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# **IN THE PUBLIC INTEREST**

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**A Special Report by the  
PUBLIC OVERSIGHT BOARD  
of the  
SEC Practice Section, AICPA**

**ISSUES CONFRONTING THE  
ACCOUNTING PROFESSION**

- **Litigation**
- **Self Regulation**
- **Standards**
- **Public Confidence**
- **Professional Practice**

**March 5, 1993**

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## PREFACE

**T**he Public Oversight Board (the "Board") was created in 1977 by the American Institute of Certified Public Accountants (the "AICPA") to oversee and report on the Peer Review Program for firms that audit publicly held entities. The program is administered by the SEC Practice Section of the Division for CPA Firms. The SEC Practice Section is governed, in turn, by an Executive Committee composed of volunteer professionals. The Peer Review Program is directed by the Peer Review Committee, also composed of volunteers. Peer reviews of members are performed by firms or groups of auditors who are hired by the member firms to be reviewed and who report to such member firms the results of their reviews.

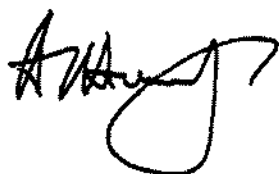
Since the peer review process is performed and administered by auditors, the AICPA determined that public confidence would be increased by creation of an independent oversight board composed of "prominent individuals of high integrity and reputation." The Board was created to perform that oversight function and to assure that the Peer Review Program is carried out in a manner consistent with the public interest. The Board's first chairman was John J. McCloy, one of the great Americans of this century, who epitomized the "high integrity and reputation" sought in Board members.

The Board's independence is evidenced by its power to select the successors of its members, hire and compensate its staff, set the compensation of its members, and choose the Board's chairman.

The Board's principal functions are: (1) to oversee the operation of the Peer Review Program; and (2) to oversee the activities of the Quality Control Inquiry Committee (the "QCIC"). The QCIC was established in 1979 to review the practice quality implications of lawsuits alleging defects in the audits of publicly held entities.

The staff of the Chief Accountant of the Securities and Exchange Commission ("SEC") regularly reviews the Board's files to determine whether the peer review and the QCIC programs are being properly conducted and properly overseen by the Board. The SEC staff's conclusions are reflected in the Commission's annual reports which have stated that the SEC Practice Section's programs have increased the reliability of audits. In addition, the Board itself meets from time to time with the SEC commissioners. The Board routinely makes recommendations for improvement in the peer review and QCIC programs. The Board also publishes an annual report "and such other reports as may be deemed necessary with respect to its activities."

Over time the Board has gone beyond the oversight of the peer review and QCIC programs because it felt that the public and the profession would be ill served if these programs functioned flawlessly while other forces eroded public confidence in the profession and the services it performs. Thus, the Board and its members have included commentary in annual reports, given speeches and written articles, testified before congressional committees and commissioned special studies on matters bearing directly on the integrity of the audit process.



A.A. Sommer, Jr., Chairman



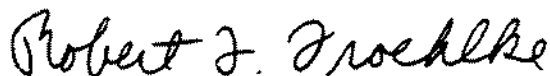
Robert K. Mautz, Vice Chairman



Melvin R. Laird



Paul W. McCracken



Robert F. Froehlike

March 5, 1993

## **REPORT OF THE PUBLIC OVERSIGHT BOARD ON ISSUES CONFRONTING THE ACCOUNTING PROFESSION**

### **INTRODUCTION**

**R**epresentatives of a number of accounting firms requested that the Public Oversight Board (the "Board") consider whether it could support the accounting profession's efforts to obtain relief from what the profession believes to be an excessive burden of litigation. The Board agreed to consider the request and to determine whether such litigation was adversely affecting the public interest.

The Board had already been concerned with the extent and impact of litigation and the influence of publicized allegations, litigation settlements and judgments on the public perception of the accounting profession and its performance. Attacks on the accounting profession from a variety of sources suggested a significant public concern with the profession's performance. Of particular moment is the widespread belief that auditors have a responsibility for detecting management fraud which they are not now meeting. The Board could not ignore these signs of failing public confidence in public accountants and auditing. A general loss of confidence in the audit function would pose severe problems for our credit economy.

The Board believes that the integrity and reliability of audited financial statements are critical to the American economy. Management, investors, creditors and government agencies make decisions of enormous magnitude in reliance upon such statements. Roughly half of a trillion dollars was invested in or loaned to corporations last year. A substantial portion of those funds were used to finance the expansion and improvement of production facilities. Decisions about the ways in which funds are committed are made on the basis of financial information available to management. Investors and creditors provide funds on the basis of the same information. Without the auditor's opinion, investors and creditors would have to rely on the unverified — and possibly self-serving — statements of those seeking the funds. The quality and value of that opinion are clearly debased when management fraud and illegalities go undetected.

Trustworthy, quality audits are essential to the efficient allocation of resources in our capitalistic society, and the detection of management fraud and illegal conduct is equally essential to this society. Because of these facts and the Board's belief that implementation of the recommenda-

## INTRODUCTION

tions in this Report will improve the usefulness and reliability of financial statements and the ability of auditors to detect fraud and illegalities, the Board urges that the recommendations in this Report receive careful consideration and quick implementation.

### **Basis for the Recommendations in this Report**

Board members have become familiar with the profession and its problems during their aggregate of forty-five years membership on the Public Oversight Board. During those years, the Board has met with literally hundreds of members of the profession, including its leaders, for the express purpose of discussing the effectiveness of the self-regulatory program and the quality of the profession's performance. Board members have also met frequently with government officials who have an interest in auditing matters and the accounting profession. This includes the chairmen and commissioners of the Securities and Exchange Commission (the "SEC"), its chief accountants, the Comptroller General of the United States, the chairman of the Federal Deposit Insurance Corporation and ranking staff members of congressional committees. In preparing this Report, Board members held special meetings with some of those who had been most helpful in the past and with others knowledgeable about the accounting profession and its current performance.

### **Scope of this Report**

Although discussions with representatives of the profession and some of its critics revealed a wide range of matters that warranted attention, the examination of these matters is organized under a limited number of broad topics. First, the Board turned its attention to what has been frequently referred to as the "litigation crisis." Chapter I focuses on the Board's inquiry into the extent of the litigation crisis, its causes, its present and potential impact on the accounting profession, and its remedies.

In Chapter II, the Board turns its attention to the accounting profession's present self-regulatory program for accounting firms, its genesis, constituent activities, and documented success. Because that program has not been without critics, the report includes a description of some alternative regulatory proposals and evaluates such proposals as possible replacements for the existing program.

In Chapter III, the Board sets forth a number of recommendations to make self-regulation more effective by assuring that any lessons to be drawn from allegations of audit failure will be identified to the profession as a whole.



## INTRODUCTION

Although litigation and some of the recent settlements and judgments resulting therefrom have contributed significantly to the current erosion of public confidence in accounting and auditing, the Board is convinced that more than alleged audit failures has influenced the public's present perception of independent public accountants and widened the "expectation gap." Chapter IV includes recommendations for changes in standards to make financial statements and audit reports more understandable and useful.

Chapter V proposes a number of recommendations for improving and strengthening the profession's performance by enhancing its capacity and willingness to detect fraud, strengthening professionalism and independence and improving financial reporting.

## CHAPTER I

### THE LITIGATION CRISIS

*This chapter discusses the existing litigation crisis, together with the Board's views on the need for litigation reform.*

**T**he last decade has seen an explosion of litigation in the United States. Much of this litigation has involved accounting firms.

When a client company and its management are sued because of alleged fraud or other misfeasance on the part of management or faulty financial statements, the auditor is commonly named, along with the client company, the company's officers and directors, underwriters, counsel for the client and others. Allegations that in auditing the financial statements of a client company auditors failed in performing their common law or statutory duties have become commonplace. Not infrequently, a number of the other defendants are bankrupt or have modest assets, with the result that the accounting firm is the only defendant to whom the plaintiffs can look for monetary redress.

Even if these actions are dismissed before trial — as many are — the cost of pursuing a case to dismissal is often very high. In many cases the high cost of pursuing litigation makes a settlement, including on occasions, the payment of damages even when no audit failure may have occurred, both reasonable and economically attractive.

#### **Need for a Limiting Principle**

The history of accountant litigation has been characterized by a constant search for a principle that would limit the universe of circumstances in which an auditor should be liable. In our society, the auditor's opinion has tremendous commercial importance and is relied upon heavily in financially huge transactions. Hence, the damages traceable to an alleged accounting or auditing error can be of great financial consequence. The auditor's opinion is often circulated and relied upon by many more than those to whom it was directed and for whose use it was intended. The monetary benefit which accrues to accountants is minuscule in relation to the liability which can be imposed if there is no reasonable limiting principle.

In the landmark case, Ultramares Corp. v. Touche, 174 N.E. 441 (N.Y. 1931), decided by the New York Court of Appeals (the highest court in New York State), Benjamin Cardozo, the brilliant jurist then serving as

## THE LITIGATION CRISIS

chief justice of that court (and who later served as a Justice of the United States Supreme Court), clearly recognized the consequences of extending the liability of auditors too far:

A different question develops when we ask whether [the auditors] owed a duty to [creditors and investors of the auditor's client] to make [the audit] without negligence. If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implications of a duty that exposes to these consequences (emphasis added).

For many years, "privity" was the limiting principle which protected the auditor from ruinous liability. That principle, which generally requires that the auditor have had a contractual relationship with the plaintiff or that the plaintiff have been the specifically intended user of the financial statements, has been eroded by many courts. It is noteworthy, however, that recently the Supreme Court in California, where lower courts had perhaps done the most to undercut the force of privity, affirmed its commitment to this principle in Bily v. Arthur Young & Co., 834 P.2d 745 (Cal. 1992).

### The Federal Securities Acts

The advent of the federal securities laws in 1933 and 1934 created dramatic new liability risks to auditors. The Securities Act of 1933 provided that auditors whose opinions on financial statements were filed as parts of registration statements in connection with public offerings were liable for the damage suffered by investors attributable to misstatements or omissions in the financial statements on which they opined unless they had, after reasonable investigation, reasonable ground to believe, and did believe, that the financial statements did not contain a material misstatement or omit any statement necessary to make the financial statements not misleading.

The Securities Exchange Act of 1934 exposed auditors to additional liability, though the threshold of liability is somewhat higher than under the 1933 Act. While other sections of that Act create some liability exposure for auditors, the principal basis for asserting auditor liability has been section 10(b). Section 10(b) and rule 10b-5 under it make it unlawful, among other things, for any person to buy or sell a security through

## THE LITIGATION CRISIS

fraudulent or deceptive means or by making an untrue statement of material fact or omitting to state a material fact. "Aiding and abetting" a violation of rule 10b-5 is also actionable.<sup>1</sup>

The United States Supreme Court, in a landmark case involving a major accounting firm, Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), decided that for a person to be liable under rule 10b-5, it had to be shown that the person had knowingly violated the rule. Subsequent courts of appeal cases extended liability to situations in which the defendant acted with recklessness tantamount to a knowing wrongdoing.

Typically, an auditor's liability under rule 10b-5 is based upon the allegation that in stating its opinion that the financial statements fairly present the financial position and the results of operations of an entity in conformity with generally accepted accounting principles ("GAAP") and in stating that its audit was conducted in accordance with generally accepted auditing standards, the auditor either knowingly or recklessly made a material misstatement.

### Reasons for Concern in the Accounting Profession

There are several reasons for the accounting profession's extremely high level of concern with auditors' exposure to liability. First, there has been a significant increase in the number of cases charging misstatements of financial information by corporations and in the amount of damages sought. When a corporation announces a substantial write-off or other material adverse event, when its stock price drops dramatically or when its earnings drop sharply, it is commonplace for multiple suits to be filed, often within hours or days of the event, well before any sort of searching inquiry could be conducted. These suits, which routinely name the auditors as defendants, generally charge that the audited financial statements should have reflected the event or information that allegedly caused investor losses.

Second, a number of multi-million dollar judgments have been rendered in recent years against accounting firms, and a number of very substantial settlements have been made, sometimes out of fear of unreasonable verdicts. Notable among these judgments are last year's \$338 million dollar jury verdict in Arizona against a major accounting firm (the case has been ordered to be retried) and a verdict in the amount of \$204 million against a major accounting firm awarded by a jury in

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1 Aiding and abetting liability under rule 10b-5 generally requires (1) a primary violation by another, (2) knowledge of the primary violation by the aider and abettor, and (3) substantial assistance by the aider and abettor.

## THE LITIGATION CRISIS

Galveston, Texas (settled for an estimated \$45 million). A summary of the latter case illustrates the excesses of this kind of litigation.

The plaintiffs in the action, investors who had bought about \$18 million in Miniscribe bonds sold in 1987, were awarded \$20 million in actual damages and \$530 million in punitive damages. Of these amounts, \$4 million in compensatory and \$200 million in punitive damages were levied against Coopers & Lybrand . . . .<sup>2</sup>

Third, at least one important, second-tier accounting firm has been bankrupted by, among other things, the extensive liabilities which stemmed from litigation. The partnership's assets and insurance were insufficient to satisfy all claims allowed in its bankruptcy, with the result that some individual partners were reported to have been required to contribute over \$500,000 each toward the settlement of claims.<sup>3</sup>

Fourth, leaders of the accounting profession have expressed concern that, as a consequence of litigation liabilities, one or more of the major firms may be rendered insolvent with devastating consequences, not only for the partners and employees of the failed firm, but also for the profession as a whole and indeed for the public interest as well. These leaders of the profession point to the impact such an event would have on the willingness of partners in other firms to continue to pursue their careers exposed to such liability dangers, the difficulties of recruiting outstanding persons into a profession so imperilled, the complications which would be posed for clients of the failed firm in satisfying the SEC requirements that financial statements filed annually be audited by independent accountants, and a host of other extremely damaging consequences which would flow from such an event.<sup>4</sup>

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2 Paul Geoghan, Punitive Damages: A Storm Over the Accounting Profession, J. Acct., July 1992, at 47 (emphasis added).

3 L&H: The Grim Realty, Pub. Acct. Rep., May 31, 1992, at 4. Laventhol and Horwath, then the seventh largest accounting firm in the United States, was forced into bankruptcy in large measure because of a staggering \$2 billion in liability claims and the resulting cost of defending against the lawsuits. The former partners agreed to pay \$48 million as part of the liquidation of the firm in order to avoid personal bankruptcy.

4 Arthur Andersen & Co., Coopers & Lybrand, Deloitte & Touche, KPMG Peat Marwick & Price Waterhouse, The Liability Crisis in the United States: Impact on the Accounting Profession, A Statement of Position 3-5 (Aug. 6, 1992), in J. Acct., Nov. 1992, at 21-24.

## THE LITIGATION CRISIS

### **The Board's View of the Need for Litigation Reform**

The Board has examined the evidence available on the liability exposure of the accounting profession. It has examined that exposure from the standpoints of fundamental fairness, the future development of the profession and the preservation of a sound accounting profession. From all these perspectives, it has concluded that the public interest requires remedial legislation.

The Board believes that, apart from the danger of the collapse of one or more major firms — which it does not take lightly — the litigation risks confronting the profession pose serious dangers to its ability to perform its assigned role in society. While no systematic study appears to have been made, there is ample anecdotal evidence that the liability threat is a factor students are now taking into account in determining whether to pursue a career in public accounting. There have been instances of promising young managers refusing partnership in accounting firms because of concerns with exposing their personal assets to litigation risks. There have also been instances in which these concerns were important factors in the decision of partners to leave public accounting for corporate positions. These are reasonable and expectable responses to the highly publicized risks of becoming a partner in an accounting firm.

The litigation liability danger directly affects the public, as well as the profession, in other ways; for example, the profession is increasingly reluctant to provide assurances on forward-looking financial data or other "soft information" that would be of benefit to the capital markets.<sup>5</sup> There is a flood of other types of financial information which is becoming increasingly available to users of financial information. The accounting profession has the expertise and the objectivity to provide assurances to the public regarding many of the new types of information. The profession would be more inclined to provide these assurances if the "Damocles Sword" of excessive liability claims did not hang over it.

Moreover, since many of the suits result from the failure of small companies, firms are reportedly refusing to undertake the audits of such companies because of the higher risks associated with such audits. This poses a grave problem because it severely hampers the access of such companies to the credit and equity markets. This could significantly hamper the ability of small companies to grow, create jobs and develop imagi-

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<sup>5</sup> The management's discussion and analysis of financial condition and results of operations as required by Item 303 of Regulation S-K, financial forecasts and information about compliance with laws are examples of such information.

## THE LITIGATION CRISIS

native products and services, all of which would be a severe national detriment, since small companies created more than half of all new jobs in the last decade.

Apart from these considerations, and transcending them, there is the question of fairness. In many instances, the role of the auditor in relation to a fraud is peripheral. It is noteworthy how very few are the instances in which a certified public accountant has knowingly and deliberately given a false opinion or participated in a client's misdeeds. A typical pattern is for an executive and one or more conspirators within a company to perpetrate a cunning fraud carefully designed to be concealed, not only from colleagues within the company, but also from its auditor.<sup>6</sup>

In another typical scenario, the financial statements are prepared by management using liberal interpretations of permissible accounting practices. The auditor, unable to point convincingly to prohibitions against the use of the alternative interpretation chosen by management, gives its honest opinion that the statements fairly present the financial position and the results of operations of the entity in conformity with GAAP. Then, when the company fails or suffers a setback, these honest judgments are transmuted into grossly overdrawn charges.

