recommends giving the IIA the privilege of confidentiality as well as the power of subpoena to compel testimony and produce documents. Cases of alleged misconduct could be brought before hearing examiners. When

warranted, these examiners could recommend to the IIA board the imposition of sanctions, ranging from fines to expulsion from the profession. Cases could be referred to the Justice Department for possible prosecution, or to the SEC, state boards of accountancy, or other agencies, as appropriate.

- Funding would be provided through fees imposed on public corporations in amounts sufficient to cover the costs of the Institute. The POB strongly believes that the funding mechanism must be beyond the reach of the profession to prevent it from withholding necessary funds, as it did in May of 2000.
- The IIA would be charged with coordinating international liaison and overseeing continued professional education for those in the profession.

Beyond these functions, the POB recommends that:

- With regard to non-audit services for audit clients, the POB recognizes that there has been disagreement on restricting scope of services and that various models have been suggested for what should be allowed and what should be excluded.

The POB strongly agrees with a point made in President Bush's 10-point reform plan that "Investors should have complete confidence in the independence and integrity of companies' auditors." The specifics on the President's plan recognize the importance of prohibiting certain non-audit services in order to safeguard auditor independence.

The POB takes note of a statement issued by the AICPA on February 1, 2002, in which it affirmed that it "will not oppose federal legislation restricting the scope of services that accountants may provide their public audit clients, specifically in information technology and internal audit design and implementation."

Against this background, the POB proposes that SEC regulations concerning independence be legislatively codified with appropriate revisions to update restrictions on scope of services involving information technology and internal audit services as noted above. At the same time, the POB believes such legislation should affirm that tax work not involving advocacy and attest work by audit firms in connection with SEC registration and other SEC filings be allowed. The POB also believes that small public businesses, to be defined by the SEC, should not be subject to any restriction on non-audit services for audit clients. Further, with respect to non-public corporations, it is the POB's position that such corporations and the accounting firms that audit them should not be subject to any restriction on non-audit services. We expressly emphasize this to avoid misunderstanding and any consequences to small business and small audit firms.

The IIA Office of Standards should be empowered by legislation to promulgate appropriate rules affecting independence to cover changing circumstances.

The POB believes there should be no prohibition against an audit firm offering non-audit services to non-audit clients.

- Auditors should be rotated every seven years. As a corollary, public corporations would be prohibited from firing auditors during their term of service unless such action is determined by the audit committee to be in the best interest of shareholders, with prompt notice to the IIA and the SEC. Such action would be required to be publicly disclosed by corporations in current reports and proxy statements filed with the SEC.
- Engagement and other partners who are associated with an audit should be prohibited from taking employment with the affected firm until a two-year “cooling off” period has expired.
- The Institute should expand on the recommendations of the recent Blue Ribbon Committee which made it clear that the external auditor should be accountable to a firm’s board of directors and its audit committee and not to management. Specifically, the audit committee should take full responsibility for hiring, evaluating, and – if necessary – terminating an audit firm.
- To discourage conflicts of interest involving public corporations, Congress should amend the Securities Exchange Act of 1934 to require more meaningful and timely disclosure of related party transactions among officers, directors, or other affiliated persons and the public corporation. Such disclosures should be made promptly in current reports as well as in proxy statements filed with the SEC.
- Management of public corporations should be required to prepare an annual statement of compliance with internal controls to be filed with the SEC. The corporation’s chief financial officer and chief executive officer should sign this attestation and the auditor should review it. An auditor’s review and report on the effectiveness of internal controls would – as the General Accounting Office (GAO) found in a 1996 report – improve “the auditor’s ability to provide more relevant and timely assurances on the quality of data beyond that contained in traditional financial statements and disclosures.” Both the POB and the AICPA supported the recommendation when the GAO made it, but the SEC did not adopt it.

## **A Brief History of Self-Regulation**

### **The Stock Market Crash of 1929 and Its Aftermath**

The 1929 crash revealed a general absence of accounting and auditing standards, thereby permitting public companies to report financial position and results of operations that sometimes bore little relation to economic reality. The crash and ensuing depression led to congressional hearings, which in turn led to several pieces of reform legislation, beginning with the Securities Act of 1933 and the Securities Exchange Act of 1934. The Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, and the Investment Company Act and Investment Advisers Act of 1940 followed. These acts require, or permit the SEC to require, as the SEC summarized in 1994, “that financial statements filed with the Commission by public companies, investment companies, broker/dealers, public utilities, investment advisors, and others, be certified (or audited) by independent accountants.”

Although audits of public corporations were common before the federal securities acts of 1933 and 1934, they had not been required by statute. Beginning in April 1932, the New York Stock Exchange (NYSE) requested corporations applying for listing to agree to have their annual financial statements audited by independent accountants.

The 1929 market crash revealed improper accounting practices at large public companies that had become bankrupt. In 1939, the AICPA’s Committee on Accounting Procedure issued the first Accounting Research Bulletin and the AICPA’s Committee on Auditing Procedure issued the first Statement on Auditing Procedure. At present, accounting standards are issued by FASB, auditing standards are issued by the AICPA’s Auditing Standards Board (ASB), and interpretations of the Code of Professional Conduct are issued by the AICPA’s Professional Ethics Executive Committee – all of which are private sector bodies.

### **The 1970s – Expansion of the Regulatory Structure**

The major reforms of the 1930s and the regulatory system they created survived for more than 40 years with only minor modifications. That the regulation of the accounting profession remained unchanged for so long may be attributed in part to the relatively few allegations of audit failures during most of that period, at least in comparison with later years.

To this day, the responsibility for promulgating auditing and ethical standards resides within the AICPA. The AICPA also was responsible for promulgating accounting standards until mid-1973 through its Committee on Accounting Procedure and its successor body, the Accounting Principles Board. Both of those committees were comprised principally of practicing auditors, often those who were responsible for their firms’ accounting policies. In 1973, responsibility for promulgating accounting standards passed to FASB in the belief that the setting of accounting standards by an independent body with no ties to either auditors or preparers of financial statements would enhance the public’s confidence in the financial reporting process. At the same time, the Financial Accounting Foundation was created to raise funds for FASB, among other tasks, and a Financial Accounting Standards Advisory Council was created to advise FASB on its agenda and deliberations. That structure remains largely unchanged today.

A series of cases involving alleged audit failures in the 1970s led the AICPA to create the Commission on Auditors' Responsibilities, chaired by Manuel F. Cohen, a former chairman of the SEC. Those cases involved fraudulent financial reporting and illegal or questionable corporate acts, such as bribes, political payoffs, and kickbacks. The Cohen Commission's *Report, Conclusions, and Recommendations* issued in 1978 made numerous recommendations to improve audit practice in several areas. Those recommendations led to the promulgation of Statements on Auditing Standards (SAS) that increased the auditor's responsibility to detect and report fraudulent financial reporting and illegal acts by corporate management. Several other auditing standards can be traced either to Cohen Commission recommendations or to specific audit failures and the litigation that they spawned.

The same cases that spawned the Cohen Commission also led to hearings by both the Senate and House of Representatives in 1977 and 1978. In particular, the Senate's Subcommittee on Reports, Accounting, and Management of the Committee on Government Operations (the Metcalf subcommittee) held hearings to determine whether additional governmental regulation of the accounting profession was necessary or a system of professional self-regulation was sufficient.

