
THE PANEL ON AUDIT EFFECTIVENESS
REPORT AND RECOMMENDATIONS
AUGUST 31, 2000

The Panel on Audit Effectiveness

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PUBLIC OVERSIGHT BOARD
PANEL ON AUDIT EFFECTIVENESS

Date: August 31, 2000

To: The Public Oversight Board and Other Interested Parties

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

Subject: Report and Recommendations

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

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

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

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

Among the Panel's major recommendations are:

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

- The Auditing Standards Board should make auditing and quality control standards more specific and definitive; in certain specified areas, audit firms should review and, where appropriate, enhance their audit methodologies, guidance and training materials; and peer reviewers should “close the loop” by reviewing those materials and their implementation on audit engagements and then reporting their findings.
- Audit firms should put more emphasis on the performance of high-quality audits in communications from top management, performance evaluations, training, and compensation and promotion decisions.
- The POB, AICPA, SECPS and SEC should agree on a unified system of governance for the profession under a strengthened, independent POB that would oversee standard setting (for auditing, independence and quality control), monitoring, discipline and special reviews.
- A majority of the members of the Independence Standards Board (ISB) should be from outside the profession, and the SEC should encourage and support the ISB in carrying out its mission.
- The SECPS should strengthen the peer review process, including requiring annual reviews for the largest firms, and the POB should increase its oversight of those reviews.
- The SECPS should strengthen its disciplinary process.
- Audit committees should pre-approve non-audit services that exceed a threshold amount and should consider certain specified factors when doing so. The ISB should identify the factors.
- The International Federation of Accountants should establish an international self-regulatory system for the international auditing profession.

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

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

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

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

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

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EXHIBITS

- 1. September 28, 1998, Letter from the SEC to the POB regarding formation of the Panel**
- 2. January 6, 1999, Letter from Shaun O'Malley to the Public Oversight Board**
- 3. October 7/8, 1999, Public Hearings Timetable**
- 4. January 25, 2000, Report of the Peer Review Process Task Force – Executive Committee, SEC Practice Section of the AICPA**
- 5. July 10/11, 2000, Public Hearings Timetable**

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

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EXECUTIVE OVERVIEW

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

GENESIS AND SCOPE OF THE PROJECT

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

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

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

When auditors express their opinion on the fair presentation in conformity with generally accepted accounting principles of a public company's financial statements, they do not guarantee that the financial statements are not misstated. Rather, auditors provide only *reasonable assurance* that the financial statements are free of *material* misstatement. Nevertheless, when

previously issued audited financial statements turn out to be unreliable and must be restated in corrected form, the logical question is, “Where were the auditors?” Implicitly, the question not only asks about the efficacy of the audit process, but also raises doubts about the value of audits in ensuring the reliability of financial statements – a key element in the efficient functioning of the capital markets. A fundamental assumption underlying the Panel’s project is its belief in the value of an audit and the public’s need for effective audits.

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

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

APPROACH TO THE PROJECT

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

The Panel also undertook many other activities. It held meetings with representatives of the SEC and various private-sector bodies involved in the governance of the profession, such as the AICPA; SECPS Executive, Peer Review and Quality Control Inquiry committees; Auditing Standards Board (ASB); Independence Standards Board (ISB); and POB. The Panel conducted a survey and held public hearings. It also conducted focus groups with financial executives and internal auditors from public companies, audit personnel at all levels from the eight largest firms and partners from smaller accounting firms. In addition, the Panel conducted research, with the

assistance of the SEC staff, into the circumstances that led to recent SEC Accounting and Auditing Enforcement Releases involving the five largest firms or their clients; studied the profession's current governance structure and analyzed alternatives to that structure; analyzed the academic, professional and regulatory literature on the effects of non-audit services on auditor independence; and studied recent international initiatives to strengthen audit effectiveness on a global basis.

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

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

RECOMMENDATIONS

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

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

Conduct of Audits

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

enforcement of high standards of conduct by management, boards of directors and audit committees, auditors can be an important factor in promoting high standards.

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

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

- Definitive auditing standards form the starting point for promoting quality audits.
- Audit firms need comprehensive and vigorous audit methodologies, based on the standards, to drive the behavior of their auditors to a higher plane.
- The peer review process is a critical element in "closing the loop" to provide assurance to the public that audit performance measures up to high standards and continues to improve.

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

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

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

calls upon the POB and the ASB to work together in establishing priorities for implementing its recommendations and setting future agendas.

Leadership and Practices of Audit Firms

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

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

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

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

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

Auditor Independence – Non-audit Services

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

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

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

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

Governance of the Auditing Profession

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

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

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

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

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

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

International Perspectives

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

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

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

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

THE PROFESSIONAL AUDITOR

This report contains many recommendations to enhance audit effectiveness that are addressed to a variety of constituencies. The Panel recognizes that, in the final analysis, the most important determinants of audit effectiveness are the personal attributes and skills of the individual auditor. The personal attributes of individuals provide structure and definition for their role in society and establish the foundation for what constitutes a true professional. For the individual auditor, these

attributes are independence in fact and in appearance, adherence to strong ethical standards, a great sense of personal integrity and the will to act objectively even in the face of intense pressures. Most importantly, individual auditors, as members of a respected profession, should assign their highest priority to protecting the public interest.

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

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

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