In these situations, and in innumerable others, it is unfair to put the entire onus upon the auditor. Auditors should be accountable for their conduct and they should bear responsibility for the consequences of their legal failings and shortcomings; however, they should not be responsible or accountable for the shortcomings of others. A system that would allocate financial responsibility among those involved in a financial failure or in financial misdeeds in proportion to the responsibility of each for losses suffered by investors and creditors would, in the estimation of the Board, be fairer and more compatible with the American sense of justice than is

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<sup>6</sup> AU Section 316.07 states: "Because of the characteristics of irregularities, particularly those involving forgery and collusion, a properly designed and executed audit may not detect a material irregularity. For example, generally accepted auditing standards do not require that an auditor authenticate documents, nor is the auditor trained to do so. Also, audit procedures that are effective for detecting a misstatement that is unintentional may be ineffective for a misstatement that is intentional and is concealed through collusion between client personnel and third parties or among management or employees of the client." 1 Codification of Professional Standards, U.S. Auditing Standards (AICPA) § 316.07, at 245-2 (Jan. 1992).

## THE LITIGATION CRISIS

the present system, which can result in the full monetary loss being borne by a relatively minor participant.

### Proposed Legislative Reforms

Much of the risk to the accounting profession derives from the fact that its responsibility is "joint and several" with other named defendants. An alternative to the familiar "joint and several" liability is "separate and proportionate" liability as a basis for allocating damages. This is the standard urged by the profession and others. Under "joint and several," each defendant can be held liable for the full loss suffered by the plaintiffs. Thus, if the only defendant with insurance protection or substantial assets is the accounting firm, it may be held liable for the damages caused by each of the parties even though the losses suffered may be mainly the result of economic events or the wrongdoing of others. Under a "separate and proportionate" formulation, the trier of fact determines the proportion of the loss caused by each defendant and allocates the damages among the defendants based on that determination. Thus, for instance, if the trier of fact determined that only 20% of a loss was caused by the failure of the auditor to perform a proper audit, then the damages payable by the auditor would be only 20% of the aggregate damages.

The main thrust of the profession's efforts for legislative reform is directed toward Congress even though most claims are made under state laws. A few states have adopted the "separate and proportionate" assessment of damages, but most have not. Because the practices of many accounting firms cross state lines, the "separate and proportionate" formulation must apply to state as well as federal claims to be effective. Since securing relief in a sufficient number of states would probably prove to be excessively difficult, federal preemptive legislation should be sought.

The legislation proposed by the profession, which was introduced in the 102nd Congress and has been reintroduced in the present Congress, contains, in addition to the "separate and proportionate" reform, other provisions that shift the prevailing party's attorneys' fees to the losing party (as is generally done in the United Kingdom) and that eliminate several litigation practices seen as abusive. The Board observes that there are a number of complex public policy implications in these other proposals which need to be evaluated in the broader context of tort reform and hence expresses no opinion on them.

In addition, the profession should continue to press for reform of the civil liability provisions of the Racketeer Influenced and Corrupt Organi-



## THE LITIGATION CRISIS

zations Act ("RICO") of the 1970 Organized Crime Control Act. These provisions, which create the danger of treble damages in virtually all cases charging auditors with violations of the federal securities laws, create unwarranted pressures on defendants to settle claims which might otherwise be litigated to a successful conclusion for the defendants. The RICO provisions have created a powerful tool which plaintiffs' attorneys use successfully to secure settlements in excess of what would otherwise be justified.

The RICO civil liability provisions have been extended by courts well beyond the very real problem of organized criminal activity that led to their enactment. Congress should amend the RICO civil liability provisions to eliminate their application to actions under the federal securities laws.

Let there be no misunderstanding: The Board's advocacy of the reforms discussed above should not be construed to mean the Board does not believe accountants and their firms should be responsible civilly and, in those rare cases where the circumstances indicate criminal conduct, criminally, for their conduct. The Board believes that the existence of civil remedies for misconduct in connection with professional activity is both fair and appropriate as a powerful inducement to professionals to adhere to proper standards of conduct.

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### RECOMMENDATION I-1:

Financial responsibility among those involved in a financial failure or in fraudulent financial reporting should be allocated in proportion to responsibility for losses suffered. Accordingly, "separate and proportionate" liability legislation applicable to both federal and state claims should be enacted by Congress. The civil liability provisions of RICO should be amended to eliminate treble damages in cases that arise under the federal securities laws.

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## Incorporation of Accounting Firms

The partnership mode of accounting practice became common at about the turn of the century. It was chosen to assure clients and others that the partners in accounting firms were financially committed to the integrity of their work. This kind of commitment was commendable and reasonable in a time when partners in even the largest firms knew each other. The

## THE LITIGATION CRISIS

time is long past when this sort of knowledge is possible. This form of organization for the profession is obsolete and should be discarded.

The membership of the American Institute of Certified Public Accountants (the "AICPA") has modified its Code of Professional Conduct to permit firms to practice in corporate or quasi-corporate form, which would limit the liability of partners not at fault in a deficient audit to the amount of their investment in the firm. The Board believes it is important for firms in the profession to be permitted to practice accountancy in a corporate or quasi-corporate form that preserves the liability of an individual partner for his or her derelictions, but does not visit the consequences upon other partners. The financial security and well-being of the officers of, say, General Electric are not imperilled by the misdeed of one of their number. There is no more reason why all partners in modern multi-national accounting firms, which often count their partners in the thousands, should be in peril because of the laxity or incompetence of one of their number.

As matters now stand, the AICPA's amendment to its Code of Professional Conduct, to be effective, must be implemented by state action permitting the corporate or quasi-corporate form of organization. Securing approval in fifty states for firms to practice in a corporate or quasi-corporate form will be time consuming and difficult. Therefore, the Board believes this is a situation where Congress should adopt preemptive legislation that authorizes accounting firms to incorporate or to become limited liability companies under federal law. The legislation should provide that accountants organized under the federal statute could not be barred from practicing in states that do not allow a structure which limits recovery to the assets of the firm, the available liability insurance and the assets of the errant professionals involved. The objective is to get innocent partners' personal assets out of harm's way.

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### RECOMMENDATION I-2:

Congress should adopt preemptive legislation to permit the practice of accountancy in a form that appropriately limits the liability of individual members of the firm.

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## CHAPTER II

### ASSESSMENT OF THE SEC PRACTICE SECTION'S SELF-REGULATORY PROGRAMS

*This chapter provides background material about the SEC Practice Section's programs, an assessment of their effectiveness and a recommendation to assure that auditors of all SEC registrants are subject to peer review.*

Critics of the accounting profession have not spared the self-regulatory program for accounting firms overseen by the Board. Some argue that the major fault of the present program is that it does not identify failed audits, establish fault in such failures and impose appropriate sanctions.

Some of these criticisms suggest that the profession's present self-regulatory program for accounting firms is so unsatisfactory that some other form of regulation should be adopted. The National Association of Securities Dealers, Inc. (the "NASD") and the National Transportation Safety Board (the "NTSB") have been suggested as models to be emulated by the accounting profession.

Because of such criticism, the Board undertook a thorough review of the present self-regulatory program and its history and an examination of the suggested alternatives to that program. This and the following chapter of this special Report present some of the Board's findings and its recommendations growing out of that review.

#### **The Profession's Self-Regulatory Programs**

In 1977, the AICPA started an ambitious new program of self-regulation for accounting firms. This was partially in response to the hearings conducted by the late Senator Lee Metcalf, partially in response to the SEC's endorsement of peer reviews, and partially in response to years of discussions within the accounting profession about the need for, and benefits of, expanded self-regulation.

The AICPA organized the Division for CPA Firms, which was divided into two sections: one, the Private Companies Practice Section designed for firms that do not audit clients which file reports with the SEC; and two, the SEC Practice Section, intended for firms that do audit clients which file with the SEC. Membership in either section was voluntary.

## ASSESSMENT OF THE SEC PRACTICE SECTION'S SELF-REGULATORY PROGRAMS

Many firms joined both sections. The firms that audited the overwhelming majority of entities that filed with the SEC joined the SEC Practice Section, as did many firms with no SEC clients. In January 1990, the AICPA amended its bylaws to provide that no AICPA member could be associated with a firm which audited one or more "SEC clients" unless the firm was a member of the SEC Practice Section. The AICPA has implemented this bylaw change by defining "SEC client" as an "issuer making an initial filing . . . under the Securities Act of 1933" and a "registrant that files periodic reports . . . with the SEC under the Securities Exchange Act of 1934 (except brokers or dealers registered only because of Section 15(a) of the Act) or the Investment Company Act of 1940."

The Peer Review Committee (the "PRC") and the Quality Control Inquiry Committee (the "QCIC") are the working arms of the SEC Practice Section. (These self-regulatory programs are explained further in Appendix B.) The PRC administers the Peer Review Program of the SEC Practice Section, which requires each member firm to have its quality controls and its compliance with them reviewed by other auditors every three years. The QCIC administers a program which examines the quality controls of firms against whom allegations of failure in connection with the audit of an SEC client, as well as certain other entities, have been made to find out whether the allegations indicate that there is a quality control deficiency.

### The Peer Review Program

The triennial peer reviews required of members of the SEC Practice Section are conducted by teams of experienced auditors from other SEC Practice Section member firms. Team leaders are required to attend special courses to qualify for peer review work. The peer review includes reviewing relevant materials setting forth the firm's quality control standards and practices; determining whether the SEC Practice Section's membership requirements, including such matters as continuing professional education requirements, have been satisfied; and examining selected audits to determine whether they were conducted properly and in accordance with the firm's and the profession's quality control standards. The work of the peer review teams is carefully reviewed by the PRC under the oversight of the Board's staff.

These reviews occasionally identify an audit that was not done in accordance with generally accepted auditing standards or financial statements that were not prepared in accordance with GAAP. When such a problem is encountered, the firm is required to take appropriate action, e.g., undertake additional audit procedures or withdraw its opinion and advise its client to amend the financial statements to bring them into compliance with GAAP.

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If quality deficiencies are found and the firm fails to take corrective action, the Executive Committee of the SEC Practice Section has the authority to impose sanctions. These have included: (1) corrective measures by the firm, including measures involving personnel; (2) additional continuing professional education; (3) accelerated or special peer reviews; (4) admonishments, censures, or reprimands; (5) suspension from membership in the SEC Practice Section; and (6) expulsion from membership.

### **Effectiveness of the Peer Review Program**

The Board's assessment of the Peer Review Program provides abundant evidence that it is a success.

- Since 1983, the SEC's Annual Reports have stated that the SEC Practice Section's Peer Review Program has enhanced the quality and consistency of practice before the Commission.
- Federal and state regulators and legislators are increasingly mandating peer reviews of auditors who undertake audit and attest engagements of entities or programs that use governmental funds.
- The Board's 1991-92 Annual Report noted that 25% of the approximately 300 firms subject to initial peer reviews in 1991 (most of whom joined the SEC Practice Section because of the AICPA bylaw change) received opinions in publicly available reports that the firms' quality control systems were significantly flawed. By contrast, 93% of the firms that had repeat reviews were reported to have satisfactory quality control systems. This is strong evidence that the peer review process has a significant effect on the quality of auditing.

### **Avoidance of Peer Review**

As noted, in 1990 the AICPA amended its bylaws to provide that no member of the AICPA could be associated with a firm which audited one or more SEC clients unless the firm was a member of the SEC Practice Section. At the present time, an overwhelming number of SEC clients are audited by members of the SEC Practice Section. However, there are some sole practitioners and small firms that continue to audit SEC clients without ever having had a peer review.<sup>7</sup> Several years ago the SEC con-

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<sup>7</sup> See, e.g., Daniel Pearl, How 2 Florida Firms Fooled Stockholders, Auditors and the SEC, Wall St. J., July 8, 1992, at A1 (discussing the audits of Cascade International Inc. and College Bound Inc.)

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sidered a proposal that would have required that all auditors of SEC registrants — which include the same entities referred to by the AICPA as SEC clients — except certain foreign and predecessor auditors and auditors involved in an initial public offering, be included in a peer review program having certain minimal characteristics. The Commission's reluctance to adopt this rule was based on concern that it lacked the power to do so.

The Board believes the Commission has the power to require SEC registrants to disclose appropriate information about the peer review of the registrant's auditor. The Board recommends that the Commission amend its rules to require such disclosure because it will assist in preventing situations in which the auditors of SEC registrants manage to avoid the peer review process.

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### **Recommendation II-1:**

**The SEC should amend its rules to require SEC registrants to disclose whether their auditors have had a peer review, the date of the most recent peer review and its results.**

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## **The Quality Control Inquiry Committee Program**

### **The Mission of the QCIC**

The QCIC performs one of the two principal functions of the SEC Practice Section's self-regulatory effort. Accounting firms that are members of the SEC Practice Section must report to the QCIC allegations of deficiencies in the conduct of an audit of present or former SEC clients made in civil suits or criminal indictments against the member firm or its personnel or in any public proceeding or investigation by a regulatory agency. In addition, members must report allegations relating to the conduct of an audit of a financial institution that files periodic reports under the Securities Exchange Act of 1934, and of an audit of a subsidiary or investee of an SEC client if the financial statements of such an entity are presented separately in the parent or investor company's filing.

Further, the QCIC may request member firms to report allegations of deficiencies in the conduct of an audit of a non-SEC client not otherwise covered by the requirement if the Executive Committee of the SEC Practice Section feels there is "a significant public interest in [such alleged] audit failure." The QCIC may also request member firms to report allega-

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tions of deficiencies in the conduct of an audit of financial statements of a regulated financial institution even if it is not an SEC client or is not publicly held.

Reports of allegations of audit deficiencies must be filed with the QCIC within 30 days of the service of the first pleading on the firm. The QCIC's mission is to review the allegations of audit failure against the member firm to determine:

- (a) Whether the allegations indicate a need for corrective measures by the member firm with respect to the firm's quality control system; and
- (b) Whether the facts related to the specific alleged audit failure indicate that changes in generally accepted auditing standards or quality control standards need to be considered. If the QCIC finds guidance on the application of GAAP inadequate, the QCIC reports the situation to the AICPA's Accounting Standards Executive Committee.

If a member firm refuses to cooperate with the QCIC or fails to take the corrective actions deemed reasonable and necessary by the QCIC, the Committee may ask the Executive Committee of the SEC Practice Section to impose sanctions.

### Effectiveness of the QCIC

Since its inception, the QCIC has made numerous recommendations for actions to be taken by firms or the profession as a result of the QCIC review of reported cases. In addition to corrective measures addressing specific quality control deficiencies, the QCIC has required special reviews, reviews of other relevant work, and expanded peer reviews. In addition, the QCIC has made referrals to appropriate AICPA technical bodies urging them to consider the need for changes in, or guidance on, professional standards and to the AICPA Professional Ethics Division, with a recommendation for investigation of the work of specific individuals.

The accounting profession and the SEC have both said that the QCIC plays an important role in the self-regulatory process. The 1987 report of the SEC Practice Section Task Force on SIC Methodology said that the QCIC (previously known as the Special Investigations Committee (SIC)), "[performs] a very important role in enhancing the future quality of practice of member firms . . . a role not necessarily performed by the SEC or the courts." The SEC's 1991 Annual Report states:

The Commission believes that the [QCIC] process provides added assurances, as a supplement to the SEC Practice Section peer review

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program, that major quality control deficiencies, if any, are identified and addressed in a more timely fashion. Therefore, the Commission believes that the QCIC process benefits the public interest.

The Board believes that the QCIC performs an essential function. The Board's goal in re-examining the QCIC process and considering alternative models has been to recommend measures to make it even more responsive to the public interest and the public's expectations.

### **Scope of the QCIC's Role**

The QCIC process was never intended to determine whether an audit failure had occurred as alleged or the reasons for the failure if one did occur; the QCIC was not given the power to punish anyone for misconduct in performing an audit. When it established the QCIC, the Executive Committee of the SEC Practice Section believed that giving the QCIC such a mandate would duplicate existing means of determining the existence of, and reasons for, an audit failure, which include civil litigation brought by persons allegedly harmed, injunctive and disciplinary proceedings by the SEC, proceedings by state licensing boards and AICPA proceedings for ethical violations. A determination in a QCIC proceeding that there had been an audit failure or that specific individuals were responsible for an audit failure would not preclude a re-examination of those questions in civil litigation, an SEC proceeding or an action by state authorities or the AICPA.

The courts, the SEC and other regulatory and governmental bodies can secure evidence through subpoenaed documents and sworn testimony to determine whether allegations of audit failure are valid and, if so, can impose appropriate sanctions on firms and individuals while protecting the rights of all parties. Without such power, a self-regulatory body would rarely be able to make a fair and just judgment as to whether an audit was deficient or someone was guilty of a misdeed. Audit documentary evidence alone rarely is sufficient to indicate whether an audit has been substandard. Working papers cannot reflect what the auditor does not know — whether documents were falsified, agreements were concealed or fictitious transactions were engaged in — or whether the auditor's ignorance stemmed from neglect or artful deceit by management. To determine what the auditor should have known — which is necessary to determine culpability — almost always requires access to client documents and records and the testimony of client personnel who are unlikely to testify voluntarily or to produce documents establishing their own misconduct. (It is noteworthy that even a statutorily authorized self-regulator



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like the NASD [see p. 23 and Appendix C] does not have the power to subpoena documents or witnesses.)

The Board believes these considerations are as valid now as they were when the QCIC was established in 1979 and that the mandate of the QCIC should not be expanded to include determining whether audit failures have occurred or who may have been responsible for the failure.