In response to these hearings, the AICPA, in consultation with the SEC, created a voluntary self-regulatory framework consisting of the SEC Practice Section (SECPS) of the Division for CPA Firms, with an independent POB to oversee the activities of the Practice Section and to monitor and comment on matters that affect the public interest in the integrity of the audit process – a structure that exists to this day. While no additional governmental regulation was imposed once the voluntary self-regulatory system was created in the 1970s, Congress did pass the Foreign Corrupt Practices Act (FCPA) in 1977, following Senate hearings which revealed the payment of bribes by American corporations to foreign officials. The FCPA made it clear that bribery of foreign officials by American companies is an unacceptable and illegal practice. The act required SEC registrants to maintain a system of internal accounting controls to provide reasonable assurance that certain objectives would be achieved. For example, transactions must be executed consistent with management authorization and be recorded to permit preparation of financial statements in conformity with generally accepted accounting principles and to maintain accountability for assets. In addition, the FCPA required public corporations to make and keep books and records which, in reasonable detail, accurately and fairly reflect underlying transactions.

### **The 1980s and 1990s – Congressional Hearings and Legislation**

As noted in a September 1996 report of the GAO, *The Accounting Profession – Major Issues: Progress and Concerns*, “In the 1980s, continued business failures, particularly those involving financial institutions, led to a series of congressional hearings on auditing and financial reporting under the federal securities laws.” Two major pieces of legislation resulted from those hearings: the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) and the Private Securities Litigation Reform Act of 1995. While those laws increased responsibilities for auditors, they did not address the regulatory structure of the accounting profession.

FDICIA added Section 36 to the Federal Deposit Insurance Act to provide early identification of needed improvement in financial management at banks and savings and loan

institutions. Management's responsibilities under regulations implementing Section 36, which apply to institutions with total assets of \$500 million or more, include reporting on management's responsibility for and assessment of the effectiveness of the institution's internal controls over financial reporting. Each institution is required to have an audit committee composed of outside directors independent of management. Audit committees of institutions with \$3 billion or more in assets must include members with relevant banking or financial expertise, have access to their own outside counsel, and exclude large customers. Under Section 36, the independent accountant must examine and report on management's assertions about the institution's internal controls over financial reporting, using the AICPA attestation standards. This requirement constitutes one of the few statutory or regulatory requirements that independent auditors report publicly on client internal controls.

The Private Securities Litigation Reform Act of 1995 addressed the concerns of Congress and regulators about auditors' responsibilities with respect to their clients' compliance with laws and regulations and about how instances of noncompliance were reported. Those concerns led to inclusion in the act of a requirement that auditors of public companies notify the SEC of material illegal acts when an entity's management and board of directors have failed to take timely and appropriate remedial action.

The 1996 GAO report, which was commissioned by Rep. John Dingell (D-Mich.), the ranking minority member of the House Committee on Energy and Commerce, identified five major issues discussed in the various studies concerning the accounting profession from 1972 through 1995: (1) auditor independence, (2) auditor responsibilities for fraud and internal controls, (3) audit quality, (4) the accounting and auditing standard-setting processes and the effectiveness of financial reporting, and (5) the role of the auditor in the further enhancement of financial reporting.

The report summarized the results of these reviews as follows:

GAO's analysis of the actions taken by the accounting profession in response to the major issues raised by the many studies from 1972 through 1995 shows that the profession has been responsive in making changes to improve financial reporting and auditing of public companies. Further, GAO's analysis of statistical data on the results of peer reviews of accounting firms that audit public companies registered with the SEC shows that most firms now have effective quality control programs to ensure adherence with professional standards. However, GAO's review of the studies' findings shows that the actions of the accounting profession have not been totally effective in resolving several major issues. Issues remain about auditor independence, auditor responsibility for detecting fraud and reporting on internal controls, public participation in standard setting, the timeliness and relevancy of accounting standards, and maintaining the independence of FASB.

While the profession and the SEC subsequently have addressed several of the issues that the GAO review identified as being unresolved in 1996, a number of them, such as reporting on internal controls, remain unresolved in 2002.

### **Changes in the Practice and Culture of Accounting Firms**

The business model that describes the practice of the large accounting firms – a wide array of financial services performed both domestically and internationally for both audit clients and others – has existed for many years.

Each of the large public accounting firms provide accounting and auditing services, tax services, and management consulting services, and the largest firms provide those services globally through overseas offices and foreign affiliates. These characteristics have existed for decades. As the Cohen Commission noted in 1978:

Before independent audits became widespread in the United States, public accountants were already performing a variety of other services. Public accountants in the early 1900s offered advice on accounting systems, kept accounting records, prepared financial statements and tax returns, and performed a variety of consulting services, including appraisals.

The Cohen Commission also noted that “large corporations typically operate at a number of different locations. A public accounting firm must provide services at many places throughout the country and the world.” The Panel on Audit Effectiveness, citing SEC data, noted in its 2000 report that:

the number of foreign companies that have registered securities in the United States has almost tripled since 1990. . . . 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.

While multi-faceted practices of the international accounting firms described above have existed for many years, the extent to which non-audit services are provided to audit clients and the globalization of the profession have changed over the years. Superimposed on the growth of non-audit services and globalization is the high level of competition among the firms for audit clients in recent years that many believe has changed the culture of auditing practice.

Certain non-audit services provided to audit clients – particularly the design and implementation of large integrated information systems and internal audit and valuation services – have long raised concerns about both the fact and the appearance of auditor independence, and thus about the quality of audits. The size of the fees from those services in many cases and their relationship to the amount of audit fees from the same client has added to those concerns. Similar concerns about audit quality are a natural result of a firm’s international practice in

countries that do not have the same level of accounting, auditing, and quality control standards as the United States. Lastly, some fear that excessive competition for audit clients has driven audit fees down to a level that cannot support a quality audit but that serves primarily to provide the firm with “a foot in the door” for marketing other services.

Some have suggested that an increasing appetite for growth and profits is now driving the “culture” and “tone” of most accounting firms. Accounting firms sometimes seem to view their clients – even their audit clients – as “business partners.” There are also those who contend that audits are sometimes used as “loss leaders” to build a relationship with a client for the marketing of the accounting firm’s non-audit services.

One can question whether, together with the natural reluctance to lose the audit fee, a diminished professionalism makes it more difficult for a firm to reject a client’s proposed accounting treatment. There seems to be little doubt that the forces described in this section as presenting challenges to audit quality were present in several of the widely publicized recent business and audit failures. And that, in turn, suggests the need for additional regulation of the profession and a degree of oversight that significantly exceeds what exists at present.

### **The SEC’s 1998 and 2000 Initiatives**

In a September 1998 speech at the New York University (NYU) Center for Law and Business, SEC Chairman Arthur Levitt noted that “qualified, committed, independent and tough-minded audit committees represent the most reliable guardians of the public interest.” He announced that the NYSE and the National Association of Securities Dealers had agreed to sponsor a “blue-ribbon” panel to develop recommendations “to empower audit committees and function as the ultimate guardian of investor interests and corporate accountability.” The committee’s report was issued in February 1999.

The SEC responded with new disclosure rules in December 1999. Among them is the requirement that a report by the audit committee be included in the company’s proxy statement, indicating whether the audit committee has, among other things:

- reviewed and discussed the audited financial statements with management;
- discussed with the independent auditors the matters required to be discussed by auditing standards (which includes the quality of the accounting principles and underlying estimates reflected in the financial statements); and
- discussed with the auditors their independence.

In addition, the SEC adopted a rule requiring that independent accountants review a company’s interim financial information before the company’s quarterly report is filed.

The major stock exchanges also responded to the committee’s recommendations by enacting rules covering the independence, qualifications, and composition of audit committees, including a requirement that committee members be financially literate. The exchanges further required that the audit committee adopt a formal written charter approved by the board of directors; the exchanges also specified that the charter should contain minimum audit committee responsibilities.