### Consideration of Alternative Regulatory Structures

In re-evaluating the SEC Practice Section's self-regulatory program, and particularly the QCIC portion of that program, the Board considered other mechanisms that might serve the public interest better than the present program. These included the accounting regulatory structures in the United Kingdom and Canada and the NASD and the NTSB in the U.S. The NASD was chosen for study since it has been mentioned frequently as a possible model for a new self-regulatory structure for the accounting profession.<sup>8</sup> The NTSB was chosen because its remedial objective is the same as the QCIC's and its means for achieving that objective most closely resembles what the Board believes should be an additional activity of the QCIC, namely, using information about past mishaps to avoid future ones.

The Board concluded that the regulatory programs that address the quality of audits performed in the United Kingdom and Canada have some of the characteristics of the SEC Practice Section's self-regulatory programs, but are not as comprehensive and provide no features not present in the SEC Practice Section's programs. The Board also concluded that neither the NASD nor the NTSB is an appropriate model for a new accounting profession self-regulatory organization or system.

### The National Association of Securities Dealers

Many, including some present leaders of the profession and governmental observers, have suggested that a self-regulatory structure modelled on that of the NASD is appropriate for the accounting profession. In 1985, a major firm suggested such a structure and, in 1977, then-Representative John

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<sup>8</sup> See A.A. Sommer, Jr., *Is There Hope For Self-Regulation?*, Address at the Abraham J. Briloff Lecture on Accounting and Society (Sept. 23, 1986), in Abraham J. Briloff Lecture Series on Acct. & Soc'y 1985, 1986, at 20 (discussing sources for the idea of an NASD-type self-regulatory organization for the accounting profession); Donald H. Chapin, *The Changing Image For the CPA*, Remarks Before The President's Plenary Session of the 59th Annual Conference of the New York State Society of CPAs (June 8, 1992), in *CPA J.*, Dec. 1992, at 23 [hereinafter Chapin].

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Moss even incorporated such a structure in legislation that did not reach the floor of the House. More recently, Donald H. Chapin, Assistant Comptroller General of the General Accounting Office, resurfaced the idea.<sup>9</sup>

The Board believes that the NASD is a totally inappropriate model for the accounting profession.

As indicated in Appendix C, which contains a comprehensive description of the NASD, the NASD was organized pursuant to an amendment to the Securities Act of 1934 at a time when the securities industry had no comprehensive self-regulatory organization.

The NASD performs various functions on behalf of the securities industry that are performed quite adequately on behalf of the accounting profession by existing entities. The NASD administers competency examinations for persons in the securities industry similar to those to which accountants are subject, and the NASD's registration procedures closely resemble the accounting profession's licensing procedures. The NASD has adopted and enforces "Rules of Fair Practice" which roughly correspond to the Code of Professional Conduct adopted by the AICPA and enforced by it and the state boards.

Many who believe that an NASD-type self-regulatory organization would be desirable for the accounting profession seem to believe that the profession would benefit by a replication of the NASD's mechanisms and procedures for enforcing its rules, and on occasion, the federal securities laws. These NASD procedures provide for the investigation by NASD member-constituted committees of alleged misconduct by members (or persons associated with members) and the determination by the committees of whether there has been an infraction.<sup>10</sup>

The Board believes it would be impractical for the accounting profession to adopt this model to determine whether charges of audit failure are meritorious.

The typical NASD proceeding takes a few hours and rarely do the proceedings last longer than a day.<sup>11</sup> Generally, the issues are fairly sim-

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<sup>9</sup> See Chapin, *supra*, at 23.

<sup>10</sup> See generally Lee A. Pickard and Anthony W. Djinis, NASD Disciplinary Proceedings: Practice and Procedure, 37 Bus. Law. 1213, 1223-37 (1982) (discussing the NASD investigation and disciplinary process) [hereinafter Pickard & Djinis].

<sup>11</sup> Telephone Interview with Norman Sue, Associate General Counsel, NASD (June 26, 1992) [hereinafter Sue].

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ple:<sup>12</sup> did the registered representative make false representations to customers or misappropriate funds; did the representative sell a customer a security which was unsuitable or in conflict with customer instructions; did the firm fail to properly supervise the activities of its employees or accurately maintain books and records? Usually the only evidence necessary for such determinations is selective records of the NASD member, the testimony of the registered representative or of other employees of the member (or a combination of them depending on the type of case) and, in some cases, the records and testimony of the customer.<sup>13</sup> There is rarely, if ever, a need to secure records in the possession of third parties or the testimony of others.<sup>14</sup> The NASD does not have subpoena powers; hence, when it does confront a situation where such additional information might be useful, it can only rely on the voluntary cooperation of those having such information.<sup>15</sup>

An adequate inquiry into an alleged audit failure, on the other hand, entails the examination of masses of papers, many of which are in the hands of the charged firm's client who might, for reasons of self protection, refuse to produce them. The testimony of many witnesses is usually necessary. Such testimony would likely include employees of the client who might, for a number of reasons — not all of them honorable — refuse to testify. The trial of a recent case against a major accounting firm in Arizona took eleven months. While this is not a typical case, episodic evidence indicates that most trials take several weeks, often months. There is no reason to believe that because a "trial" would be conducted by a self-regulatory organization, it would be significantly simpler or more brief than a civil trial. Even if all the information were available to reach a conclusion about the adequacy of an audit, the availability of professionals willing to participate in such prolonged proceedings would pose a considerable problem.

If an NASD proceeding finds that the member or an associated person committed a wrong, it can order reimbursement by the respondents for losses and impose a penalty on the firm or associate, consisting of a

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12 Telephone Interview with P. William Hotchkiss, Surveillance Director, NASD, and Norman Sue, Associate General Counsel, NASD (Sept. 29, 1992) [hereinafter Hotchkiss & Sue]; See generally, Ann C. Flannery, SRO Disciplinary Sanctions, 1991 A.B.A. Litig. Sec. Subcommittee on SRO Matters at Tab A (Summarizing Types of NASD Disciplinary Actions for 1991).

13 Hotchkiss & Sue, supra.

14 Id.

15 See Pickard & Djinis, supra, at 1223; Sue, supra.

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monetary fine, a suspension or a bar from engaging in the securities business.<sup>16</sup> Determination of the amount of loss suffered is usually easy and simple and does not entail the complexities of determining, for instance, the losses of a class of plaintiffs. The availability of an NASD proceeding does not, however, preclude the member firm or the customer from seeking relief in another forum if it is dissatisfied with the outcome of the NASD proceeding.<sup>17</sup> If the auditor's client sought relief initially in the courts, the NASD-type self-regulatory organization would still have an interest in enforcing its rules and would undoubtedly commence a separate proceeding for the purpose of imposing a fine, a suspension or a bar against a member or the associate of a member charged with wrongdoing. Consequently, the NASD's model does nothing to mitigate the litigation problem, and may in fact exacerbate it.

In short, it is difficult to see what benefit would accrue to the profession, or the public, if an additional adjudicative mechanism were added to those which already exist: the SEC which can seek either injunctive or administrative relief and fines; the civil courts which can determine whether anyone with proper standing to bring suit has been harmed; and the state disciplinary boards which have the power to bar individuals from practice and impose penalties on firms (as several have recently done). Redundant proceedings would be expensive, which would ultimately increase the cost of accounting services without any demonstrable benefit to the public.

### The National Transportation Safety Board

The NTSB model is described in Appendix D. The Board concluded that the efforts of the NTSB to draw lessons from past mishaps to avoid future mishaps is relevant to the QCIC process and that similar procedures would be in the interest of both the profession and the public. Moreover, the NTSB's focus is remedial rather than punitive, which is consistent with the SEC Practice Section's objective in reviewing litigation.

The Board concluded, however, that the structure of the NTSB model would not be appropriate for the accounting profession. NTSB investigations are directed at events that require immediate on-site investigations to establish the facts.<sup>18</sup> The accident scene is sealed so that the integrity and availability of relevant facts can be protected; relevant facts are then

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16 See Pickard & Djinis, *supra*, at 1238-39; Hotchkiss & Sue, *supra*.

17 Hotchkiss & Sue, *supra*.

18 See generally 1990 NTSB Ann. Rep. to Congress 11 (discussing the function of the NTSB).

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gathered and validated.<sup>19</sup> Because factual information produced from such investigations could not be reconstructed at a later date, immediacy is essential to establishing the facts.

The gathering of factual information surrounding an alleged audit failure does not require immediacy. The relevant audit personnel, work papers and client records are all accessible at a later date and the passage of time does not impede the inquiry.

Most important, while the NTSB investigates events whose occurrence is indisputable, the existence of an audit failure is almost never indisputable. Thus, any investigation to determine whether an audit failure actually occurred, which would be required before "probable cause" could be pursued, would duplicate the process of adjudicating civil claims for monetary damages and the SEC's disciplinary and injunctive proceedings without additional benefit to the public.

Moreover, the NTSB's conclusions with respect to "probable cause," which are at the heart of the NTSB's work and which form the basis for the remedial measures taken as a result of its investigations, generally may not under the federal law be introduced in evidence in any proceeding arising from the accident.<sup>20</sup> This provision is intended to avoid prejudicing the defense of those determined to have had responsibility for an accident against charges in other proceedings. There is at present no law which would prevent the conclusions with respect to the "probable cause" of an alleged audit failure reached by a self-regulatory body patterned on the NTSB from being introduced in evidence in any SEC, administrative, civil or criminal proceeding. Obviously, the introduction of such conclusions in a proceeding could seriously damage the ability of an audit firm to defend itself against charges brought against it.

The Board does not believe that the NTSB structure is appropriate for the accounting profession even if that structure included subpoena power and statutory protection of evidence because it would be duplicative of other proceedings. Nevertheless, the Board believes that the objective of the QCIC's procedures can be modified so that, as the transportation industry learns from NTSB investigations, the accounting profession can use information gained from past allegations of audit failures to improve the quality of future audits.

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19 Telephone Interview with Brent N. Bahler, Director of the Office of Public Affairs, NTSB (Sept. 29, 1992) [hereinafter Bahler].

20 See 49 C.F.R. §§ 835.2-.3 (1991); Bahler, *supra*.

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**Conclusion**

The accounting profession should not pursue legislation to create an accounting self-regulatory organization patterned after the NASD or a body modeled on the NTSB. Rather, as discussed in the following chapter of this Report, the Board recommends modifications to the SEC Practice Section's membership requirements, the peer review performance standards and the QCIC process.

## CHAPTER III

### RECOMMENDATIONS TO IMPROVE THE SELF-REGULATORY PROCESS FOR ACCOUNTING FIRMS

*This chapter recommends modifications to the SEC Practice Section's membership requirements, the peer review performance standards, and the QCIC process.*

#### **Modifications of the Self-Regulatory Process to Better Assure Against Future Audit Failures**

**H**aving considered and rejected new mechanisms to regulate the accounting profession, the Board turned its attention to ways of improving the current structure to reduce the incidence of audit failures.

It must be recognized that no self-regulatory process (or, for that matter, any governmental regulatory scheme) can ever protect the public completely from audit failures. Deficiencies in the conduct of an audit will continue to occur irrespective of how good a firm's quality control system is. There will always be human failures, misunderstanding of instructions or facts, mistakes of judgment, carelessness, failures to react to "red flags" and other personal failings. Managements will occasionally continue to deceive auditors.

Nevertheless, the Board believes that the self-regulatory process for accounting firms can and must do more than it does now. The present mechanisms of self-regulation do not provide the opportunity for the profession to learn from its mistakes or to improve its performance in one area that is increasingly troublesome — the detection of management fraud. When frauds are perpetrated, the entire profession must learn how the financial data were manipulated, how detection was initially avoided, what audit procedures might have discovered the irregularity and what should be done to make sure the same sort of mishap does not occur again.

The Board believes that the SEC Practice Section should expand its membership requirements and its activities in a manner that will assure that any lessons to be drawn from allegations of audit failure will be identified and become available to all SEC Practice Section members and to the profession as a whole. This can be done by having the QCIC include this

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mission in its charge and by requiring the members to report to the QCIC the audit guidance which in their judgment might have avoided the allegations made against the firm.

### Limitations of Present Audit Guidance

To understand the Board's recommendations, it is important to outline the limitations of the audit guidance presently available to the profession. By definition, auditing standards define, and provide guidance with respect to, the nature and extent of auditors' responsibilities; they should not, and usually do not, specify guidance on what procedures are appropriate or inappropriate in specific circumstances. Through its standard-setting organization, the auditing profession has produced a comprehensive set of auditing standards and interpretations of those standards.

What is missing are specifics: a) examples of possible fraudulent practices linked to precisely targeted auditing guidance and rooted in an analysis of allegations of audit failure; and b) the identification of auditing practices that require reconsideration or the development of guidance so they are consistently applied. This guidance could be issued in a manner similar to the guidance issued in the accounting area by the Financial Accounting Standards Board's Emerging Issues Task Force. This guidance should direct attention to business, accounting and auditing practices that pose new or special problems for auditors.

The following are examples of situations identified through the analysis of QCIC cases where such guidance might be appropriate:

- As a result of an analysis of management fraud perpetrated in part through the use of photocopied invoices, one auditing firm's policy manual instructs the auditor to check the authenticity of documents and to accept only original documents as corroborative audit evidence. The Board believes all firms should do this.
- In several instances, auditors failed to discover or identify concealed "bill and hold" arrangements used by the client to inappropriately recognize revenue. Audit staff who had examined shipping documents may have failed to question the location to which the goods were shipped. Guidance should be provided to the audit staff to routinely examine shipping destinations on sales invoices and to be alert to shipments to locations other than the customer's premises as a possible clue to "bill and hold" transactions.
- The question of whether physical counts of retail and other inventories on a test basis constitute reliable evidential matter



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when the client knows where the tests are going to be conducted needs to be addressed.

- Auditing literature does not provide any guidance on whether the auditor should be responsible for opening cartons, examining contents, and testing inventory for adherence to technical specifications. Whether this is appropriate is debatable; that it should be addressed is not.

Examples like these, coming as they do from alleged audit failures, point to matters that the profession needs to address and resolve.

The Board believes that member firms should report to the QCIC any standards or guidance implications identified during their internal analyses of allegedly failed audits so the QCIC can evaluate these findings, along with those identified by the QCIC's own proceedings, and see that appropriate guidance is published. In this way the profession can pool the knowledge it gains on an individual basis concerning the causes and circumstances of alleged audit failures and gain from it as a profession, just as, for instance, all airline operators and all airplane manufacturers learn from the investigations of the NTSB and make changes in airline procedures or in airplane construction reflecting the new knowledge.

In determining means of implementing this recommendation, the legitimate concerns of firms with respect to the weakening of their position in pending litigation must be recognized. However, the Board understands that some firms provide such guidance in writing to their own professionals. Since such internal documents would, in any event, be subpoenaable in litigation, the Board does not believe making such information available more broadly would significantly affect a firm's litigation posture.

Notwithstanding the acknowledged value of the QCIC's present procedures in quickly identifying and addressing major quality control deficiencies, the Board believes that measures can be taken which would better assure the public that firms and the self-regulatory process are taking steps to protect the public from future audit failures by examining past ones.

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### Recommendation III-1:

The SEC Practice Section's membership requirements should be changed to require member firms to modify their quality control systems to specify that they take the following steps in response to allegations of deficiencies in the conduct of an audit of financial statements of an SEC client (or another client encompassed by the

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QCIC process) that are made in litigation against the member firm or its personnel, or in any public proceeding or investigation by a regulatory agency:

- (1) Perform a complete internal analysis of the audit; review all relevant work papers, correspondence and other files; interview members of the engagement team.
- (2) Assess the capabilities of the senior audit personnel and determine whether the firm should monitor, reassign or terminate such personnel.
- (3) Identify any problems with the firm's quality control system or training activities.
- (4) Identify any implications of the allegations relating to the adequacy of auditing, quality control or accounting standards.
- (5) Identify any implications of the allegations relating to the adequacy of guidance with respect to the manner in which audits are conducted, including the evaluation of risks in audits, and relating to variations in practice and the interpretations of standards that should be resolved.
- (6) Communicate the implications identified in items (4) and (5) in a structured manner to the QCIC.

### Recommendation III-2:

The peer review performance standards should be amended to require peer reviewers to test firms' compliance with these modifications to their quality control systems.

### Recommendation III-3:

The QCIC procedures should be modified to require the QCIC to develop additional procedures to permit it, on the basis of its analysis of the QCIC cases and the information reported to it under the expanded membership requirements discussed above, to facilitate the resolution of unresolved audit practice issues and to formulate, either by itself or in collaboration with other appropriate bodies, practice and guidance directions to the accounting profession in a retrievable format such as EITF Abstracts, which present issues considered by the Financial Accounting Standards Board's Emerging Issues Task Force.

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## CHAPTER IV

### IMPROVEMENTS TO STANDARDS FOR FINANCIAL STATEMENTS AND AUDIT REPORTS

*This chapter discusses factors that have led to an erosion of public confidence in the accounting profession, the "expectation gap," and provides some facts about financial statements and audits. This chapter also proposes recommendations for changes in standards to make financial statements and audit reports more understandable and useful.*

#### Confidence in the Profession and the "Expectation Gap"

The accounting profession has suffered a serious erosion of public confidence: confidence in its standards, in the relevance of its work and in the financial reporting process. The reasons for this are not hard to identify. In some cases, not long before an entity failed, it received an auditor's report giving no indication that the entity was in its latter days. How could it be, the intelligent and thoughtful layman asks, that the bank or other business was so near its demise and the auditors could not see it?

Many have also been concerned about the failure of auditors to detect alleged management fraud in a number of highly publicized cases in which auditors have been named as defendants. The Phar-Mor, Comptronix, College Bound, Cascade International and MiniScribe cases come quickly to mind. Many believe that a carefully planned and executed audit would have detected the alleged fraud.