Also in 1999, the Independence Standards Board (ISB) adopted Independence Standard No. 1, *Independence Discussions with Audit Committees*. The standard requires that, at least annually, an auditor intending to be considered an independent accountant with respect to a specific entity under the federal securities acts shall:

- a. disclose to the audit committee of the company (or the board of directors if there is no audit committee), in writing, all relationships between the auditor and its related entities and the company and its related entities that in the auditor's professional judgment may reasonably be thought to bear on independence;
- b. confirm in the letter that, in its professional judgment, it is independent of the company within the meaning of the Acts; and
- c. discuss the auditor's independence with the audit committee.

In his 1998 NYU remarks, Chairman Levitt also proposed that “the Public Oversight Board form a group of all the major constituencies to review the way audits are performed and assess the impact of recent trends on the public interest.” In response, the POB formed the Panel on Audit Effectiveness. Its report and recommendations, issued in August 2000, are discussed below.

In November 2000, the SEC adopted amendments to its auditor independence rules. These amendments to the independence requirements placed limits on certain services, particularly information technology and internal audit services, that accounting firms may provide to their audit clients without impairing their independence. In those two areas in particular, the final independence rule was not as restrictive as the rule originally proposed – it did not completely prohibit auditors from providing them to their audit clients. In early 2002, in apparent response to concerns emanating from the Enron collapse, the five largest accounting firms announced their intent to no longer provide any internal audit or certain information technology services to their audit clients.

The release containing the SEC’s revised independence rules noted the risk of compromised independence when a former partner, principal, stockholder, or professional employee of an accounting firm is hired by an audit client of the firm. Accordingly, under the Commission’s final rule, as under the then existing requirements, an auditor’s independence is impaired when such an individual is employed in an accounting or financial oversight role at an audit client, unless certain conditions are met. Both the SEC and the ISB considered the notion of a mandatory “cooling off” period before accounting firm personnel join an audit client. Neither body adopted it because of concerns it would unnecessarily restrict the employment opportunities of former firm professionals.

### **The POB’s Role in the Voluntary Regulatory Structure**

As previously noted, the POB is a private sector body – independent of the accounting firms, the AICPA, and the SEC – that was created in 1977 by the AICPA in consultation with the SEC for the purpose of overseeing and reporting on the self-regulatory programs of the SECPS.

In addition to its ongoing monitoring and oversight responsibilities, the POB has undertaken or commissioned special studies and reviews over the years. The reports emanating from them have had a significant effect on regulation of the accounting profession and the quality of audits. The following are examples of these reports:

- *In the Public Interest: Issues Confronting the Accounting Profession*, which contained recommendations designed to enhance the usefulness and reliability of financial statements, strengthen the performance and professionalism of auditors, and improve self-regulation (1993).
- *Strengthening the Professionalism of the Independent Auditor*, which contained recommendations in the areas of auditor independence, involvement of audit committees and boards of directors with independent auditors, litigation reform, and the relationships among the accounting profession, standard-setting bodies, and the SEC (1994).
- Report and Recommendations of the Panel on Audit Effectiveness, which is discussed below (2000).

In addition to its ongoing oversight of the peer review and quality control inquiry processes, the POB's principal activities in 2001 and 2002 centered around monitoring the implementation of the recommendations of the Panel on Audit Effectiveness, overseeing the ASB, and preparing for the reviews of the firms' systems, procedures, and internal controls relating to independence, as discussed below. Over the past year, the POB has made significant additions to its full-time and part-time staff to carry out expanded oversight and monitoring responsibilities called for in the new charter.

The POB's charter affirms that it is independent and specifies that the purpose of the POB's oversight activities is, as noted above, "to represent the public interest on all matters that may affect public confidence in the integrity, reliability and credibility of the audit process." The public interest is represented by the quality, breadth, integrity, and stature of the members of the POB, which the Board believes should serve as a model for the future membership of any successor oversight body. The POB's first chairman was John J. McCloy, former high commissioner for Germany who also served his country in many other capacities over a long and distinguished career. He was followed by Arthur Wood, former CEO and chairman of Sears, Roebuck & Co., and then by another distinguished public servant, A. A. Sommer, a former SEC commissioner and securities lawyer. Other former board members included Melvin R. Laird, former member of Congress and Secretary of Defense, who served on the POB for 17 years, and Paul H. O'Neill, who resigned from the board to become Secretary of the Treasury. The current Board consists of Charles A. Bowsher, former Comptroller General of the United States, who was appointed to the Board in 1999 to serve as its chairman; Norman R. Augustine, former chairman and CEO of Lockheed Martin; Aulana L. Peters, former SEC commissioner; and John H. Biggs, chairman and CEO of TIAA-CREF. Donald J. Kirk, former chairman of FASB, resigned as vice chairman on January 18, 2002.

## **The Panel on Audit Effectiveness**

As previously indicated, in October 1998, at the request of SEC Chairman Arthur Levitt, the POB appointed the Panel on Audit Effectiveness to examine the way independent audits are performed and to assess the effects of recent trends in auditing on the public interest. The panel issued its report and recommendations on August 31, 2000. Its recommendations were addressed to many constituencies – standard setters, accounting firms, the SECPS, audit committees, the SEC, and others – and covered a wide range of matters, including:

- 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.

The panel’s report received widespread endorsement. SEC Chairman Levitt, for example, stated that “[i]mplementation of the specific recommendations made by the [p]anel to improve the audit process through more comprehensive and vigorous audit methodologies and standards will engender greater confidence among investors that they are receiving high-quality audits.” He also commended the members of the panel “for their proposals to improve the self-regulatory framework of the profession.” POB Chairman Bowsheer predicted that the report would play an important part in setting a future course for the accounting profession.

No conclusions can yet be drawn about the extent to which the actions taken to date to implement the panel’s recommendations have enhanced audit effectiveness. The panel’s report was published less than two years ago, and the process of responding to the panel’s recommendations is incomplete.

## **Experience With Self-Regulation**

The POB experience with self-regulation of the accounting profession has varied throughout the period of its existence. For years, the profession and the AICPA were responsive to the POB and the need to improve audits to enhance investor confidence in financial statements of public corporations.

The environment changed in recent years as accounting firms expanded greatly the scope of their services which, in turn, led to a re-examination of the concept of independence by the SEC. During the late 1990's, the relationship between the accounting profession and the SEC became very strained, with division among the Big 5 on whether to support or oppose the SEC.

During the same period, the relationship between the accounting profession and the POB also became strained over the adoption of a charter for the POB, particularly with respect to the section in the charter dealing with funding. In effect, the proposed POB charter became hostage to the dispute among the accounting profession and the SEC over resolution of proposed revisions to the independence requirements and rules. But, even during this period, several of the Big 5 supported the POB.

The relationship between the accounting profession and the POB was further strained when the POB, at the SEC's request, attempted to conduct reviews of the Big 5 firms' policies, procedures and internal controls related to independence. The SEC and the firms had agreed to these reviews, and requested the POB to conduct such reviews and issue written reports on them. Some of the firms, unfortunately, adopted an approach that resulted in delay and a lack of progress. This did not permit the POB to conduct the reviews.

In the final analysis, the experience with voluntary self-regulation has been mixed in recent years. The AICPA and several of the Big 5 firms, in the view of some, saw the POB's role as one of a "shield" for the profession rather than as an independent overseer.

Mr. Levitt, the former SEC chairman, also described this problem in testimony before the Senate Banking Committee in February 2002. "More than three decades ago," he said, "Leonard Spacek, a visionary accounting industry leader, stated that the profession couldn't 'survive as a group, obtaining the confidence of the public...unless as a profession we have a workable plan of self-regulation.' Yet, all along the profession has resisted meaningful oversight."

## **Problems with Current System of Self-Regulation**

The current system of self-regulation of the accounting profession has significant problems.

First, the funding of the POB is subject to control by the firms through the SECPS, which in the past has cut off that funding in an effort to restrict POB activities.

Second, the disciplinary system is not timely or effective. Disciplinary proceedings are deferred while litigation or regulatory proceedings are in process. This results in years of delay and sanctions have not been meaningful. The Professional Ethics Division of the AICPA, which handles disciplinary matters against individuals, does not have adequate public representation on its Board. Investigations by the Quality Control Inquiry Committee of the SECPS, which handles allegations of improprieties in litigation against member firms arising out of audits of SEC clients, do not normally include access to firm personnel and work papers. The disciplinary system does not include the power to issue subpoenas or compel testimony. Thus, investigators must rely on the cooperation of the individual being investigated. The QCIC has no access to the complaining party or the client involved. Furthermore, there is no privilege or confidentiality protection for investigations or disciplinary proceedings, and disciplinary actions are often not made public.

Another problem is that monitoring of firms' accounting and auditing practices by the peer review process has come to be viewed as ineffective, as either a diagnostic or remedial tool. More important, the process has lost credibility because it is perceived as being "clubby" and not sufficiently rigorous. Finally, the peer review team does not examine the work of an audit that is under investigation or in litigation.

Other problems include the fact that the current governance structure does not have the weight of a congressional mandate behind it. There is also a perceived lack of candid and timely public reporting of why and how highly publicized audit failures and fraud occurred and what actions have or will be taken to ensure that such problems do not recur.

### **Auditing Standards and Termination of the ISB**

The Auditing Standards Board (ASB) was not subject to oversight by an independent entity until it was put under the oversight of the POB in February 2001. In contrast, under the SEC's proposed governance structure for the accounting profession announced in January by SEC Chairman Harvey Pitt, there will be no oversight of the ASB other than by the profession's trade association, the AICPA. Most of the members of the ASB are associated with the eight largest public accounting firms.

The auditing standards promulgated by the ASB have not provided sufficiently specific and definitive guidance, a weakness noted in the Panel on Audit Effectiveness Report and Recommendations issued on August 31, 2000.

During a speech in January 1978, then-SEC Chairman Harold Williams stated, "The issue of independence is the key one" for the accounting profession. The Independence Standards Board (ISB), which was established in 1997, was terminated in July 2001 because both the

AICPA and SEC, for different reasons, did not agree with what the ISB had done. The ISB was established to create, codify, and interpret independence standards for auditors of public companies. Its termination has left a significant void.

### **The Public Oversight Board Charter**

For more than two decades, the POB operated under a set of bylaws, but without the benefit of a charter. Creation of a charter to provide expanded and greater assurances of POB independence became a priority of the Board in December 1999, and was one of the key recommendations of the Panel on Audit Effectiveness, which issued its draft report in May of 2000 and its final report in August of the same year. Yet it took over a year – from December 1999 to February 2001 – to negotiate a new charter.

The primary reason for this delay was the resistance of the AICPA and the large firms to various points. For example, the AICPA and accounting profession, contrary to the recommendation of the Panel on Audit Effectiveness, wanted limitations on POB funding. In addition, for many months they opposed giving the POB authority to approve nominations for the chairs of the SECPS executive committee and the ASB, even though they acknowledged that in the past, the POB, in effect, had approved those nominations informally.

In the end, the POB adopted a pragmatic attitude in order to further the public interest. A charter was approved which gave the POB expanded oversight and an enlarged budget and staff. It took effect in February 2001.

The recommendations of the Panel on Audit Effectiveness, including a formal charter for the POB, were designed to improve the existing voluntary self-regulatory system, not to create a new regulatory structure for the profession. At the time of the panel's recommendations in August 2000, neither the POB nor members of the panel thought it was likely that Congress would approve a statutory regulatory organization to govern the profession.

### **Independence Reviews**

In a letter to the POB dated December 9, 1999, then SEC Chief Accountant Lynn Turner expressed concern that public accounting firms possibly lacked adequate quality controls for independence. As a step to “safeguard the public interest,” he “strongly recommend[ed]” that the POB undertake “a special review of SECPS member firms’ current compliance” with independence requirements. On December 21, 1999, the POB agreed to do so. Two weeks later, on January 6, 2000, the SEC announced that an internal investigation at PricewaterhouseCoopers LLP (PwC) had disclosed more than 8,000 independence violations there. At this time, there were publicly expressed concerns that the widespread independence violations at PwC might also be found at other large accounting firms if they were subject to a similar compliance review. Against this background, the POB commenced preliminary work on the special reviews in January 2000, and had meetings with the firms to discuss the reviews.

Then, in early May 2000, the POB’s work on the special reviews was stopped by a decision of the SECPS to cut off funding for them. Mr. Levitt, the Chairman of the SEC, stated that this was “a significant setback to self-regulation and independent oversight” and raised “serious questions as to the profession’s commitment to self-regulation.” Melvin Laird, former

Congressman and Secretary of Defense and the longest-serving member of the POB, said that this was “the worst incident in my 17 years” on the POB.

The special reviews did not go forward, but shortly afterward, in June 2000, the SEC and the Big 5 firms entered into a “Term Sheet for Independence Look-Back Testing Program” (term sheet), which called for the POB to conduct more limited independence reviews.

Subsequently, on October 10, 2000, the POB received a letter from Mr. Turner asking that the POB do the independence reviews called for by the term sheet “in lieu of” the special reviews previously requested in his December 1999 letter to the POB. The POB agreed to do so, and commenced preliminary work on these reviews in November 2000. Between then and January 2002, a period of more than a year, the POB did a substantial amount of work preparing to conduct the independence reviews. This work included a request for documents sent to the firms and the SEC staff in July 2001 as well as comprehensive work programs for both phase I (evaluation of design and implementation effectiveness) and phase II (testing and evaluation of operating effectiveness) of the reviews, sent to the firms and SEC staff in October 2001 and January 2002, respectively. In addition, the POB was involved in working with the firms on a confidentiality agreement for the independence reviews. The POB’s efforts to enter into a confidentiality agreement with the firms, going back to July 2001, met with no success. In addition, by the middle of January 2002, the POB still had not been able to obtain from the firms documents it had requested for the independence reviews in July 2001. This lack of progress in conducting the independence reviews was one of the factors that led to the POB voting to terminate its existence.

In a letter to the SEC and the firms dated March 5, 2002, the POB set forth its position on the transfer of its responsibility for conducting the independence reviews to an independent person and discussed the background of the independence reviews. This letter can be found on the POB’s web site at [www.publicoversightboard.org](http://www.publicoversightboard.org).

### **The POB Decision to Terminate**

As noted above, although the POB commenced preliminary work on the independence reviews in November 2000, by January 2002, it still had not been able to obtain information and documents it had requested from the firms in July 2001. The POB was concerned that the lack of progress on the independence reviews would continue. This lack of progress was one of the considerations that caused the POB to vote its intention to terminate its existence no later than March 31, 2002.