Public confidence has been affected by the unpleasant fact that failed audits do occur. Audits are performed by people, and not all people are at their best all the time. A brilliant lawyer occasionally gives his client poor advice. A distinguished musician is not always at the top of his form. A professor known for his expository skills may deliver a flat lecture. Accountants and auditors also at times fail — no matter the extent of help their firms' quality control programs provide them.

Much of this erosion of confidence has been inextricably linked with the business and economic history of the 1980s.

LBOs, MBOs and other ingenious ways of restructuring enterprises resulted in complicated financial arrangements that often sowed the seeds of corporate disaster and taxed the skills of auditors.

## IMPROVEMENTS TO STANDARDS FOR FINANCIAL STATEMENTS AND AUDIT REPORTS

The deregulation of the financial industry led to new ways of doing business that stretched the ability of the accounting profession to keep up with the changes. New financial instruments proliferated, each presenting novel accounting challenges. It was difficult to determine how these assets and liabilities should be measured and classified. Financial regulators often tolerated non-traditional financial reporting practices to help the institutions under their authority stay open. The problems were compounded by the vast devaluation of property values which made shambles of many financial institutions' balance sheets. These developments created enormous problems for management and for accounting firms which were trying to value complex assets and account for transactions which they had never seen before.

All of these developments created huge risks for investors, lenders and auditors. Not surprisingly there were more bankruptcies and business failures than had been seen since the Great Depression of the 1930s. Much of the litigation referred to earlier in this Report arose out of the failures which flowed from these enormous risks taken during the 1980s by investors and creditors.

In many cases traditional financial reporting was unequal to the challenges posed. Often difficult accounting decisions had to be made for which there were no clear precedents. When many of the enterprises that participated in the euphoria of the "booming 80s" paid the price of their excesses, the auditor was usually among those charged with some involvement in the failure.

The events of the 1980s widened the "expectation gap" that was identified and described in the Report of the Commission on Auditors' Responsibilities (the Cohen Commission). In that report, the Commission said:

A number of surveys have been taken to determine what the public, or knowledgeable segments of it, expect of the independent auditor and how they interpret the audit function. Users of financial statements expect auditors to penetrate into company affairs, to exert surveillance over management, and to take an active part in improving the quality and extent of financial disclosure. In all of these areas, users seem to expect more than they believe they are receiving from the auditors. . . . Some segments of the public have an erroneous impression of the auditor's role. Several expectations are neither feasible to meet nor practical from a cost-effectiveness standpoint.<sup>21</sup>

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21 The Commission on Auditor's Responsibilities: Report, Conclusions and

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Since that report, the "expectation gap" has been extensively discussed in this country, the United Kingdom, Canada and other countries as well. The Commission to Study the Public's Expectations of Audits (the Macdonald Commission), created by the Canadian Institute of Chartered Accountants, pointed out that the "expectation gap" has a number of components. It wisely distinguished the "reasonable" public expectations from the "unreasonable" ones, and the "actual" shortfall in the performance of auditors from the "perceived" shortfall.

The Board believes these distinctions are useful in analyzing the "expectation gap" and the erosion of public confidence in the profession.

For instance, the Board believes it is unreasonable for users of audited financial statements to expect auditors to guarantee the honesty and integrity of the information contained in them. Similarly, auditors should not be expected to warrant that management is honest, competent, or honorable, or that the business will prosper or continue indefinitely in existence.

While the Board believes that a better understanding of the limits of financial statements and audits can do much to close the expectation gap, like the Cohen Commission, the Board believes the principal obligation for closing the gap rests with the profession and that only improved performance and an expansion of its responsibilities can close the gap to the extent necessary if the profession is to serve the public interest and satisfy the reasonable expectations of users of financial statements.

The Board believes that the users of audited financial statements must obtain some measure of additional assurance that the company's affairs are being conducted in accordance with specified laws (to the extent auditors have the ability to make such judgments); that the company's internal controls meet the criteria recently adopted by the Committee of Sponsoring Organizations of the National Commission on Fraudulent Financial Reporting; and that management is not manipulating its financial reports or committing other frauds.<sup>22</sup>

The Board believes the "expectation gap" can be narrowed and public confidence in the profession can be enhanced if:

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Recommendations 1-2 (1978) [hereinafter Cohen Commission].

22 It is interesting to note that until late in the last century detection of fraud was perceived by auditors, as well as their clients, as the principal purpose of an audit. Sikka, Puxty, Willmott & Cooper, Eliminating the Expectations Gap? 11-18 (1992).

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1. The profession improves its standards and practices, including particularly its ability to detect management fraud; and
2. Users of audited financial statements understand the inherent limitations of those statements through better disclosure.

With the hope of perhaps reducing the "unreasonable" expectations of users of audited financial information, the Board next discusses the characteristics of financial statements and audits and what users can reasonably expect from them. Subsequent sections of this chapter recommend measures which standard setters can take to improve understanding of the limitations of financial statements and the accountant's reports thereon. Chapter V includes recommendations intended to improve and strengthen the profession's performance.

### **Some Facts About Financial Statements and Audits**

Users of financial statements need to understand the nature of these statements, the limitations of GAAP, and the significance of the auditor's opinion. The "expectation gap" must be narrowed from the user's end as well as the auditor's. The Board offers the following brief explanation as a means of helping users understand the limitations of financial statements and audits.

#### Financial Statements —

are prepared under the control of the management of the reporting company;

are a mixture of hard data and uncertain estimates:

The accuracy of the estimates in financial statements generally depends on future events and developments.

The transactions that generate financial data and the necessity of estimates vary from simple to complex, repetitive to unique, few to multitudinous, familiar to innovative.

depend for their usefulness and reliability on the extent and quality of the controls within the company and the knowledge, skill and integrity of company officers and employees;

may rapidly decline in their relevance and reliability because of changing conditions within and without the reporting company or as a result of the continuing flow of transactions and other events that affect the company; and

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are only one of the many kinds of information necessary to make an informed judgment of the risk involved in an investment in, or extension of credit to, the reporting company.

### **An Audit in Accordance with Generally Accepted Auditing Standards Includes —**

an understanding and assessment by the auditor of the reporting company's internal controls to assess audit risk and to determine the extent of audit procedures;

an assessment of the likelihood that circumstances and conditions may induce officers or employees to make inappropriate or misleading financial presentations;

a comparison of samples of the asserted facts in the financial statements with documentary and other relevant evidence of transactions, events and conditions;

a review of the adequacy and appropriateness of management's assumptions about the future in arriving at estimates, and the appropriateness and apparent reasonableness of the reported estimates;

a search for material errors and irregularities in the financial statements; and

a responsible, professional, technical opinion on whether the financial statements examined present fairly, in all material respects, the financial position and the results of operations and cash flows of the entity in compliance with GAAP.

### **Generally Accepted Accounting Principles —**

are best understood as general instructions at a given point in time for the fair presentation of a company's financial position and results of operations;

have been developed over time and from broad experience;

take into consideration: (1) the nature of financial statements; (2) the difficulty of measuring financial position and the results of operations for active participants in a competitive, uncertain market economy; and (3) the important differences among enterprises, their situations, activities and conditions;

do not and cannot provide rules for measuring or disclosing every possible transaction in which enterprises engage or events to which they are subject; and

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because of the care essential in developing appropriate standards, unavoidably lag behind the innovativeness of entrepreneurs and those who advise them.

### An Audit Cannot Assure that —

the information reported in the financial statements will lead to successful investments; or

the operating results and the financial condition reported in the audited financial statements will continue into the indefinite future.

### Auditors' Opinions —

are directed to whether the auditor believes that the financial statements present fairly, in all material respects, the financial position and the results of operations and cash flows of the entity in compliance with GAAP, as of the date stated therein, not to the health, welfare and future success of the reporting enterprise.

The above summary demonstrates that the accounting and auditing process has inherent serious limitations. It would be desirable if such limitations did not exist; nevertheless, they do and they cannot be eliminated. Neither accountants nor auditors, nor anyone else, possess the expertise that would permit them to eliminate the uncertainties inherent in the estimates in financial statements or to forecast the future with unerring accuracy.

Recognizing this, the Financial Accounting Standards Board ("FASB") should develop a brief statement to accompany all financial statements prepared in accordance with GAAP that would indicate clearly the varying degrees of reliability of the information contained in the financial statements. Many users of financial statements do not sufficiently distinguish "hard" factual assertions from estimates and value assertions whose accuracy is largely dependent upon future events.

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### **Recommendation IV-1:**

The FASB should add to its agenda a project to design a brief statement explaining the limitations of financial statements. The explanation should be made a part of every set of financial statements described as being "in accordance with generally accepted accounting principles."

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## Criticisms of the Current Accounting Model

Another cause of erosion in the public's confidence in accounting is the increasing current criticism of the accounting model. When the FASB developed its "conceptual framework," some believed that the FASB was erecting a foundation of definitions oriented to the balance sheet, thus implying that a balance sheet (value) approach should displace the present income statement approach to accounting theory. That approach gave proponents of value accounting new life. However, the FASB reached no conclusion about whether financial statement amounts should be recorded at historical cost or current market values, and the matter remains unresolved to this date.

The FASB currently does not have a comprehensive project to decide the possible merits of value reporting, although such reporting is being considered with respect to certain assets in an FASB Exposure Draft issued in September 1992, "Accounting for Certain Investments in Debt and Equity Securities." Such current FASB projects as "Accounting by Creditors for Impairment of a Loan" and "Impairment of Long-Lived Assets, Identifiable Intangibles, and Goodwill" indicate the understandable difficulty that the FASB has in departing from transaction prices in measuring the information reported in financial statements.

It is entirely possible that comprehensive value reporting may not be suitable as a substitute for transaction prices in the accounting model. However, as long as the matter remains unsettled, those who argue for this substitution are encouraged to continue their criticisms with the result that users of financial reports are confused. Users don't understand why accountants cannot make up their minds.

As long as a constant flow of criticism directed at the present accounting model appears in journals and is espoused in speeches, the public will remain confused and its confidence in accounting will decrease. The Board takes no position on the issue of value based versus historical cost based accounting. It is, however, firmly in favor of having the issue resolved. Accordingly, the Board urges the FASB to deal with this matter comprehensively and immediately.

The Board understands that the AICPA has appointed a committee to study the future of financial reporting to better satisfy the needs of users in the future; so has the Financial Executives Institute. The Association for Investment Management and Research has recently issued a position paper entitled "Financial Reporting in the 1990's and Beyond."

**Recommendation IV-2:**

The FASB should add to its agenda a project to study comprehensively the possibility of requiring the reporting of values and changes in values rather than historical transaction prices, either as a basis to propose changes to financial accounting standards or to explain publicly why such a change in accounting standards is impractical or otherwise inappropriate. In carrying out this effort, the FASB should consider and take into account the conclusions of the AICPA, the Financial Executives Institute and the Association for Investment Management and Research studies with respect to the future of financial reporting.

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**Risks and Uncertainties**

Many believe that adequate disclosures relating to risks and uncertainties are envisioned by Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies," but the fact is that neither preparers nor auditors interpret that standard in a way that results in a clear statement from management describing the nature and extent of material risks and uncertainties. Financial statements as now prepared fall short in disclosing risks and uncertainties. The AICPA's Accounting Standards Executive Committee has developed a draft Statement of Position on disclosures in financial statements about risks and uncertainties that was recently cleared by the FASB for public exposure.

The Board believes that this matter is of vital importance. Although, to the Board's knowledge, no empirical research has been done to confirm this, it is the Board's belief that, had this statement been in effect before the thrift institution debacle, some of the charges made against thrift institutions and their auditors would have been avoided.

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**Recommendation IV-3:**

The AICPA's Accounting Standards Executive Committee should promptly adopt a Statement of Position providing guidance on, and requiring disclosure of information about, the nature of risks and

uncertainties associated with the reporting entity's operations and financial condition.

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### **Reporting on Sensitive Accounting Estimates**

The sufficiency and competence of evidential matter available to auditors to assess managements' assertions about sensitive valuation judgments and other estimates often do not reduce audit risk sufficiently to justify the degree of assurance provided in the auditor's report on historical financial statements. Many of these valuation judgments and estimates are the equivalent of a financial forecast and are based primarily on conditions expected to exist in the future and courses of action management expects to take. The following is an example.

The evidential matter available to the auditor to support a judgment about the carrying value of a financial institution's loan or equity participation in a real estate project under development is limited primarily to an evaluation of: (a) the developer's reputation and financial stability (which is usually dependent on the success of the project being considered); (b) assumptions on the marketability of the project; and (c) whether costs incurred to date are within budget.

If the auditor were requested to provide assurance to a third party in a separate financial presentation, this presentation would be cast as a financial forecast and the auditor's report would include a caveat that the prospective results are dependent on assumptions that may not be achieved. But the same situation when included in an historical financial statement usually results in the auditor expressing a clean opinion on the financial statements, including the valuation of this very uncertain project.

This variation in auditor assurance for similar situations cannot be justified. The financial collapse of many financial institutions resulted directly from their equity participations in, and loans to, real estate projects. The auditor's assurances about the value of these projects were the same as the assurances provided on the carrying value of the cash account, rather than the assurance that would accompany a forecast.

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#### **Recommendation IV-4:**

The Auditing Standards Board should revise the auditor's standard report to make the prospective nature of certain accounting estimates clear, including a caveat that the estimated results may not be achieved. This communication should not be written as a defen-

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**sive retrenchment by the auditing profession, but rather as a more realistic and reasonable explanation of the limitation of assurance that can be provided on certain accounting estimates.**

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In making these recommendations, the Board urges those involved to be ever alert to the dangers of creating expectations that cannot realistically be fulfilled by accounting and auditing. Efforts to assure that regulators, financial statement users and the general public have a sound understanding of what accounting and auditing can and cannot do will do much to answer allegations that accountants and auditors have failed in meeting public expectations.

## CHAPTER V

### OTHER RECOMMENDATIONS TO IMPROVE AND STRENGTHEN PERFORMANCE

*This chapter includes recommendations intended to improve the profession's performance by enhancing its capacity and willingness to detect fraud, strengthening professionalism and independence and by improving financial reporting.*

This chapter is not intended to set forth an exhaustive set of recommendations directed at improving public confidence in the accounting profession. There are other proposals for reform of the profession being discussed in this country and abroad which are not included here. Some would restructure the profession in radical ways, *e.g.*, there is a proposal by a group in the United Kingdom that companies not be permitted to select their auditors or negotiate their fees. The Board rejects this extreme proposal as unnecessary in this country.

However, the auditing profession must aggressively strengthen its role and performance in a rapidly changing society. If it does that, the "expectation gap" will surely narrow, the risks of litigation will recede and public confidence in the profession will increase.

The Board emphasizes that the process of improving public confidence in the profession must be ongoing. The profession should be constantly alert to ways to improve its performance and financial reporting and should be alert to areas where attest skills can improve the reliability of information provided to regulators and the public. The following recommendations are a start toward the goal of improved professional performance and improved financial reporting.

#### **Recommendations to Enhance the Detection of Management Fraud**

There has been considerable publicity about a number of recent alleged management frauds resulting in financial misstatements which have concealed financial distress or irregularities and have contributed to substantial economic losses by investors and creditors. These frauds have eroded the public's confidence in the audit function. Many observers question the value of an audit that does not detect material intentional misstatements.

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No problem confronting the profession is as demanding, or as difficult to resolve, as the problem of management fraud and its detection by auditors. Before the turn of the century both auditors and users of audited financial information regarded the detection of fraud as one of the primary purposes of an audit. For many reasons the profession has moved from acceptance of that purpose to the view that its role in detecting fraud is secondary to the other purposes of audits. In contrast, the public has continued to regard fraud detection as an important goal of the audit process — and now attaches even greater importance to that goal.

Auditing standards were strengthened in 1989 to require auditors, when performing an audit, to assess the risk that management fraud may cause the financial statements to be materially misstated. Based on that assessment, auditors are then required to design the audit and “exercise . . . the proper degree of professional skepticism to achieve reasonable assurance that material errors or irregularities will be detected.”<sup>23</sup> However, even a properly planned audit may not discover an entanglement of falsified records and documents or collusion between client personnel and third parties or among management and employees of the client — all of which are expressly designed to mislead the auditor. Moreover, when performing an audit the auditor does not have the benefit of investigatory subpoena power to discover fraud. Nor is the auditor able to threaten criminal or civil proceedings or draconian prison sentences to get admissions from at least some of the perpetrators. Nevertheless, the Board believes that the auditing standard, if properly implemented and followed, could enhance the detection of fraud. However, the Board understands that auditors are not consistently complying with this standard, and they are not sufficiently sensitive to the requirement that they exercise the proper degree of professional skepticism.

The Board believes there are other measures that can be taken to improve performance in this difficult area. The Board believes that, to a greater extent than it now does, the profession must accept responsibility for the detection of fraud by management. The profession cannot, and it cannot be expected to, develop methods that will assure that every fraud, no matter how cleverly contrived, will be unearthed in the course of the audit, but it must develop means of increasing significantly the likelihood of detecting fraud. Adoption of the Board’s recommendation to expand the QCIC’s mission to include a more careful analysis of the factors con-

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<sup>23</sup> 1 Codification of Professional Standards, U.S. Auditing Standards (AICPA) § 316.05-.08, at 245-2 (Jan. 1992).