However, the precipitating factor in the POB’s decision to terminate was the announcement of a proposed new self-regulatory structure by SEC Chairman Pitt. The POB was not consulted on this new proposed governance structure for the accounting profession, announced by Mr. Pitt at a press conference on January 17, 2002, even though the POB had requested and been assured that it would have the opportunity to provide input as the proposals were being developed and prior to any public announcement. Instead, without including the POB in the process, the SEC worked privately with representatives of the AICPA and the Big 5 firms and developed the new SEC proposal. Thus, the private sector entity which was charged with oversight of the profession’s self-regulatory activities and with representing the public

interest had no input into what may well be the most significant change in regulating the accounting profession in the last 30 years.

A January 23, 2002 article in *The Wall Street Journal* reported that a spokesman for PwC confirmed that chief executives of the Big 5 firms, including PwC, had held a series of private meetings with the SEC chairman in Washington between December 4, 2001, and January 17, 2002, on this matter, and that the gatherings “took place at Mr. Pitt’s invitation.”

On the same day that one of these meetings was being held, December 4, 2001, Charles Bowsher, Chairman of the POB, had a discussion with Barry Melancon, President and CEO of the AICPA, at the John J. McCloy dinner hosted by the POB. During this discussion, which also included James Castellano, Chairman of the AICPA, Mr. Melancon told Mr. Bowsher that the profession and the SEC were working on proposed changes to the governance structure of the accounting profession. Mr. Bowsher specifically asked that the POB be included in any such discussions so that it would be able to provide input before any public announcement of a proposed new structure. Mr. Melancon assured Mr. Bowsher that this would be done.

At a meeting of the SECPS executive committee on January 4, 2002, Mr. Bowsher, Aulana Peters, a POB member, and Jerry Sullivan, the POB Executive Director, were told that a proposed governance structure for the profession would be announced within a month. Messrs. Bowsher and Sullivan and Ms. Peters asked that the POB be “brought in the loop” and be given an opportunity to participate. They were told the POB would be consulted.

The SEC did not seek input from the POB on the new regulatory structure. While Chairman Pitt had left a voice message for Mr. Bowsher on January 10, 2002, and Mr. Bowsher had called back twice, in the end Mr. Bowsher did not receive a return call and the two men did not speak before the press conference.

On January 17, 2002, Mr. Bowsher received a call from Mr. Melancon and Robert Kueppers, Chairman of the SECPS executive committee, a few hours before Mr. Pitt announced the new SEC proposal at a press conference. In this call, Mr. Bowsher asked specifically if there would be a place for the POB in the new structure. Mr. Melancon replied that there was no place for the POB in the new regulatory structure to be announced by Mr. Pitt and that the POB would be a redundancy. Subsequently, the POB was advised by the Chairman of the SECPS that the SECPS working group had provided the SEC with an outline of a proposal a week before the January 17, 2002 press conference.

The POB believes that one of its primary functions is to facilitate communication. The Panel on Audit Effectiveness found that “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.” The panel recommended that the SEC should “[s]upport 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.”

During Chairman Pitt's press conference on January 17, he was specifically asked whether there would be a role for the POB in the new SEC proposal. He did not answer the question.

John Coffee, the distinguished Columbia Law School professor who has written extensively about securities regulation, faulted the SEC chair for the way in which the new regulatory structure was created. Professor Coffee said that "It's not the high watermark of public accountability when the industry to be regulated designs its own regulatory structure in negotiations with its former lawyer."

The foregoing was the context in which the POB voted unanimously on January 20, 2002, its intention to terminate its existence pursuant to Section IX of the POB's charter no later than March 31, 2002. The reason for this action was that the new SEC proposal had been worked out by the SEC, in collaboration with the AICPA, SECPS executive committee and representatives of the Big 5 firms, without any consultation with the POB, which is charged with representing the public interest. The new proposal rendered the POB a "lame duck". In making its decision, the POB was also cognizant of the experience of negotiating its new charter, the fact that the SECPS had cut off funds for the special reviews, and that there had not been progress in connection with the reviews to which they had agreed. The POB believed it could not effectively oversee the activities of the accounting profession under the circumstances and that it would mislead the public to appear to do so. Furthermore, if the POB were to continue during an interim period before a new governance structure were in place, it believed it would leave the impression that it approved of the Pitt proposal. As the "conscience and critic" of the profession, the POB felt it had no choice but to terminate its existence to protect the public interest. What the POB did was akin to what an auditor does when it believes it must resign from a client engagement because of a fundamental disagreement.

## **The POB Proposal for Reform**

The Public Oversight Board is mindful that there are many suitable models that could be adopted as part of a reform program for regulation of the accounting profession. Congress will undoubtedly consider many of the available options in coming weeks as decisions are made on regulatory changes in the aftermath of the Enron debacle. Whatever the details of reform, the POB strongly believes that a legislative foundation for any future regulatory structure is crucial.

Because it has had oversight responsibility for a good portion of the voluntary self-regulatory structure of the accounting profession for the past 25 years, the POB has first-hand knowledge of the strengths and weaknesses of the existing system and, thus, a unique perspective on regulatory reform. The POB considered a number of options for reform based on the present system, but ultimately came to the conclusion that a complete overhaul is essential. The Board believes that the existing system has become ineffective.

Dating back to the 1970s, when bribery of foreign officials by American corporations was first uncovered, followed by the audit failures associated with the bankruptcy of the Penn Central railroad – the Enron failure of its day – reforms have been largely incremental and piecemeal. The creation of the POB and other early reforms grew out of hearings in the House and Senate that followed the Penn Central bankruptcy and the “sensitive payments” scandal. While the POB believes that many of these early reforms served a useful purpose and strengthened the profession, it is also clear that in recent years, regulatory oversight and attempts at further reforms have been met with resistance or outright rejection by the profession. As noted earlier in this paper, the profession over the past two years has acted to preserve the status quo and has resisted major reform efforts.

Faced with this opposition, the Public Oversight Board believes the time for legislative action has come. The current system needs to be replaced. To accomplish this, the POB believes it is essential that all critical elements of regulation – including all standard setting, inspections and reviews of accounting firms, enforcement and discipline, and other functions – be placed under the aegis of a single regulator operating under statutory authority. This new entity – an Independent Institute of Accountancy (IIA) – would employ a professional staff of individuals unaffiliated with the profession or any of the Big 5 accounting firms and would be run by a seven-member Board, which itself would be totally independent of the profession.

The SEC would have oversight of the IIA, and the SEC’s Office of the Chief Accountant would be the liaison to the IIA. A chart showing the organizational structure of the IIA is attached as Appendix A.

### **The Board**

Under the POB’s model, the chair and vice chair of the IIA board would be employed on a full-time basis. Five other members would serve on a part-time basis. Each member, including the chair and vice chair, would serve a five year term and no member could serve more than two consecutive terms. To assure future continuity, it is anticipated that the initial membership of the Board would have staggered terms. While qualified persons with accounting experience, such as

retired accounting professionals, would be allowed to serve on the Board, the majority of members would have no ties whatever to the profession.

The importance of independence cannot be stressed enough. Independence removes any conflict of interest – real and apparent – on the part of Board members. Independence enhances the likelihood that when the narrow needs of the profession conflict with the broader public interest, it is the public interest that will be served. Independence will also serve the interests of the accounting profession itself. Because the accounting profession depends on the trust of investors and the public, that trust will wither and die if the profession is seen to be self-serving in its actions. The best way to keep that trust is to place regulatory decisions at arms-length in an independent, legislatively mandated oversight structure within the private sector.

The chair of the Board would be selected by a committee composed of the chair of the SEC, the chair of the Federal Reserve Board and the Secretary of the Treasury. Once named, the IIA chair would become a member of the selection committee and would join in selecting the vice-chairman and the other members. To assure independence, members could be removed only by a two-thirds vote of the IIA board itself. Having a selection committee of these individuals would enhance the credibility of the Institute.

## **Standards and Interpretation**

The POB charter gave it authority to oversee the issuance and interpretation of auditing and independence standards for the profession by the ASB and the ISB. Accounting standards have been set for nearly three decades by FASB.

The POB believes it is time to consolidate all standard setting bodies under one roof. Thus, a basic and critical function of the new Institute would be oversight of the issuance and interpretation of accounting, auditing and independence standards for the profession. To accomplish this end, an Office of Standards would be created by the IIA board and would report to it. Within the Office of Standards, separate bodies would be created to issue accounting standards, auditing standards, and independence standards. While the POB envisions a system in which the IIA board would have overall authority to create the structure under which standard setting would take place and to make appropriate rules for the standard setting process, the standard setting bodies within the Office of Standards would be given considerable autonomy in carrying out their work. A well-staffed and funded research arm within the Office of Standards would support the standard setting entities. The Office of Standards would also be charged with issuing interpretations of standards and be subject to monitoring by the IIA board.

With respect to FASB, the POB is cognizant of its hard work in setting accounting standards for nearly three decades, but believes it should be integrated along with all standard setting bodies into one unified and coordinated structure under the aegis of the IIA. Placing the responsibilities of FASB under the new IIA would lessen the chances of it being influenced by those whose its standards affect and could likely help alleviate what some – including the current SEC chairman – have said is a slow process for promulgating standards. As Lee Seidler, Deputy Chairman of the 1978 AICPA Commission on Auditor's Responsibilities, testified before the Senate Banking Committee in March 2002, "FASB has been beset by enormous outside pressures." Also, former SEC Chairman David Ruder expressed similar concerns before the

same committee in February 2002, noting that “FASB continually faces difficulties in financing its operations.”

These problems would be alleviated because FASB’s independent funding would be guaranteed by the IIA. Further, one of the major advantages to placing the activities of FASB under the new IIA would, as Mr. Turner testified before that committee in February 2002, be “the accounting standard setting, and enforcement of those standards, residing within a single organization. In turn, when the disciplinary process identifies shortcomings in the standards, they could then be promptly referred to the standard setter for timely action.”

With respect to auditing standards, the POB believes that standards promulgated by the current ASB have not provided guidance that is sufficiently specific and definitive, a problem noted in the recommendations of the Panel on Audit Effectiveness. The ASB is controlled by the AICPA, and eight of its 15 members are partners of the eight largest accounting firms. As with other standard setting entities, it should be placed under the aegis of the newly created Institute.

As discussed earlier, the termination of the ISB – established to create, codify and interpret independence standards for auditors of public corporations – has left a significant void. The POB believes this void should be filled by creating a new entity independent of the profession and operating under the aegis of the Institute, with sufficient resources and staff to issue clear, unambiguous standards of independence.

As to the membership of the separate bodies that would be created under the Office of Standards of the IIA, the POB believes a majority of their members should be independent of the profession. The new Office of Standards with separate bodies would help alleviate the concerns expressed by former SEC Chief Accountant Michael Sutton, who testified in February 2002 before the Senate Banking Committee that “standard setters too often pull their punches, backing down from solutions they believe are best – perhaps because of a perceived threat to the viability of private sector standards setting – perhaps because of the sometimes withering strains of managing controversial, but needed change – perhaps because of a loss of focus on mission and concepts that are supposed to guide their actions.” Public representation would assure that, at the least, the public had a voice and a vote in the process.

### **Annual and Special Reviews**

Since 1977, peer review of one accounting firm by another has been the backbone of the voluntary self-regulatory system in the United States, and the POB has been charged with overseeing this process. The POB believes that peer review resulted in major improvements in the profession. The recommendations that flowed from peer reviews in the early days led to substantive improvements in the quality controls at accounting firms, large and small. At the same time, as former SEC Chairman Williams testified on February 12, 2002, before the Senate Banking Committee, peer review “in its present form [has become] too incestuous. A system needs to be established which is independent of the accounting profession.”

Because it is not a transparent system (details of peer reviews are not made public) and is limited in scope (audits subject to investigation or litigation are not looked at as part of a peer review), peer review has come under considerable criticism from members of Congress, the

media, and others. “You scratch my back, I’ll scratch yours” is the prevailing cynical opinion of peer review raised by many.

The Public Oversight Board is of the opinion that peer review, as it has been conducted, should be discontinued in favor of a more thorough, independent, and transparent system. Each accounting firm now carries out an internal inspection each year. The POB would mandate that, for firms that audit more than 100 public corporations each year, these inspections would be subject to a comprehensive and thorough review, carried out by an independent professional staff hired by the Institute. While these reviews would usually look at a representative sample of a firm’s work, IIA reviewers would have the authority, unlike current peer reviewers, to look at any aspect of a firm’s operations it might find appropriate. Details would be compiled in reports that would be made available to the public. Reviews of smaller audit firms would be performed by other firms selected and paid by the IIA. Their reports would be addressed to the IIA as the client of the reviewer.

Professor Joel Seligman, who testified before the Senate Banking Committee in March 2002 stated that “the most significant issue may prove to be who conducts periodic examinations and inspections. To paraphrase the classical adage: Who will audit the auditors? I would urge serious consideration be devoted to replacing peer review with a professional examination staff in the new SRO. Peer review has been, to some degree, unfairly maligned. But even at its best it involves competitors reviewing competitors. The temptation to go easy on the firm you review lest it be too critical of you is an unavoidable one.”

But these reviews are only one piece of an updated oversight structure. To supplement them, the POB believes that special reviews should be carried out, when warranted, on a case-by-case basis. These special reviews, similar to those the SEC originally asked the POB to undertake of the Big 5 firms, could take a more systemic and in-depth look at a firm’s systems, policies, procedures and operations. If necessary, they would delve deeply into questions affecting a firm’s compliance with SEC rules and applicable professional standards. As with annual reviews, an independent professional staff hired by the Institute would carry out any special reviews and results would be public.

## **Enforcement and Discipline**

One of the most pervasive complaints about the current voluntary system is that firms and their personnel are rarely disciplined by the profession for infractions in carrying out audits or other work.

Dave Cotton, a member of the AICPA’s Professional Ethics Committee’s Technical Standards Subcommittee, wrote in a January 2002 *Washington Post* article that, while the Ethics Committee expels someone from the AICPA five to 10 times a year, “[m]ore typically, when [that] committee finds that a CPA has violated professional standards, it orders continuing professional education classes. A CPA found to have violated an accounting standard in connection with a multibillion-dollar corporate collapse, causing massive damage to investors and the public, might receive this sort of minimal sanction.”

When discipline is imposed by the present system, it almost always comes years after the fact because of procedures which delay the process, including sanctions, until after the outcome of litigation. Mr. Cotton noted in the *Washington Post* article cited above that, as a result of delays in the disciplinary system, “accountants who have committed the most egregious ethical lapses – the ones resulting in SEC investigations, bankruptcy and litigation – can often continue to practice for 10 years or more after the alleged violation until all the cases are resolved.” Bevis Longstreth, a former SEC commissioner and member of the POB’s Panel on Audit Effectiveness, stated in his congressional testimony in February 2002 that the present system “results in long delays in investigation and, as a practical matter, renders the disciplinary function a nullity in almost all instances.”

The POB believes these concerns about the present system have validity and that an effective mechanism for timely and effective discipline is essential to any reform effort.