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tributing to failed audits should lead to improved guidance to the profession on the detection of fraud. The Board also recommends that the profession develop comprehensive guidelines to further assist auditors in identifying symptoms that indicate the heightened likelihood of management fraud involving the manipulation of financial information and specify additional audit procedures when such symptoms appear. This undertaking should be broad in scope and include the development of guidance to facilitate the analysis of both financial data and non-financial factors that may be indicative of management fraud.

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### **Recommendation V-1:**

Accounting firms should assure that auditors more consistently implement, and be more sensitive to the need to exercise the professional skepticism required by, the auditing standard that provides guidance on the auditor's responsibility to detect and report errors and irregularities.

### **Recommendation V-2:**

The Auditing Standards Board, the Executive Committee of the SEC Practice Section or some other appropriate body should develop guidelines to assist auditors in assessing the likelihood that management fraud which may affect financial information may be occurring and to specify additional auditing procedures when there is a heightened likelihood of management fraud.

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## **Recommendations to Strengthen Independence and Professionalism**

### **Advocacy in Relationships with Clients**

Some of the criticism levelled at auditors implies that observers of the profession see the auditor as less than objective and independent. The Board urges the profession to give this subject its prompt attention.

As a start, the Board suggests that auditors consider the distinction between client advocacy and client service. Client advocacy might best be understood as a matter of attitude, a willingness to serve the immediate interests of the client company, or its management, in any way requested as long as the law permits that activity. Client service means serving the

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client company's best interests without coming into conflict with professional standards, the best interests of the audit function, or the auditor's best judgment.

Developing such a distinction and incorporating it into the profession's Code of Professional Conduct could do much to prevent any diminution of the auditor's independence.

Partners and staff members must be reminded constantly that the firm's reputation for independence is far more valuable than the fees obtained from any client. When firms were smaller and the firm's senior management could know every partner personally, the inculcation of professional attributes was a different matter than it is today. The sheer size of firms reduces the intimate knowledge that senior management once had of every partner. Without that knowledge, personnel evaluations become less personal and more statistical.

As a practical matter, independence depends largely on judgments made by the audit partners on the job. If partners are judged solely, or even primarily, on the basis of hours and dollars billed, the audit partner faced with a client who is demanding advocacy is not in the best position to uphold the firm's reputation for independence and objectivity. Mechanisms to aid and protect the partner faced with such decisions now exist within many firms engaged in auditing. Concurring partner review is one of them; requiring consultation is another. However, the Board believes that programs to strengthen the desire of each audit partner to protect the firm's independence are so important that constant review of the efficacy of these mechanisms, and their improvement where necessary, is a must.

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### **Recommendation V-3:**

The AICPA should undertake a project to sharpen further the distinction between client advocacy and client service and incorporate that distinction into the profession's Code of Professional Conduct. Individual accounting firms should constantly review their programs regarding client advocacy and client service to strengthen the desire of each audit partner to protect the firm's independence.

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### **Client Advocacy with Standard Setters and Regulators**

Stephen A. Zeff, a well-known accounting academic, has identified one form of client advocacy that he views as inappropriate — CPA firms acting as "hired guns" for their audit clients by helping them present their



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views to the FASB.<sup>24</sup> The Board is less troubled by this service — ghost-writing has long been an honorable profession — than by what some perceive as more pernicious developments; namely, allowing the views of major clients to bias a firm's ostensibly independent response to FASB discussion memoranda, invitations to comment and exposure drafts or to influence a firm to not take a contentious and complex issue to the Emerging Issues Task Force because of concern about getting the "wrong" answer. To the extent this more subtle and covert kind of client advocacy exists, it damages the standard-setting process and the interpretive process by denying those processes benefits that would otherwise be obtained from objective, well-reasoned and well-researched analyses of the issues. The mere perception that it exists damages the profession by lessening the regard that standard setters and the public have for auditors' independence, objectivity, and professionalism.

A belief that clients were able to unduly influence the views of auditing firm partners who sat on the Accounting Principles Board contributed to that organization's demise and replacement with the Financial Accounting Standards Board in the early 1970s. The problem is not a new one.

However, the Board's inquiries lead it to believe that while client advocacy of the nature described does on occasion occur, it is less frequent than critics think. Critics must realize that considering the thoughtful views of clients as well as others in reaching informed professional decisions about complex accounting issues is legitimate and proper; it should not be surprising that firms and their clients, even major clients, frequently arrive at similar conclusions independently.

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#### **Recommendation V-4:**

**Accounting firms should take special care to ensure that their participation in the standard setting process is characterized by objectivity and professionalism. Standard setters and leaders of the profession should discuss and address the issues related to client advocacy in the standard setting process and establish ways of identifying and correcting aberrant behavior when it occurs.**

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<sup>24</sup> Stephen A. Zeff, *The Decline of Professionalism*, 98 De Acct. NR (Netherlands) 264, 264-67 (Jan. 1992).

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Another potential for inappropriate advocacy on accounting matters occurs when an auditor supports a client's accounting policy with the SEC staff and that policy is clearly an unreasonable application of generally accepted accounting principles or is otherwise at odds with the economic reality of the underlying event or transaction. The Board has been advised that in most instances where this has occurred, it is typically the engagement partner who has acted as the client's advocate, and has done so without the benefit of appropriate consultation within his or her firm. The advocacy in these cases represents one individual's attitude and bias. When this type of unprofessional behavior occurs, it should be corrected by the firms involved.

The Board also believes that the SEC staff should recognize that there are many accounting issues on which reasonable people may disagree — that not every policy with which the staff disagrees is necessarily an instance of "creative" or "incredible" accounting or "clearly" at odds with the economic reality of a transaction. It is frequently in the public interest for clients with their auditors to discuss with the SEC staff the resolution of complex or unaddressed accounting issues.

The Board believes that both types of client advocacy it has described have the potential for reducing both the fact and appearance of objectivity and independence in performing audits; they also lower the perception of professionalism that standard setters, regulators and the public have of auditors. While the Board knows of no way to legislate objectivity and professionalism, it urges the leaders of the accounting profession to be constantly on the alert to this problem and to remind their colleagues periodically of the importance of manifesting objectivity and professionalism.

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### **Recommendation V-5:**

**Firms' consultation policies and procedures should ensure that client accounting issues are not discussed with SEC staff without the benefit of consultation at the appropriate level within the firm.**

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## **Recommendations to Improve Financial Reporting**

### **Determination of Accounting Treatment**

In many situations, accounting standard setters have not specified the appropriate method of accounting for a particular event or transaction. As a result, more than one accounting method appears to be available and ac-

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ceptable and at least a reasonable basis may exist for each of them. The views of management and the auditor may differ as to which of the permissible methods is preferable and management may not always be guided solely by a desire to provide a reliable financial report.

The Cohen Commission recognized that "deciding among alternatives in the absence of specific guidance is admittedly difficult," but it went on to note that "there are many examples of auditors relying on objective bases and making such judgments with skill and competence."<sup>25</sup> The Macdonald Commission of Canada expressed its belief that "the auditor has a particular responsibility, when faced with situations for which there is no clear precedent, to be satisfied that the accounting proposed is reasonable in relation to the substance or economic reality of the thing or transaction accounted for."<sup>26</sup>

In these situations, the U.S. auditing literature provides that the auditor "should consider whether the substance of transactions or events differs materially from their form" and, when possible, "to account for the [new type of] event or transaction on the basis of its substance by selecting an accounting principle that appears appropriate when applied in a manner similar to the application of an established principle to an analogous event or transaction."<sup>27</sup>

The Board believes that further emphasis on the appropriate application of accounting policies is needed.

When the need to select an accounting treatment arises in the context of an event or transaction that is new to a particular enterprise, the audit partner frequently, either as a matter of firm policy or voluntarily, consults with accounting experts at the office, regional or national level, as appropriate. In fact, the SEC Practice Section requires its members to adhere to the AICPA's quality control standards which provide, among other things, that "[p]olicies and procedures for consultation should be established to provide the firm with reasonable assurance that personnel will seek assistance, to the extent required, from persons

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25 Cohen Commission, *supra*, at 19.

26 Report of the Commission to Study the Public's Expectations of Auditors, Toronto: Canadian Institute of Chartered Accountants 58 (1988) [hereinafter Macdonald Report].

27 1 Codification of Professional Standards, U.S. Auditing Standards (AICPA) § 411.06 -.09, at 486-87 (Apr. 1992).

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having appropriate levels of knowledge, competence, judgment, and authority."<sup>28</sup>

Effective policies and procedures for consultation are more than a matter of complying with the quality control standards; they are also good business. Accounting firms should view the consultation process as the last line of defense on accounting issues that could be a cause of subsequent litigation. The Board's review of cases of alleged audit failure studied by the QCIC in recent years indicates that in many such cases consultation on accounting matters had occurred and the matters had been extensively considered and debated. In too many cases, however, the preference of client management — influenced at least in part by objectives other than producing the most reliable financial reporting possible in the circumstances — nevertheless prevailed over the preference of the auditing or consulting partner.

Implementation of the Macdonald Commission's recommendation relating to "economic substance" will be difficult without the benefit of hindsight. But it is clear that an accountant cannot identify "economic substance" if those whose views are sought in the consultation process do not know all the relevant facts and circumstances when giving their advice. QCIC inquiries suggest that this has happened on at least several occasions.

Among the membership requirements of the SEC Practice Section is second partner review of audits. This requirement has been strengthened through the years, largely at the behest of the Board. The Board is frankly puzzled as to why, if a truly thorough second partner review is conducted objectively, financial statements reflect some of the accounting judgments it sees as a result of its overview of the QCIC's activities.

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#### **Recommendation V-6:**

**The following recommendation of the Macdonald Commission should be adopted by the Auditing Standards Board in the United States:**

**When new accounting policies are adopted in response to new types of transactions or new kinds of assets or obligations, the**

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<sup>28</sup> 2 Codification of Professional Standards, Statements on Quality Control Standards (AICPA) § 90.13, at 17,221 (May 1984).

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auditor should be satisfied that the accounting policies adopted properly reflect the economic substance of the transaction, asset, or liability in accordance with the broad theory governing present-day financial reporting and the established concept of conservatism in the face of uncertainty.<sup>29</sup>

### **Recommendation V-7:**

Peer reviewers should evaluate the consultation process by which specific accounting conclusions are reached, as they do now, and should also inquire whether that process leads to accounting that is appropriate in the circumstances. In testing compliance with the consultation policies and procedures in a firm, the peer review team should evaluate the quality of the conclusions reached.

### **Recommendation V-8:**

The concurring partner, whose participation in an audit is a membership requirement of the SEC Practice Section, should be responsible for assuring that those consulted on accounting matters are aware of all of the relevant facts and circumstances, including an understanding of the financial statements in whose context the accounting policy is being considered. The concurring and consulting partners should know enough about the client to ensure that all of the relevant facts and circumstances are marshalled, and also possess the increased detachment that comes from not having to face the client on an ongoing basis. The concurring partner should have the responsibility to conclude whether the accounting treatment applied is consistent with the objectives of Recommendation V-6.

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## **Corporate Governance**

As the Treadway Commission rightly recognized, responsibility for fraudulent financial reporting does not rest only, or even principally, with the auditor. Every fraudulent financial statement for which an auditor has been held responsible was prepared by executives who were intentionally committing a fraud, not only upon their shareholders, investors and the markets, but also on the auditor as well. The responsibility of corporate boards and their audit committees for the integrity of management

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<sup>29</sup> Macdonald Report, *supra*, at 59.

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and financial reports should be pinpointed and reinforced and the appropriate authorities should adopt measures to assure that it is.

In the United Kingdom, the financial statements of a corporation are deemed to be the directors' statements. Because of the difficulties of maintaining litigation in that country against directors, directors have been willing to accept this responsibility. In the United States, the financial statements of an enterprise are statements of the entity. Directors may in some circumstances be liable for fraudulent or incorrect financial statements; however, rarely have there been holdings to that effect. The SEC requires that a majority of the directors of an issuer sign the Form 10-K which includes the issuer's audited financial statements; it is doubtful, however, whether this exposes directors to additional liabilities.

Most major publicly held corporations today have audit committees. A recent Korn/Ferry survey of 322 companies revealed that 98% of those responding had audit committees. The three major securities markets in this country — the New York Stock Exchange, the American Stock Exchange, and NASDAQ/NMS — all require listed companies to have audit committees made up entirely of outside directors or with a majority of outside directors.

In most corporations the responsibility for scrutiny of financial statements has been delegated by boards to their audit committees. The experience of the members of the Board indicates that in too many instances the audit committees do not perform their duties adequately and in many cases do not understand their responsibilities.

The Institute of Internal Auditors has embarked on a project to identify and publicize the best audit committee practices. The Board applauds this and hopes that this will provide clear and comprehensive guidance to audit committees in discharging their oversight responsibilities. Until that study is completed, the Board urges all audit committees to evaluate the scope and adequacy of their oversight activities to ensure that they are as comprehensive as those recommended by the Treadway Commission. The matrix included as Appendix E should assist audit committees in performing such an evaluation. In the Board's opinion, audit committees should assume defined responsibilities, as outlined in the recommendation set forth below.

To encourage audit committees or boards to fulfill such responsibilities and to inform investors whether audit committees or boards perform those responsibilities, the SEC should require registrants to include in a document containing the annual financial statements a statement by the audit committee or the board of directors as to whether its members have

#### OTHER RECOMMENDATIONS TO IMPROVE AND STRENGTHEN PERFORMANCE

reviewed the company's audited annual financial statements, have conferred with management and the independent auditor concerning them, have received from the auditor the information required to be communicated by the auditor,<sup>30</sup> and believe that the financial statements are complete and consistent with information known to them and reflect appropriate accounting principles. The Commission should reduce the exposure of members of the audit committee (or board) to liability by indicating that the report of the audit committee (or board) will not be deemed to be "soliciting material" or "filed" for purposes of Section 18 of the Securities Exchange Act of 1934. The recent action of the SEC with respect to compensation committee reports is a precedent for this.

The auditor should assist the audit committee and the board in understanding their responsibilities and the best practices to follow. The auditor should help the committee to assess its own performance and indicate the areas in which the committee's procedures could be strengthened. Not only would such auditor activity result in better financial reporting, but it would also reduce the danger of litigation against the auditor.

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##### **Recommendation V-9:**

**Audit committees (or the board if there is no audit committee) should assume the following responsibilities relating to an SEC registrant's preparation of annual financial statements: (a) review the annual financial statements; (b) confer with management and the independent auditor about them; (c) receive from the independent auditor all information that the auditor is required to communicate under auditing standards; (d) assess whether the financial statements are complete and consistent with information known to them; and (e) assess whether the financial statements reflect appropriate accounting principles.**

##### **Recommendation V-10:**

**The SEC should require registrants to include in a document containing the annual financial statements a statement by the audit committee (or by the board if there is no audit committee) that describes its responsibilities and tells how they were discharged. This**

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<sup>30</sup> 1 Codification of Professional Standards, U.S. Auditing Standards (AICPA) § 380.06 - .14, at 465-2 to 466 (July 1992).

## **OTHER RECOMMENDATIONS TO IMPROVE AND STRENGTHEN PERFORMANCE**

disclosure should state whether the audit committee members (or, in the absence of an audit committee, the members of the board): (a) have reviewed the annual financial statements; (b) have conferred with management and the independent auditor about them; (c) have received from the independent auditor all information that the auditor is required to communicate under auditing standards; (d) believe that the financial statements are complete and consistent with information known to them; and (e) believe that the financial statements reflect appropriate accounting principles.

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### **The Audit Committee and Audit Fees**

Often audit committees, in addition to recommending the election of auditors to the board of directors, also undertake to negotiate the auditor's fee. It is believed that on many such occasions the thrust of the committee's endeavor is to negotiate the lowest possible fee for the entity.

While it is legitimate for an audit committee to try to get a fair bargain for the entity, its overriding concern must be the quality of the audit, not the price charged for it. If an audit fee is negotiated at unrealistically low levels, it may lead to pressure on the engagement partner to reduce the cost of doing the audit; this may lead to "short cuts" and staff economies that adversely affect the quality of the audit. Even if the audit committee does not itself negotiate the auditor's fee, it should assure itself that the fee negotiated by management is fair compensation for a comprehensive and competent audit and will not impair the integrity of the audit. Audit firms have a related obligation to refuse to perform audit services for fees that may compromise the integrity of the audit.

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#### **Recommendation V-11:**

**The audit committee or the board of directors should be satisfied that the audit fee negotiated by it or management for the entity's audit is sufficient to assure the entity will receive a comprehensive and complete audit.**

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### **Reporting on Internal Control**

There is considerable enthusiasm in this country on the part of regulators and others for requiring corporate managements to include with their an-

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## OTHER RECOMMENDATIONS TO IMPROVE AND STRENGTHEN PERFORMANCE

nual financial statements an evaluation of the reporting company's internal controls. The SEC has an outstanding proposal which would require that management include in its annual report to security holders and its annual report on Form 10-K, among other things, an assessment as of the end of the most recent fiscal year of the effectiveness of the company's system of internal control and a statement as to how management has responded to any significant recommendations concerning the system of internal control which its internal auditors and independent accountants have made. Earlier versions of proposed legislation relating to financial fraud detection and disclosure included a provision that would have required independent accountants to evaluate whether their clients' internal accounting controls reasonably ensured, among other things, that receipts and expenditures are recorded and accounted for properly.

Present audit standards call for a review of internal controls to assess audit risk and to determine the extent of audit procedures. This review of internal controls is neither sufficient nor intended to provide a basis for the evaluation of the quality of the client's system of internal control.