One reason for the delay in the current system stems from the fact that those charged with administering the system lack privilege to ascertain facts. Privilege would give the investigative entity the authority to protect information it uncovers from outside demands until any enforcement action is concluded. At present, firms will not disclose documents or other information that is likely to wind up in the hands of litigants in legal proceedings. As Shaun O’Malley, Chairman of the POB’s Panel on Audit Effectiveness and former Chairman of Price Waterhouse, pointed out in his testimony in March 2002 before the Senate Banking Committee, the present system has been “hampered by distrust and by concerns that the materials developed were not protected. Providing confidentiality will expedite and vastly improve the review, investigatory, and disciplinary processes.”

Further hampering those charged with discipline in today’s system is the lack of subpoena power. Because of this, the system may not be able to obtain important information from auditors or audit clients. Also, sanctions are limited; the most that can be done is expel someone from membership in the AICPA. Further, the disciplinary process is not transparent, so the public is often unable to determine what, if any, action has been taken, even with respect to major audit failures.

The POB suggests that an Office of Enforcement and Discipline be formed within the new IIA to have full legal authority to investigate allegations of wrongdoing by public accounting firms and their personnel, including subpoena power. The office would be staffed by accounting and other professionals, as well as investigators. Cases of alleged improper professional conduct would be brought before IIA hearing officers, who would be charged with recommending, where warranted –after public notice and opportunity for public hearing – that the IIA board impose sanctions that would range from fines to suspension or expulsion from the profession. Cases could be referred to the Justice Department for possible prosecution, or to the SEC, state boards of accountancy, or other agencies, as appropriate.

Allegations brought before the Office of Enforcement and Discipline would go forward to investigation regardless of any pending litigation, unlike the present system. Disciplinary hearings and decisions would be public.

## **Funding and Staff**

If the Institute is to be successful in all that it is charged with overseeing and regulating, it must be appropriately funded and it must have an adequate, well-trained staff. It is clear that to attract a talented staff, competitive salaries must be available. Further, the Institute must be assured that the funds will be there when needed.

Former SEC Chairman Williams testified before the Senate Banking Committee in February 2002 that the POB “is not adequately funded and is beholden for its funding to the very people it is supposed to oversee. I suggest that the SEC consider a requirement that a percentage of the audit fees of public companies be assessed to pay for independent oversight, whether it is the Public Oversight Board or a successor body, so that its funding is assured.”

Another former Chairman of the SEC, David Ruder, said in testimony the same day that: “Independent and adequate funding is crucial. An independent body that depends upon sporadic voluntary contributions from industry or the financial community may risk loss of financial support if it takes positions seen as contrary to the best interest of those it regulates.”

The POB recommends that funding be provided through fees imposed on public corporations in an amount that would be sufficient to cover the costs of the Institute. The fees would vary according to the total revenues of the corporation. The POB strongly believes that the funding mechanism must be beyond the reach of the profession to prevent it from withholding necessary funds, as it did in May of 2000.

## **International Liaison**

Convergence of international accounting and auditing standards is one of the most pressing issues facing the profession. In an era when major firms either own or are affiliated with large accounting entities throughout the world and major corporations engage in global trade, common accounting and auditing standards are fast becoming a critical need. The Public Oversight Board believes that international liaison should be a primary function of the Institute.

Paul Volcker, the former Federal Reserve Chairman and Chairman of the trustees of the International Accounting Standards Board (IASB), told the Senate Banking Committee in February 2002 that FASB and IASB were working together on a number of issues and that the “result should be convergence and significant improvement in both bodies of standards.” Since the IIA would oversee accounting standard setting as well as auditing and independence standard setting, the Institute would be in the best position to act as international liaison to promote convergence and significant improvement to U.S. and international standards. This is a POB function under its charter and should be transitioned to a new regulatory body.

## **Continuing Professional Education**

Education has always been a hallmark of the accounting profession, and accountants and auditors are required to accumulate 80 hours of continuing professional education credits every two years. As important as education has been in the past, however, it will become even more crucial in years to come. The ability of auditors to deal with audits of companies involved in cross border offerings and derivatives and other new financial instruments that are constantly

being invented is largely dependent upon their ability to understand them – and that is a function of education. Similarly, convergence of standards across international boundaries will present new and unprecedented challenges to accountants and auditors and only continuing education will make it possible for the profession to remain on top of new developments. For these reasons, continuing education should be a primary focus of the new Institute.

## **Other Matters Affecting the Profession**

Beyond the regulatory structure of a new system, the POB believes there are a number of other issues that should be addressed as part of legislation creating a charter for the new Institute.

### **Auditor Independence**

The POB recognizes that there are several models available to deal with the matter of auditor independence and that there continue to be disagreements on this matter.

The Panel on Audit Effectiveness, for example, was split on the issue of scope of services for audit clients. Some panel members wanted to essentially ban non-audit services for audit clients. But these members would have allowed a “carefully circumscribed exception” if the client’s audit committee (composed only of independent directors) found that the best interests of the company and its shareholders would be served by retaining its auditor to render such non-audit services in cases where “no other vendor of such service can serve those interests as well.” This proposal would also have required submission of such a finding to the SEC and POB and disclosure in the corporation’s proxy statement of the finding and the amount paid for the non-audit services.

On the other hand, those on the panel who opposed restricting non-audit services – a majority – held that “audit firms can provide both audit and non-audit services to the same public audit client, and with proper safeguards and disclosures, can maintain independence and objectivity.” Those taking this view believed that “nothing in the long history of the profession’s providing non-audit services has indicated otherwise.”

Mr. Volcker said during the September 2000 public hearings on the SEC’s proposed independence rules that

The extent to which the conflict has in practice actually distorted auditing practice is contested. And surely, instances of overt and flagrant violations of auditing standards in return for contractual favors—an auditing capital offense so to speak—must be rare. But more insidious, hard-to-pin down, not clearly articulated or even consciously realized, influences on audit practices are another matter.

Importantly, President Bush’s 10-point plan “to improve corporate responsibility and protect America’s shareholders,” announced in March 2002, provides that “Investors should have complete confidence in the independence and integrity of companies’ auditors.” The specifics on this plan recognize the importance of prohibiting certain non-audit services in order to safeguard auditor independence.

On February 1, 2002, the AICPA issued a statement, which said it “will not oppose federal legislation restricting the scope of services that accountants may provide their public audit clients, specifically in information technology and internal audit design and implementation.”

In considering this matter, the POB started from the premise that the accountant's audit and report add significant credibility and reliability to a corporation's financial statements in the process of capital formation and that the foundation of that credibility is auditor independence.

To effectively assure independence, the POB believes legislation governing non-audit services to audit clients is necessary. The POB proposes that SEC regulations concerning independence be legislatively codified with appropriate revisions to update restrictions on scope of services involving information technology and internal audit services as noted above.

The POB believes such legislation should also affirm that tax work not involving advocacy and attest work in connection with SEC registration and other SEC filings be allowed, and that small public businesses, to be defined by the SEC, should not be subject to any restriction on non-audit services. Further, with respect to non-public corporations, it is the POB's position that such corporations and the accounting firms that audit them should not be subject to any restriction on non-audit services. We expressly emphasize this to avoid misunderstanding and any consequences to small business and small audit firms.

The IIA Office of Standards should be empowered to promulgate appropriate rules affecting independence to cover changing circumstances. The POB also believes that non-restricted, non-audit services should require approval by the audit committee if it finds such services to be compatible with maintaining independence. Also required would be prompt notification to the IIA Office of Standards and public disclosure in current reports and proxy statements filed with the SEC.

The POB believes there should be no prohibition against an audit firm offering non-audit services to non-audit clients.