The difficulties that management would experience in complying with the SEC's proposal and that the profession would face in complying with the legislative proposal are gradually being removed. The Committee of Sponsoring Organizations (those which sponsored the National Commission on Fraudulent Financial Reporting) recently published Internal Control — Integrated Framework which provides guidance on the components of a good system of internal controls over financial reporting. The AICPA's Auditing Standards Board is preparing performance and reporting standards for engagements providing for assurances about management assertions on internal controls over financial reporting.

When the Auditing Standards Board project is finished, it will be feasible to ask management to make a statement about the company's internal controls and for the auditor to comment on that statement. The Board believes that the SEC should then adopt the rule it has proposed for management reports on internal controls and, in addition, require auditors to express an opinion on management's assertions. 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.

## **OTHER RECOMMENDATIONS TO IMPROVE AND STRENGTHEN PERFORMANCE**

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### **Recommendation V-12:**

**The SEC should require registrants to include in a document containing the 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 registrant's independent accountant on the entity's internal control system relating to financial reporting.**

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In making this recommendation, the Board recognizes that this requirement may set the stage for another important expectation gap unless the scope and limitations of internal control systems are understood.

A company with an inadequate system of internal control may have excellent controls because its people are all honest, intelligent, well trained and highly motivated. Another company with an excellent system of internal control may be defrauded because its management overrides the system or because a number of officers or employees conspire skillfully to deceive the auditor.

Internal control, and internal control over financial reporting, may be terms that lend themselves to misunderstanding. To many, a satisfactory system of internal control means that the company is well managed. What investors and creditors want is assurance that they will suffer no loss on their investment. Thus they may be inclined to believe that if a company is reported to be "under satisfactory control," there will be no unpleasant surprises for investors.

Unless independent auditors explain clearly the extent of responsibility they are assuming when evaluating management's assertions about its internal control, there will be a serious gap between public expectations and audit performance.

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### **Recommendation V-13:**

**The Auditing Standards Board should establish standards that require clear communication of the limits of the assurances being provided to third parties when auditors report on the adequacy of client internal control systems.**

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### **Reporting Illegal Acts**

Congressmen John Dingell, Ron Wyden and Edward Markey have reintroduced in the present Congress the "Financial Fraud Detection and Disclosure Act" which would provide a mechanism for the establishment of auditing procedures designed to detect illegal acts and for reporting such findings to the SEC if the management of the enterprise and its directors fail to respond to the report by the auditors of its findings. The Board believes enactment of legislation to expand beyond the requirements of the present auditing standards the obligations of auditors with respect to the detection and reporting of illegal acts is desirable. Some commentators have suggested that the auditing procedures called for by the bill should, at least initially, be established by the Auditing Standards Board, which presently has the responsibility for establishing auditing standards in general. Others have suggested the bill does not provide adequate guidance since it does not reflect the limitations in the ability of auditors to recognize illegal acts when companies are subject to such a plethora of federal, state and local statutes. And still others believe the legislation should not be limited to illegal acts which may have a material effect on financial statements or that reporting should be confined to the SEC. The Board urges that these criticisms be candidly and fully discussed between those in Congress sponsoring the legislation and members of the profession, that a good faith effort be made to resolve them in the light of the public interest, and that then legislation be enacted to expand the obligation of auditors to seek out and report illegal acts.

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#### **Recommendation V-14:**

**The accounting profession should support carefully drafted legislation requiring auditors to report to the appropriate authorities, including the SEC, suspected illegalities discovered by the auditor in the course of an audit if the client's management or board of directors fails to take necessary action with respect to such suspected illegalities and the auditor believes that they are or may be significant to the entity. The profession should seek adequate guidance as to the types of illegalities that would be encompassed by this requirement.**

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**OTHER RECOMMENDATIONS TO IMPROVE AND STRENGTHEN PERFORMANCE**

**Continuing Professional Education**

One of the SEC Practice Section's membership requirements is that each professional in a member firm must receive a minimum of forty hours of continuing professional education each year. The requirement does not define the nature of the instruction that would satisfy this requirement. As a result, courses totally unrelated to auditing or even accounting can permit professionals involved in an accounting and auditing practice to meet the requirement. Seminars on how to manage a practice, how to prepare tax returns, how to build a practice and so on now qualify.

Since this requirement was intended to improve audit quality, the membership requirement should require for professionals involved in an accounting and auditing practice that a substantial number of those hours must be spent in courses relating to accounting and auditing.

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**Recommendation V-15:**

The SEC Practice Section's membership requirements relating to continuing professional education should be revised to require that a substantial number of the required hours of continuing education relate to accounting and auditing.

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## CONCLUSION

The Board recognizes that at first glance it may appear that some of its recommendations, particularly those pertaining to reporting on internal controls and the institution of additional measures to detect fraud, will result in increased audit costs and greater threats of auditor liability. The Board believes that, while the costs of reports by auditors on internal controls may entail an increase in audit expense, such expense is necessitated by the public interest. The additional protections afforded by such reports and the implementation of additional measures to detect fraud will provide substantial benefits to shareholders that should, in the long run and in the aggregate, substantially exceed the out-of-pocket costs associated with those recommendations.

As for additional exposure of auditors to liability, the Board does not believe its recommendations will have that result; on the contrary, the implementation of its recommendations should reduce the likelihood of faulty audits and thereby reduce the risk of liability. Further, the recommendation that auditors report on a client's internal controls is coupled with another recommendation that such reports clearly communicate the limits of the assurances provided by the reports.

The Board has sought to avoid "aspirational" recommendations, such as that auditors should be more concerned with their professionalism, their independence, etc. Rather, it has sought to frame proposals that urge identified groups and entities to take specific actions to implement the proposals. Such an approach facilitates monitoring and measuring the activity of the profession and its bodies, as well as others, including Congress and the SEC, in effecting the changes urged.

The Board believes that its recommendations, if adopted, will go far to restore public confidence in the accounting profession and will bring the work of the profession closer to the public's expectations of the profession. These recommendations should also result in a reduction in the profession's exposure to liability.

The challenge to any profession to improve its performance is a constant and continuing one. The profession must be sensitive to changes in the public's expectations of it and should promptly respond to those expectations the profession can reasonably satisfy. It must be alert to changes in the environment in which it works — regulatory, legal and economic — so that it may take measures promptly to safeguard its integrity and reputation. The accounting profession must be willing to extend the embrace of its unique attestation function to the new kinds of informa-

## CONCLUSION

tion that management, investors, creditors and others are demanding and are using.

In its meetings with the present and emerging leaders of the profession, the Board senses a concern for the future of the profession, but more importantly, also sees a willingness to confront and conquer the challenges, present and future, that face and will face the profession. The Board, to the extent that its mandate permits, hopes to assist the profession in meeting those challenges, for as they are met responsibly the public interest to which the Board is committed will be well served.

# **RECOMMENDATIONS OF THE PUBLIC OVERSIGHT BOARD**

## **TO CONGRESS**

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### **Recommendation I-1:**

**Financial responsibility among those involved in a financial failure or in fraudulent financial reporting should be allocated in proportion to responsibility for losses suffered. Accordingly, "separate and proportionate" liability legislation applicable to both federal and state claims should be enacted by Congress. The civil liability provisions of RICO should be amended to eliminate treble damages in cases that arise under the federal securities laws.**

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### **Recommendation I-2:**

**Congress should adopt preemptive legislation to permit the practice of accountancy in a form that appropriately limits the liability of individual members of the firm.**

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## **TO THE SECURITIES AND EXCHANGE COMMISSION**

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### **Recommendation II-1:**

**The SEC should amend its rules to require SEC registrants to disclose whether their auditors have had a peer review, the date of the most recent peer review and its results.**

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### **Recommendation V-10:**

**The SEC should require registrants to include in a document containing the annual financial statements a statement by the audit committee (or by the board if there is no audit committee) that describes its responsibilities and tells how they were discharged. This disclosure should state whether the audit committee members**

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## RECOMMENDATIONS OF THE PUBLIC OVERSIGHT BOARD

(or, in the absence of an audit committee, the members of the board): (a) have reviewed the annual financial statements; (b) have conferred with management and the independent auditor about them; (c) have received from the independent auditor all information that the auditor is required to communicate under auditing standards; (d) believe that the financial statements are complete and consistent with information known to them; and (e) believe that the financial statements reflect appropriate accounting principles.

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### Recommendation V-12:

The SEC should require registrants to include in a document containing the 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 registrant's independent accountant on the entity's internal control system relating to financial reporting.

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## TO THE SEC PRACTICE SECTION OF THE DIVISION FOR CPA FIRMS

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### Recommendation III-1:

The SEC Practice Section's membership requirements should be changed to require member firms to modify their quality control systems to specify that they take the following steps in response to allegations of deficiencies in the conduct of an audit of financial statements of an SEC client (or another client encompassed by the QCIC process) that are made in litigation against the member firm or its personnel, or in any public proceeding or investigation by a regulatory agency:

- (1) Perform a complete internal analysis of the audit; review all relevant work papers, correspondence and other files; interview members of the engagement team.



**RECOMMENDATIONS OF THE PUBLIC OVERSIGHT BOARD**

- (2) Assess the capabilities of the senior audit personnel and determine whether the firm should monitor, reassign or terminate such personnel.**
- (3) Identify any problems with the firm's quality control system or training activities.**
- (4) Identify any implications of the allegations relating to the adequacy of auditing, quality control or accounting standards.**
- (5) Identify any implications of the allegations relating to the adequacy of guidance with respect to the manner in which audits are conducted, including the evaluation of risks in audits, and relating to variations in practice and the interpretations of standards that should be resolved.**
- (6) Communicate the implications identified in items (4) and (5) in a structured manner to the QCIC.**

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**Recommendation III-2:**

The peer review performance standards should be amended to require peer reviewers to test firms' compliance with these modifications to their quality control systems.

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**Recommendation III-3:**

The QCIC procedures should be modified to require the QCIC to develop additional procedures to permit it, on the basis of its analysis of the QCIC cases and the information reported to it under the expanded membership requirements discussed above, to facilitate the resolution of unresolved audit practice issues and to formulate, either by itself or in collaboration with other appropriate bodies, practice and guidance directions to the accounting profession in a retrievable format such as EITF Abstracts, which present issues considered by the FASB's Emerging Issues Task Force.

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**Recommendation V-7:**

Peer reviewers should evaluate the consultation process by which specific accounting conclusions are reached, as they do now, and

**RECOMMENDATIONS OF THE PUBLIC OVERSIGHT BOARD**

should also inquire whether that process leads to accounting that is appropriate in the circumstances. In testing compliance with the consultation policies and procedures in a firm, the peer review team should evaluate the quality of the conclusions reached.

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**Recommendation V-15:**

The SEC Practice Section's membership requirements relating to continuing professional education should be revised to require that a substantial number of the required hours of continuing education relate to accounting and auditing.

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**TO THE FINANCIAL ACCOUNTING STANDARDS BOARD**

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**Recommendation IV-1:**

The FASB should add to its agenda a project to design a brief statement explaining the limitations of financial statements. The explanation should be made a part of every set of financial statements described as being "in accordance with generally accepted accounting principles."

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**Recommendation IV-2:**

The FASB should add to its agenda a project to study comprehensively the possibility of requiring the reporting of values and changes in values rather than historical transaction prices, either as a basis to propose changes to financial accounting standards or to explain publicly why such a change in accounting standards is impractical or otherwise inappropriate. In carrying out this effort, the FASB should consider and take into account the conclusions of the AICPA, the Financial Executives Institute and the Association for Investment Management and Research studies with respect to the future of financial reporting.

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**RECOMMENDATIONS OF THE PUBLIC OVERSIGHT BOARD**

**TO THE AICPA'S ACCOUNTING  
STANDARDS EXECUTIVE COMMITTEE**

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**Recommendation IV-3:**

The AICPA's Accounting Standards Executive Committee should promptly adopt a Statement of Position providing guidance on, and requiring disclosure of information about, the nature of risks and uncertainties associated with the reporting entity's operations and financial condition.

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**TO THE AUDITING STANDARDS BOARD**

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**Recommendation IV-4:**

The Auditing Standards Board should revise the auditor's standard report to make the prospective nature of certain accounting estimates clear, including a caveat that the estimated results may not be achieved. This communication should not be written as a defensive retrenchment by the auditing profession, but rather as a more realistic and reasonable explanation of the limitation of assurance that can be provided on certain accounting estimates.

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**Recommendation V-6:**

The following recommendation of the Macdonald Commission should be adopted by the Auditing Standards Board in the United States:

When new accounting policies are adopted in response to new types of transactions or new kinds of assets or obligations, the auditor should be satisfied that the accounting policies adopted properly reflect the economic substance of the transaction, asset, or liability in accordance with the broad theory governing present-day financial reporting and the established concept of conservatism in the face of uncertainty.

**RECOMMENDATIONS OF THE PUBLIC OVERSIGHT BOARD**

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**Recommendation V-13:**

The Auditing Standards Board should establish standards that require clear communication of the limits of the assurances being provided to third parties when auditors report on the adequacy of client internal control systems.

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**TO THE AICPA AND ACCOUNTING FIRMS**

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**Recommendation V-1:**

Accounting firms should assure that auditors more consistently implement, and be more sensitive to the need to exercise the professional skepticism required by, the auditing standard that provides guidance on the auditor's responsibility to detect and report errors and irregularities.

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**Recommendation V-2:**

The Auditing Standards Board, the Executive Committee of the SEC Practice Section or some other appropriate body should develop guidelines to assist auditors in assessing the likelihood that management fraud which may affect financial information may be occurring and to specify additional auditing procedures when there is a heightened likelihood of management fraud.

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**Recommendation V-3:**

The AICPA should undertake a project to sharpen further the distinction between client advocacy and client service and incorporate that distinction into the profession's Code of Professional Conduct. Individual accounting firms should constantly review their programs regarding client advocacy and client service to strengthen the desire of each audit partner to protect the firm's independence.

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RECOMMENDATIONS OF THE PUBLIC OVERSIGHT BOARD

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**Recommendation V-14:**

The accounting profession should support carefully drafted legislation requiring auditors to report to the appropriate authorities, including the SEC, suspected illegalities discovered by the auditor in the course of an audit if the client's management or board of directors fails to take necessary action with respect to such suspected illegalities and the auditor believes that they are or may be significant to the entity. The profession should seek adequate guidance as to the types of illegalities that would be encompassed by this requirement.

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**TO ACCOUNTING FIRMS**

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**Recommendation V-4:**

Accounting firms should take special care to ensure that their participation in the standard setting process is characterized by objectivity and professionalism. Standard setters and leaders of the profession should discuss and address the issues related to client advocacy in the standard setting process and establish ways of identifying and correcting aberrant behavior when it occurs.

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**Recommendation V-5:**

Firms' consultation policies and procedures should ensure that client accounting issues are not discussed with SEC staff without the benefit of consultation at the appropriate level within the firm.

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**Recommendation V-8:**

The concurring partner, whose participation in an audit is a membership requirement of the SEC Practice Section, should be responsible for assuring that those consulted on accounting matters are aware of all of the relevant facts and circumstances, including an understanding of the financial statements in whose context the accounting policy is being considered. The concurring and consult-

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## RECOMMENDATIONS OF THE PUBLIC OVERSIGHT BOARD

ing partners should know enough about the client to ensure that all of the relevant facts and circumstances are marshalled, and also possess the increased detachment that comes from not having to face the client on an ongoing basis. The concurring partner should have the responsibility to conclude whether the accounting treatment applied is consistent with the objectives of Recommendation V-6.

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### TO AUDIT COMMITTEES

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#### Recommendation V-9:

Audit committees (or the board if there is no audit committee) should assume the following responsibilities relating to an SEC registrant's preparation of annual financial statements: (a) review the annual financial statements; (b) confer with management and the independent auditor about them; (c) receive from the independent auditor all information that the auditor is required to communicate under auditing standards; (d) assess whether the financial statements are complete and consistent with information known to them; and (e) assess whether the financial statements reflect appropriate accounting principles.

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#### Recommendation V-11:

The audit committee or the board of directors should be satisfied that the audit fee negotiated by it or management for the entity's audit is sufficient to assure the entity will receive a comprehensive and complete audit.

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## APPENDICES

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## APPENDIX A

### Biographies of Board Members

#### **A.A. Sommer, Jr., Chairman**

A.A. Sommer, Jr., Chairman, joined the Board in 1983 and was elected Chairman in 1986. Mr. Sommer served as Commissioner of the SEC from 1973 to 1976 and is currently a partner in the Washington, D.C. office of the law firm of Morgan, Lewis & Bockius, specializing in securities law. He is a member of a host of legal and civic organizations and has actively served such organizations in various capacities, such as advisor, trustee, committee chairman and member. He is currently on the Board of Governors of the National Association of Securities Dealers, Inc. and was formerly a member of the boards of the American Bar Association and the American Institute of Certified Public Accountants and a member of the Financial Accounting Standards Board Advisory Council. He is a member of several boards of directors of public companies and is a frequent lecturer and author on corporate, securities, and accounting subjects.

#### **Robert K. Mautz, Vice-Chairman**

Robert K. Mautz, Vice-Chairman, joined the Board in 1981. Mr. Mautz is Professor Emeritus of the University of Illinois and the University of Michigan. He is a member of the Accounting Hall of Fame, past President of the American Accounting Association, and former editor of the Accounting Review and Accounting Horizons. He has been awarded the Gold Medal, the AICPA's highest honor, and the American Accounting Association's Outstanding Educator Award. He is a renowned author of textbooks and technical articles. His service contributions include member of the AICPA Committee on Auditing Procedure, AICPA Council and Board of Directors, Commission to Study the Common Body of Knowledge for CPAs, Cost Accounting Standards Board, Financial Accounting Standards Advisory Council and Chairman of the Governmental Accounting Standards Board Organization Committee.

#### **Robert F. Froehlke**

Robert F. Froehlke joined the Board in 1987. Mr. Froehlke served as Assistant Secretary of Defense for Administration from 1969 to 1971, and was appointed Secretary of the Army in 1971. He is currently a Director



### **Biographies of Board Members**

of the Institute for Defense Analyses, in addition to being a director of several other corporate and civic organizations. He is past president of the American Council of Life Insurance, past Chairman of the Board of Directors of Equitable Life Assurance Society of the U.S. and currently is President and CEO of IDS Mutual Fund Group.

#### **Melvin R. Laird**

Melvin R. Laird became a member of the Board in August 1984. Mr. Laird served as Representative in the U.S. Congress from Wisconsin for nine terms, as Secretary of Defense from 1969 to 1973, and as Counsellor to the President for Domestic Affairs from 1973 through 1974. He is a member of several corporate boards of directors and over sixty boards of directors of civic organizations. He has received many honors, including the U.S. Medal of Freedom, the Order of Merit (Federal Republic of Germany), the Legion of Honor (France), Man of the Year Awards by the American Cancer Society and National Association of Mental Health, the Military Order of the Purple Heart, and the Lasker Award for Medical Research. He currently serves as Senior Counsellor for National and International Affairs for the Reader's Digest Association and is Chairman of the Board of the Communications Satellite Corporation.

#### **Paul W. McCracken**

Paul W. McCracken joined the Board in 1985. Mr. McCracken served as a member of the President's Council of Economic Advisers from 1956 to 1959 and as its Chairman from 1969 to 1971. He also served President Reagan as a member of the Economic Policy Advisory Board. Since 1948, he has been a member of the faculty of the School of Business Administration at the University of Michigan, and in 1966 was appointed the Edmund Ezra Day Distinguished University Professor. He has served as a director on several corporate boards, authored many papers and monographs on economic and financial policy, and frequently lectured and participated in national and international economic commissions, task forces and conferences.

## **APPENDIX B**

### **THE ACCOUNTING PROFESSION'S SELF-REGULATORY PROGRAMS**

**T**he SEC Practice Section ("SECPS" or the "Section") was founded in 1977 as part of the Division for CPA Firms of the American Institute of Certified Public Accountants ("AICPA") and is overseen by the Public Oversight Board (the "Board" or the "POB").

The Section imposes membership requirements and administers two fundamental programs to ensure that SEC clients are audited by accounting firms with adequate quality control systems: (1) peer review, through which Section members have their practices reviewed every three years by other accountants, and (2) quality control inquiry, which reviews allegations of audit failure contained in litigation filed against member firms relating to SEC clients and certain other entities to determine if the firms' quality control systems require corrective measures.

Currently, the requirements of the SECPS affect more than 105,000 professionals at 1,214 member firms, which audit more than 14,750 SEC clients.

#### **The Peer Review Process**

Each member firm is required to subject its quality control system to review by independent peers at least once every three years. A peer review evaluates: (1) whether a firm's system of quality control for its accounting and auditing practice is appropriately comprehensive and suitably designed for its needs; (2) whether its quality control policies and procedures are adequately communicated to professional personnel; (3) whether such policies and procedures are being complied with; and (4) whether the firm is complying with the membership requirements of the SECPS.

#### **General Considerations in a Peer Review**

Administration of the Peer Review Program is the responsibility of the Section's Peer Review Committee. The committee establishes the standards for performing and reporting on peer reviews, enforces compliance by review teams with its standards, evaluates the reports on individual peer reviews and the suitability of action plans to correct quality control deficiencies submitted by reviewed firms prior to inclusion in a publicly

## THE ACCOUNTING PROFESSION'S SELF-REGULATORY PROGRAMS

accessible file, and follows up as necessary to assure that appropriate corrective action is taken by firms.

### **The Review Team**

A review team may be appointed by the Peer Review Committee, may be formed by a member firm engaged by the firm under review or may be formed by an association or state CPA society authorized to administer peer reviews. Only partners of SECPS member firms currently involved in the audit function are eligible to serve as review team captains. Members of the review team must be independent of the reviewed firm. Reciprocal reviews between firms are not permitted.

Review teams must have knowledge of the type of practice to be reviewed, including knowledge of the specialized industries of the reviewed firm's clients. In the case of firms with SEC practices, review team personnel must possess current knowledge of SEC rules and regulations.

### **Performing the Review**

A peer review has four distinct phases:

1. Study and evaluation of the firm's quality control system;
2. Review for compliance with the firm's quality control policies and procedures at each organizational or functional level within the firm, including review of workpaper files and reports for selected accounting and auditing engagements;
3. Review of the firm's compliance with membership requirements of the SECPS; and
4. Preparation of a written report and, where applicable, a letter on matters that require corrective action by the firm.

### **Extent of Review Team's Tests**

Careful planning is required to determine the extent of tests to be performed. In planning the review, the review team obtains an understanding of: (a) the nature and extent of the reviewed firm's accounting and auditing practice, including, for example, whether the clients are in troubled industries or have weak financial reporting systems, which are factors increasing the likelihood that the financial statements of such clients may not be presented in accordance with generally accepted accounting principles; and (b) the design of the firm's quality control policies and procedures, including, for example, whether the firm's personnel are expected to use, and are trained to use, industry specific practice aids to re-

## THE ACCOUNTING PROFESSION'S SELF-REGULATORY PROGRAMS

duce the possibility that materially deficient financial statements could go undetected after application of the firm's quality controls.

After assessing those risks and considering the findings of the firm's current year's inspection (the review that the firm performs of its own practice), the review team determines the offices and engagements to be reviewed to reasonably assure that the review would detect the presence of deficiencies in the firm's quality controls, which, should they exist, would expose the firm to a serious possibility that its engagements might not be conducted in accordance with professional standards. The offices and engagements to be reviewed are a reasonable cross-section of the firm's practice with greater emphasis on those offices and engagements with the highest levels of risk.

The effectiveness of the firm's inspection program may affect the selection process of the review team. For example, fewer offices and engagements may have to be reviewed by the review team if tests of the firm's inspection indicate that the review team may appropriately combine peer review and inspection findings in evaluating the design of a firm's quality control system and compliance therewith.

The objectives of the review of engagements are to obtain evidence that: (1) the reviewed firm's system of quality control met the objectives of quality control standards to the extent applicable to the firm's practice; (2) there was compliance by personnel of the firm with the firm's quality control policies and procedures in the performance of accounting and auditing services; and (3) there was compliance with the Section's membership requirements. For each engagement reviewed, the review team documents its conclusions as to whether anything came to its attention to cause it to believe that: (a) the financial statements were not presented in all material respects in accordance with generally accepted accounting principles; (b) the firm did not have a basis under professional standards for the report issued; (c) the documentation did not support the report issued; or (d) the firm did not comply with its quality control policies and procedures in all material respects.

While the thrust of a peer review is to identify deficiencies in a firm's system of quality control, the process also identifies engagements deemed not to have been performed in accordance with professional standards. These are reported to the Peer Review Committee, which follows up to ascertain that appropriate action is taken, for example, reports are recalled and financial statements restated or the omitted audit procedures are performed to ascertain whether the financial statements should be restated.

## **Reporting on Peer Reviews**

### **Peer Review Report**

The review team's report includes a statement of the scope of the review, a description of the general characteristics of a system of quality control, and the team's opinion — or a disclaimer of opinion — as to whether the reviewed firm's quality control system is adequate and was being complied with to provide the firm with reasonable assurance of conforming with professional standards and the membership requirements of the Section.

The review team's report may be either unqualified or modified. An unqualified report is issued when the review team is satisfied with the firm's quality control system and its compliance with that system and the membership requirements of the Section and a modified report is issued when the review team is not satisfied. A modified report may express a qualified opinion or an adverse opinion, or it may include a disclaimer of opinion. A qualified opinion identifies significant deficiencies in the system or in compliance with the system. An adverse opinion indicates that the system is not adequate, that compliance is not adequate, or both. A disclaimer of opinion is issued when limitations placed on the scope of the peer review are so significant that the review team cannot form an overall opinion.

### **Letter of Comments**

While a letter of comments always accompanies a modified report, a letter is also issued with unqualified reports when the review team discovers conditions that create more than a remote possibility of nonconformity with professional standards or discovers noncompliance with quality control policies and procedures or membership requirements at a level that requires corrective action. Letters of comment have accompanied unqualified reports for approximately 80% of the reviews conducted.

The reviewed firm is required to respond in writing to each item in the letter of comments. Its response describes actions taken or planned with respect to each deficiency or recommended improvement noted.

The Peer Review Committee carefully considers the deficiencies discussed in a letter of comments and the firm's response thereto as part of its evaluation of the appropriateness of an unqualified report or its decision whether a qualified opinion or an adverse opinion is appropriate when a firm is found to have significant deficiencies in its system or in its compliance with the system. These evaluations and discussions require

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mature and thoughtful judgment because there are no quantitative criteria that can be used to measure the significance of perceived deficiencies.

### **Peer Review Committee Supervision**

The committee's role in the peer review process is an active one. No report is official until the committee accepts it. Every report, letter of comments and accompanying response receive the attention of the committee. If there is an apparent inconsistency between a review team's findings in the peer review workpapers and its report or letter of comments, the committee pursues the matter until resolved.

In certain circumstances, the committee accepts a report only upon agreement by the firm in writing to stipulated conditions, such as a revisit by the review team captain to review the actions taken to eliminate deficiencies uncovered in the review. In this manner, the committee assures that recommended improvements in quality are carried out.

### **Public Access to Peer Review Reports**

Upon acceptance by the committee, the review team's report and letter of comments, together with the reviewed firm's response, are maintained in files available to the public at the AICPA offices in New York City. When a report is accepted only based upon a firm's agreement to a stipulated condition, relevant correspondence to that effect is also placed in the public file.

### **POB and SEC Oversight**

The staff of the Public Oversight Board (the "Board" or the "POB") directly oversees each peer review by evaluating the review team's qualifications, by reading the report, letter of comments and the firm's response, by reviewing selected workpapers and by participating in the meetings at which the committee processes the peer reviews. The staff also conducts direct oversight of many peer reviews of firms with SEC clients and reviews all the peer review workpapers of firms with SEC clients that it does not visit. As a result of recommendations of the POB's staff, changes are often made in the composition of review teams, scope, report or letter of comments, and in the corrective measures firms are required to take. In addition, the Board and its staff review and comment on or propose changes in peer review standards and the operating procedures of the committee and its staff. The Board's oversight of the process has led it to conclude that the peer review process is effective in fostering audit quality among SECPS member firms.

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The SEC performs its own independent evaluation of the peer review process and Board oversight. The staff of the Chief Accountant inspects a sample of peer review workpapers and the corresponding Board oversight workpapers. As a result, the SEC has said that "the peer review process contributes significantly to improving the quality control systems of member firms and, therefore, should enhance the consistency and quality of practice before the Commission."

### **The Quality Control Inquiry Committee Process**

#### **Mission of the Quality Control Inquiry Committee (QCIC)**

The Executive Committee of the SECPS established the QCIC in recognition of the significant public interest that exists in determining promptly whether an allegation of audit failure against a firm indicates any of the following defects that should be promptly corrected: (1) a weakness in the firm's quality control system or in compliance with that system; or (2) the need for changes in generally accepted auditing standards, accounting principles, or quality control standards.

The courts and other judicial, regulatory, and governmental bodies have the means to determine whether allegations of audit failure are correct, and if so, to punish firms and individuals, when appropriate under the law. The prompt inquiry that the QCIC makes concerning reported alleged failures provides a means to identify and correct defects in quality control, a task which the courts and other bodies are ill-equipped to, and do not, perform.

#### **Requirement to Report to the QCIC**

Member firms are required to report to the QCIC within 30 days of service any litigation (including criminal indictments) against the firm or its personnel or any investigation publicly announced by a regulatory agency that alleges deficiencies in the conduct of an audit of the financial statements or reporting thereon of a present or former SEC client or a bank or other lending institution client for which another regulator has been vested with the powers, functions and duties of the SEC.

In addition, if the committee identifies a significant public interest in an alleged audit failure not required to be reported, the Executive Committee of the Section may require the firm to report the matter. In this regard, the QCIC screens all allegations of audit failure made by federal or state governmental agencies concerning the audits of financial institutions that are not SEC clients and requests firms to voluntarily report such matters that appear to warrant further consideration.

### **Four-Phased Approach**

A task force, usually consisting of one or two committee members and AICPA staff persons, is assigned to each case. The task force proceeds in accordance with procedures specified in the document entitled, Framework for the Evaluation Process of the SECPS Quality Control Inquiry Committee, which specifies that the QCIC conduct its procedures in four distinct phases:

- Analysis of Allegations;
- General Inquiries Concerning a Firm's Quality Control Policies and Procedures and Compliance Therewith;
- In-Depth Inquiries Concerning a Firm's Quality Control Policies and Procedures and Compliance Therewith; and
- Special Review.

The assigned task force continues from one phase to the next in the process until satisfied that there is nothing to be gained by continuing further. That is, the evidence available is sufficient to persuade the task force that nothing significant is to be accomplished in the way of public protection by continuing the inquiry.

#### **Analysis**

This phase consists of reading the complaint(s), relevant financial statements and other publicly available materials related to the complaint, and informal telephone inquiry with the firm.

#### **General Inquiries**

This phase consists of a discussion of the issues raised in the litigation that may have quality control implications with representatives of the firm and, if deemed appropriate, its peer reviewers. This phase may include reading peer review workpapers or internal inspection reports.

#### **In-Depth Inquiries**

This phase consists of a discussion of relevant quality control policies, procedures and compliance with firm personnel who have become familiar with the specific engagement; reviewing firm technical manuals and guidance materials; and reading certain audit documentation.

It also may include timely inspection of other work performed by certain personnel. Under this procedure, which was adopted in 1991, the QCIC may require firms to perform a timely inspection of other work performed by individuals who supervised an audit that resulted in allega-



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tions of audit failure to enable the committee to better assure that these individuals are complying with the firm's quality control system.

### Special Review

This phase consists of reviewing relevant aspects of quality control policies and procedures and compliance therewith, following procedures similar to those applied in a peer review. There are five types:

- A review of other engagements supervised by personnel who supervised the allegedly faulty audit;
- A review of selected engagements in the same industry;
- A review of an office or offices;
- A review of selected engagements with unique transactions or conditions; and
- A review of the entire system—in effect, an accelerated peer review.

The type of review performed, its scope and the reviewers selected are determined on a case-by-case basis.

### Closed Case Summary

The QCIC closes its files on a case when it concludes that there is no need for action by the firm beyond whatever measures may have already been taken. After the committee closes a case, it prepares a "closed case summary" describing its consideration of the matter, the issues addressed, the procedures followed and the basis for the QCIC's conclusions. This summary is retained until the staff of the Chief Accountant of the SEC has reviewed it.

### **POB and SEC Oversight**

The POB and its staff monitor the activities of the QCIC and have unrestricted access to the committee's files as well as to all meetings of the committee and its task forces. The Board's staff reads the complaint, pertinent financial statements, other public documents and relevant professional literature for each reported case. The POB is represented at every committee meeting and its staff participates, at its discretion, in most of the task force meetings with representatives of firms reporting litigation.

The SEC also oversees the QCIC process and the POB oversight of it. For each closed case, the SEC reads the closed case summary and the POB's oversight work program and the SEC staff meets with the POB and

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QCIC staff to obtain further information, if necessary, about the basis for the committee's conclusions concerning any case.

### Sanctions Against Member Firms

The Executive Committee of the SECPS has the authority to impose sanctions on member firms, ordinarily based on recommendations of the Peer Review Committee or the QCIC. The decision to impose a sanction is based on the vote of a hearing panel and, if necessary, the vote of an appeals panel in accordance with rules of procedure for such proceedings. Experience to date has shown that the formal imposition of a sanction has rarely been necessary, because the objectives of the Section have been achieved through the voluntary cooperation of member firms in undertaking remedial or corrective action when deficiencies are found.

Formal sanctions may be imposed when a member firm:

- Refuses to abide by the membership requirements;
- Refuses to cooperate with the Peer Review Committee or take corrective action recommended as a result of a peer review;
- Refuses to cooperate with the QCIC or take corrective action recommended by that committee; or
- Commits an egregious act for which corrective action is an inadequate response.

To date the only type of formal sanction that has been imposed has been expulsion; however, the following additional types of sanctions may be imposed for failure to comply with the requirements of membership:

- Corrective measures by the firm including consideration by the firm of appropriate actions with respect to individual firm personnel;
- Additional requirements for continuing professional education;
- Accelerated or special peer reviews;
- Admonishment, censure or reprimand;
- Monetary fines; or
- Suspension from membership.

Following the imposition of a sanction, a copy of the documents setting forth the sanction is placed in the member firm's public file and the name of the member firm and the decision rendered is published in an AICPA membership periodical.

### SECPS Membership Requirements

To maximize the participation in the SECPS by firms auditing publicly held companies, an AICPA bylaw provides that a certified public accountant engaged in the practice of public accounting with a firm auditing one or more SEC clients may retain membership in the AICPA only if the firm in which he or she practices is a member of the SEC Practice Section.