### **Auditor Rotation and Retention**

The POB believes that the time has come to require rotation of auditors every seven years. The one effective way to prevent the emergence of too close a relationship between a corporation and its auditor is to make certain that auditors are rotated periodically. While there is merit to the argument that a long-term relationship helps the auditor do a better job, it is also true that a new auditor every seven years would provide the corporation with the benefit of a fresh perspective.

The POB agrees with its member, John Biggs, who testified in February 2002 before the Senate Banking Committee that auditor rotation is a "powerful antidote" to auditor conflicts of interest, which "reduces dramatically the financial incentives for the audit firms to placate management". In addition, as Mr. Biggs stated, rotation "reduces the problem of cross-selling other services and is likely to eliminate the revolving door that allows former auditors to become the top financial officers of the audited company." The POB also supports Mr. Biggs' idea, described in his testimony, that the new auditor at the time of rotation should do "an exhaustive review of the former audit work papers" that would assure "transactions and documentation were fully transparent." In addition, the new auditor could do "a brief, signed peer review report" on its predecessor.

As a corollary to auditor rotation, the POB recommends that public corporations be prohibited from firing auditors during their term of service. As former SEC Chairman Williams stated in his testimony before the Senate Banking Committee, the benefit of such a retention requirement is that “the auditor would be assured of the assignment and, therefore, would not be threatened with the loss of the client and could exercise truly independent judgment.”

The POB recommends allowing an exception to this retention requirement if the audit committee determines that an exception is in the best interest of shareholders, with prompt notice to the IIA and the SEC. Such action would be required to be publicly disclosed by corporations in current reports and proxy statements filed with the SEC. The POB also believes that audit committees, in engaging the auditor, should give primary consideration to the quality of the audit firm and its audit plan, and not to the lowest price.

The POB is cognizant that if an auditor rotation regulation is included in legislation, action will have to be taken to phase in the new system. The POB recommends giving the IIA authority to promulgate new rules governing the transition to an auditor rotation system. Actual rotation of auditors would begin only after those rules are in place.

### **Cooling Off Period**

For many years, members of Congress and senior federal government officials have been required to enter a “cooling off” period during which they are prohibited from taking certain actions, such as lobbying, on behalf of their new employer. The objective is obvious: to guard against undue influence by former colleagues and friends when it comes to making government decisions that could benefit the new employer of the former official.

The POB believes such a cooling off period is sound policy and feels a variant of it should be applied to the accounting profession when senior partners leave their firms. Specifically, the POB recommends that engagement and other partners who are associated with an audit be prohibited from taking employment with the affected firm until a two-year period has expired. This would end the current situation in which there is at least the appearance of impropriety in audit firms being unduly influenced by former colleagues who have taken senior positions with existing audit clients.

As Mr. Seidler said in his testimony this February, “the former auditor knows exactly how his or her former firm conducts the audit,” and also “knows how far former compatriots can be pushed to accept results preferred by management.” Mr. Seidler added that “‘we are all friends’, is not exactly the appropriate relationship between independent auditor and client.”

It is also important to recognize that in the cases of Lincoln Savings and Loan, Waste Management and, most recently, Enron and Global Crossing, senior financial officers at the company came from the outside audit firm.

Under the POB proposal, the IIA board would have the authority to adopt specific rules affecting this proposed cooling off period.

## **Audit Committees**

The POB believes that the Institute should expand on the recommendations of the *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees*, which made it clear that the external auditor should be accountable to a firm's board of directors and its audit committee and not to management. Specifically, the POB believes audit committees should take full responsibility for hiring, evaluating, and – if necessary – terminating an audit firm.

## **Conflicts of Interest**

To discourage conflicts of interest involving public corporations, Congress should amend the Securities Exchange Act of 1934 to require more meaningful and timely disclosure of related party transactions among officers, directors, or other affiliated persons and the public corporation. Such disclosures should be made promptly in current reports as well as in proxy statements filed with the SEC.

## **Internal Controls**

In the 1980s, a series of major business failures, particularly those involving financial institutions, led to congressional hearings on auditing and financial reporting matters. Out of those hearings, the FDICIA became law. This Act required among other things, that management report on internal controls and, further, that the independent auditors examine and report on those management assertions.

The Special Report by the POB dated March 5, 1993 on “Issues Confronting the Accounting Profession” recommended that the SEC require public companies to include with their annual financial statements “(a) a report by management on the effectiveness of the entity’s internal control system relating to financial reporting; and (b) a report by the [entity’s] independent accountant on the entity’s internal control system relating to financial reporting.” The POB, in support of this recommendation, stated: “The Board believes that requiring auditors to assess management’s reports on the quality of internal controls will benefit the public. First, the auditing profession’s evaluation of internal control systems will lead to improvements in those systems. Second, as long as companies’ boards and top management demand conformity with those systems, the improved systems will make management fraud and manipulation of financial reporting more difficult.”

Just a few months later, in a June 1993 position statement, the AICPA Board of Directors stated:

To provide further assurance to the investing public, we join the POB in calling for a statement by management, to be included in the annual report, on the effectiveness of the company’s internal controls over financial reporting, accompanied by an auditor’s report on management’s assertions. An assessment by the independent auditor will provide greater assurance to investors as to management’s statement. The internal control system is the main line of defense against fraudulent financial reporting. The

investing public deserves an independent assessment of that line of defense, and management should benefit from the auditor's perspective and insights. We urge the SEC to establish this requirement.

The General Accounting Office discussed this issue of reporting on internal controls in its 1996 report, "The Accounting Profession". The GAO pointed out that the POB had said "it was disappointed by the failure of the SEC to take action to mandate issuer and auditor reporting on internal controls. The POB agreed with us that such action would add immeasurably to the ability to prevent and detect fraud and would in general enhance the quality of finance reporting." The GAO stated that the SEC was "the key player" here and, further, that the SEC should move forward on this important issue. So far, the SEC has not done so.

Management of public corporations should be required to prepare an annual statement of compliance with internal controls to be filed with the SEC. The corporation's chief financial officer and chief executive officer should sign this attestation and the auditor should review it. An auditor's review and report on the effectiveness of internal controls would – as the GAO found in its report – improve "the auditor's ability to provide more relevant and timely assurances on the quality of data beyond that contained in traditional financial statements and disclosures."

In addition, strengthened internal controls over financial reporting should improve quarterly statements, interim disclosures and earnings estimates that are the basis for many market price changes during the year. They should also be helpful in avoiding restatements that are now seen so frequently.

## **Conclusion**

The Public Oversight Board has not come lightly to its recommendations for reform. For many months, members of the POB hoped that patient negotiation and discussion would prevail. In the end, however, it became apparent to the POB that real reform will take place only when Congress requires it through legislative action.

A decade ago Congress acted in the public interest when it voted major reforms in the banking industry – reforms that were widely opposed by the banks and their lobbyists. Opponents then predicted gloom and doom for the industry should the proposed reforms be enacted. In reality, the reforms contained in the FDICIA repaired flaws in regulation of the nation's banking industry. More important, they significantly strengthened the industry.

Today the Congress again is called upon to institute reform. In the wake of the Enron debacle, the POB, acting as the "conscience and critic" of the profession, strongly believes that to protect investors and the public, the old system of voluntary self-regulation for the accounting industry must be replaced. While many will urge that Congress act with caution and that the profession be again given the opportunity to fix the present system with marginal changes, the POB believes it is time to resist the continuation of the status quo and move ahead with fundamental change.

In short, the POB believes it is time for Congress to enact the kind of reform that will make a real difference.

## Appendix A