An accounting firm that is a member of the Section must meet membership requirements. Compliance with them is tested in the peer review process. A member firm must:

- Adhere to quality control standards established by the AICPA;
- Have a peer review every three years, the results of which are available to the public;
- Require all professionals in the firm — not just CPAs — to take part in 120 hours of continuing professional education every three years;
- Periodically rotate the partner in charge of each SEC audit engagement;
- Conduct a concurring, or second partner, preissuance review on each SEC audit engagement;
- Report annually to the audit committee or board of directors of each SEC audit client on the fees received from the client for management advisory services during the year under audit and on the types of services rendered;
- Report to the QCIC any litigation against the firm or its personnel that alleges deficiencies in an audit of an SEC client or regulated financial institution;
- Report directly to the SEC the termination of any client-auditor relationship with an SEC client within five business days; and
- Report annually, for the Section's public files, the number of firm personnel, the number of SEC clients, data about MAS fees and other information.

## **APPENDIX C**

### **NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.**

#### **I. Structure**

The National Association of Securities Dealers, Inc. (the "NASD") is a national securities association registered with the Securities and Exchange Commission (the "SEC") pursuant to the provisions of the Securities Exchange Act of 1934 (the "Exchange Act"). As such, it has been given the responsibility to secure compliance by its members with the rules of the NASD and the specific requirements of the federal securities laws, as well as to promote fair trade and high ethical standards for commercial conduct among its members. The NASD's main role is self-regulation of its membership through a continuous program of rulemaking, interpretation, and surveillance and enforcement of its rules, trade practices and ethical standards through its disciplinary process.

#### **A. Membership**

While membership in the NASD is voluntary, for practical purposes, with very narrow exceptions, it is impossible to conduct a securities business and deal with the public without being a member of the NASD. Membership is generally open to any broker or dealer authorized to transact an investment banking or securities business in the United States. The membership of the NASD is nationwide and includes virtually all broker-dealers.

For administrative purposes, the NASD membership is divided into eleven geographical districts. Members in all districts are subject to various fees and assessments, including an assessment on gross income. These fees are a principal source of the NASD's funding.

#### **B. Board of Governors**

The management and administration of the NASD are under the direction of the board of governors (the "Board"). The Board's duties include: (1) the determination of national policy; (2) the promulgation of rules and interpretations of those rules; (3) the supervision of the performance of its own committees and the executive staff in the administration and enforcement of Board policies and the NASD rules; and (4) the appellate review of the NASD disciplinary actions.

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The Board is comprised of twenty-nine members, consisting of fifteen members elected from the securities industry, thirteen at large members representing issuers, members, underwriters, and insurance companies, and the President of the NASD. Board members are elected for three-year terms. With the exception of the President, who serves as the spokesman for the NASD, all members of the Board serve without compensation. They are, however, reimbursed for reasonable expenses associated with meetings.

### **C. National Business Conduct Committee**

The Board has the authority to appoint committees to assist it in connection with the management of the business and affairs of the NASD. One such important committee is the National Business Conduct Committee (the "NBCC"). The principal objective of the NBCC is to ensure that disciplinary actions taken by the NASD's District Business Conduct Committees (the "DBCC"), discussed below, are consistent with NASD policy, and that sanctions imposed are consistent with those imposed in similar cases.

The members of the NBCC are chosen annually by the Board from the pool of sitting Board members; they are usually first year members of the Board. Currently, there are eight members of the NBCC.

### **D. District Committees**

The district committees in each of eleven geographic districts administer the NASD's affairs at the local level. Each district committee consists of a number of members who are active participants in the securities or investment banking business and are elected for three-year terms.

The district committees sit as the DBCCs responsible for the NASD's enforcement programs in the respective districts. The DBCCs' duties include: (1) the review of all examination reports submitted by the NASD examiners in its district; (2) the investigation of all complaints against members and persons associated with members; (3) the conduct of disciplinary proceedings; and (4) the issuance of decisions and imposition of sanctions in response to complaints filed by or with the DBCC's.

Typically, the full district committee serves as the DBCC. The only distinction between the district committees and the DBCCs is that the title, "District Business Conduct Committee," is used in all disciplinary proceedings.

## **E. NASD Staff**

The NASD maintains a staff at offices in each of the eleven geographic districts and has an executive office in Washington, D.C. Each district functions as a regional office and is staffed by a district director, mid-level supervisors, and a complement of examiners.

The NASD district staff functions are to obtain the necessary information for the DBCC to enable it to determine whether, in a given case, a disciplinary proceeding should be instituted; to administer the NASD's examination and inspection programs; and, once apparent violations have been detected, to act in a prosecutory capacity in connection with the ensuing disciplinary proceeding.

## **II. Operations**

### **A. Disciplinary Process**

#### **1. NASD Staff Investigations**

In connection with its efforts to detect possible violations of its rules and the applicable provisions of the federal securities laws, the NASD maintains a comprehensive surveillance program. The program includes two general categories of examinations: (1) routine; and (2) special.

Of the approximately 10,000 examinations conducted by the NASD in 1991, 2,600 were routine examinations. All members of the NASD are subject to a routine examination at least once every three years. Members who maintain custody of client funds are subject to such an examination annually.

A routine examination typically includes a financial/operational review and a review of sales practices. The financial/operational portion of the examination consists of an inspection of: (1) the member firm's books and records; (2) controls relating to supervision within the member's organization; and (3) various other areas of the member's business. A routine examination is not as extensive as the typical financial statement audit, and may have a duration anywhere from a day to a week depending upon the size of the firm being examined.

The sales practices portion of the routine examination varies depending on the types and volume of products sold by the member. The inspection generally focuses on the handling of

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customer accounts, including the suitability of investments, and whether customers are provided with adequate and timely information concerning their investments.

In addition to routine examinations, the NASD staff conducted approximately 7,400 special examinations in 1991. Special examinations generally originate from two sources: (1) customer complaints; and (2) reported terminations of registered representatives "for cause" by their member employers. In each case the scope of the special examination is limited to obtaining specific information about the apparent violations alleged in the complaint, or the facts surrounding the dismissal of the registered representative. In 1991, approximately 3,700 special examinations were conducted in response to each of these two categories.

The NASD staff's role in both types of examinations is to gather all relevant information for review by the DBCC. The staff, however, has no subpoena power and may not compel third parties to provide information or documents. Moreover, the cost of the examination is borne by the NASD.

Upon completion of the examination, the staff prepares a written report setting out the results of its inquiry and presents it to the DBCC. In the case of routine examinations, the NASD has a uniform form of report which is prepared for each product offered by the examinee. These reports are the basis for the DBCC determination as to whether a disciplinary action should be initiated.

## **2. The Disciplinary Hearing**

### **a. Complaint and Answer**

If the DBCC concludes that the member has violated the NASD rules or the federal securities laws, the DBCC may file a complaint against the member or associated person. Complaints may also originate from the Board or the general public. In 1991, approximately 1,000 formal and informal disciplinary actions were filed against NASD members or persons associated with them.

Common allegations contained in the DBCC complaints include sales practice violations such as churning or sharing in customer profits/losses, fraudulent or improper trade re-

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porting/practices, as well as other practices such as misappropriation or misuse of customer funds or securities.

The respondent must file with the DBCC a written answer to the charges in the complaint within twenty days from the date of receipt of the notice unless the time is extended by the DBCC. The answer is required to be on the NASD form, a copy of which accompanies the complaint when delivered to the respondent.

In order to assure the opportunity to present a defense in a hearing, the respondent must request a hearing before the DBCC at the same time the answer is submitted. If the respondent fails to do so, the right to a hearing may be deemed to be waived. In addition, if the respondent fails to answer the complaint within ten days after receiving a second notice, the DBCC may consider the allegations of the complaint as admitted by the respondent and impose the appropriate penalties.

**b. Jurisdiction and Venue**

The DBCC has original jurisdiction in handling all complaints. Normally complaints are heard by the DBCC of the district in which the principal office of the NASD member is located. In cases in which the claim arose entirely or largely from the acts or omissions of a branch office of a broker-dealer, however, the case is heard by the DBCC of the district in which the branch office is located.

**c. Pretrial Discovery**

As noted above the NASD has no subpoena power. The DBCC may, however, prior or subsequent to a filing of a complaint, require a member to submit a report on the activities in question and to open its books, records, and accounts for inspection. The refusal of a member to supply such information during the course of an investigation of a complaint may result in a violation of the NASD rules.

In addition, if the complaint concerns a customer of the respondent or a financial institution, the NASD will frequently request the submission of information by such person, whether or not such party is a member of the NASD. Obviously, for non-members, responding to the request is purely voluntary. The NASD staff, however, has found that such re-



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quests are frequently successful so long as the respondent has not previously settled its dispute with the third party.

The NASD rules do not provide for any prehearing discovery by the respondent. They do, however, require the staff of the NASD, upon request, to make available to the respondent a list of the witnesses, schedules, documents, and other exhibits in the NASD's possession which it intends to use at the hearing to support the allegations in the complaint. Moreover, the respondent has the right to formally request the NASD staff to utilize its inspection power to obtain additional information which the respondent believes is needed to present its defense.

Evidence obtained by the NASD staff in connection with a hearing, including the NASD staff report, is for reasonable cause made available by the NASD to other regulatory bodies, including the SEC. Private parties occasionally subpoena the NASD or its staff in an attempt to obtain the NASD staff report or other information for the purposes of private litigation. The NASD's policy has been to review each subpoena on a case-by-case basis. When in the opinion of the NASD the equities favor nondisclosure, the NASD will attempt to defeat the subpoena as a matter of principle.

**d. The Hearing**

After the response to the complaint is filed and a hearing is requested, and assuming a settlement is not negotiated, a hearing before the DBCC is scheduled. A typical DBCC hearing has seven stages: (1) the hearing begins with an opening statement by the designated chairman of the panel setting forth the ground rules for the hearing; (2) the NASD staff or complainant presents an opening argument; (3) the respondent presents an opening argument; (4) the NASD staff or complainant presents its case-in-chief, followed by cross-examination by the respondent; (5) the respondent presents evidence, followed by cross-examination by the NASD staff or complainant; (6) the NASD staff or complainant presents its closing argument; and (7) the respondent presents its closing argument.

The complainant or the NASD has the burden of showing a prima facie violation of the NASD rules by the respondent.

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Accordingly the NASD staff presents its case first. If the staff is considered to have made a successful showing, the burden of going forward shifts to the respondent.

NASD hearings are much more informal than a typical court hearing, with the DBCC having a wide latitude as to all phases of the conduct of the hearing. The panel members of the DBCC assigned to hear the case (typically two or more current or former members of the DBCC) are usually not lawyers but industry peers of the respondent. The NASD staff is typically represented by NASD regional counsel, who take the prosecutorial role in the proceedings and present evidence against the respondent.

Rules of evidence relevant to court proceedings are generally not applicable to the DBCC hearing. For example, testimony in the hearings is not under oath and may be offered telephonically; hearsay evidence is considered; documentary evidence will generally be received into evidence without complying with the foundational requirements applicable in court proceedings; and objections to the form of questions are rarely sustained.

Notwithstanding the lack of courtroom formalities in the DBCC hearing, the respondent is entitled to certain basic rights including: (1) the right to be heard in person and be represented by counsel at a hearing; (2) the right to cross-examine witnesses; and (3) the right to present a defense. In addition, the respondent may successfully object to the introduction of evidence if cumulative or irrelevant.

The length of the DBCC hearings vary depending upon the complexity of the issues. Approximately eighty percent of the DBCC hearings involve fairly routine matters and are completed within four to six hours. The remaining twenty percent of hearings are more complex in nature, include multiple charges, and may result in a hearing lasting several days. Hearings extending beyond a week are extremely rare. Over the last four years there have been a total of approximately five multiple week hearings.

**e. The Decision**

Any determination reached in connection with a complaint, whether or not a hearing is held, must be incorporated in a

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written decision and must set forth the specific findings of the DBCC. In 1991, 1031 decisions were issued, compared with 1044 in 1990.

All decision findings must include: (1) an enumeration of the specific rule or rules violated; (2) an explanation of the act or practice which the respondent has been found to have engaged in or omitted; (3) the basis upon which the findings are made; and (4) the penalties imposed and the reasons therefore. If the DBCC finds that no violations have occurred, a written decision to that effect is usually prepared by the NASD staff in consultation with the DBCC.

**3. Sanctions**

The NASD has a broad range of sanctions at its disposal which may be imposed for each or any violation of the NASD rules or federal securities laws by a member or a person associated with a member. These sanctions include: (1) censure; (2) imposition of a fine; (3) suspension from membership or registration; (4) expulsion from membership or revocation of registration; (5) suspension or bar from association with all members; and (6) any other sanction deemed appropriate under the circumstances.

Censure is typically imposed for any violation of the NASD rules or federal securities laws. A censure without other additional sanctions is generally imposed for violations not requiring the imposition of more severe sanctions or in situations where extraordinary mitigating factors exist.

Fines of any amount may be imposed upon a member or person associated with a member. While the highest fine imposed against any individual in 1990 was \$510,083, in 1991 the NASD levied a \$2,250,000 fine against a single registered representative and imposed fines in several cases against member firms and individuals in excess of \$1,000,000.

The suspension of a member or a person associated with a member may result in that member or person being unable to engage in certain aspects of the securities business for a period of time specified in the decision. Thus, the suspension may be limited to only specific activities. At the end of the period of the suspension, the member or person is reinstated in good standing, assuming all fines and costs assessed with the decision have been paid.

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The expulsion of a firm from membership in the NASD and the bar of an individual from future association with a member are the most severe sanctions in the NASD's arsenal. These sanctions result in a member firm being excluded from the securities business or a person associated with a member being barred from employment with a member.

In addition to the above sanctions, any member or person associated with a member who is disciplined by the NASD may be assessed costs of the proceedings. These costs may include expenses involved with preparing transcripts of the proceeding and other hearing related expenses. Moreover, the NASD frequently orders the respondent to pay restitution to any injured third party.

Monies which the NASD actually obtains through the imposition of sanctions generally amount to an insignificant percentage of the NASD's total annual funding.

#### **4. Appellate Review**

##### **a. Board of Governors**

The Board has appellate jurisdiction over all decisions of the DBCCs. Any party aggrieved by a decision of the DBCC, as a matter of right, may appeal the decision to the Board. Such appeal must be made within fifteen days after the date of notice of the decision unless the Board grants an extension. In 1991, approximately 200 cases were appealed to the Board. Practically all complex cases involving multiple claims are appealed.

In addition, the Board has the authority, on its own motion, to call for review any decision issued by a DBCC. The Board must exercise its right of review within forty-five days from the date of issuance of the DBCC's decision.

The Board has designated the NBCC as the committee to administer the NASD's disciplinary program and to exercise appellate review authority. Consequently, every decision by each of the eleven districts of the NASD is reviewed by the NBCC. The purpose of such review is to determine whether the decision is consistent with NASD policy and whether the sanctions imposed, if any, are consistent with the seriousness

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of the violations found and with sanctions imposed in similar cases.

On appeal the Board, acting through the NBCC, has the authority to: (1) affirm, dismiss, modify or reverse dismissals with respect to each of the DBCC findings; (2) increase, reduce, modify, or cancel any disciplinary action taken by the DBCC; or (3) remand the case with instructions for further proceedings. In any event, the institution of an appeal or review automatically stays any disciplinary sanction.

The Board's appellate powers are subject to limitations in that the Board may not consider grounds other than those fairly derived from the complaint as a basis to impose or affirm a sanction.

In connection with the review by the NBCC, the parties, if they participated in the DBCC proceedings, are again given the opportunity for a hearing and may appear by counsel or in person. The Board has wide flexibility concerning the conduct of the appeal hearing. The Board may render its decision based on the record before it and may review, with some limitations, evidence not previously considered but which the Board deems relevant to the appeal. In any event, the Board conducts a de novo review of the matter. Thus, a respondent has the opportunity at the NBCC level for a full review of the matter including the right to reargue his case.

Upon rendering its decision, the Board is required to provide written notification of the results of its decision to the respondent. In addition, if the decision of the Board is not appealed to the SEC, notice of the decision is issued to the press and the membership of the NASD after the Board's decision becomes effective. If, on the other hand, the Board's decision is appealed to the SEC, the Board will generally delay notice of its decision until it receives notice of the appeal from the SEC, so that the fact of the appeal may also be publicized.

**b. Appeal to the SEC**

Any person aggrieved by disciplinary action of the NASD may have such action reviewed by the SEC. Approximately twenty percent of all DBCC decisions are ultimately appealed to the SEC. In 1991 alone, approximately thirty cases were appealed to the SEC, and eighteen decisions were is-

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sued. The SEC has generally been reluctant to disturb either the major findings of violations or imposition of sanctions, choosing to affirm virtually every decision of the Board.

On appeal the SEC may: (1) affirm; (2) set aside, reduce, or otherwise modify the findings and sanctions imposed; or (3) remand the case to the NASD for further proceedings. Notably, the SEC does not have the authority to increase the sanctions imposed by the NASD.

An application for review of the NASD disciplinary action by the SEC is required to be filed by the aggrieved person within thirty days from the date notice of such action was received unless a longer period is permitted by the SEC. The SEC, on its own motion, may also initiate review proceedings.

Unless the SEC orders otherwise, the institution of review proceedings does not operate to stay automatically the disciplinary sanctions which are the subject of the review. As a matter of practice, the NASD does not enforce fines or suspensions pending SEC review, but does seek to enforce bars or expulsions from membership. The aggrieved person must, therefore, apply to the SEC for consideration of a stay of bars or expulsion orders.

An application to the SEC for review does not grant a right to a completely new evidentiary hearing. The scope of the hearing is wholly within the discretion of the SEC. Typically, the hearing will consist solely of consideration of the record of the NASD and opportunity for the presentation of supporting reasons to affirm, modify, or set aside the sanction, or to dismiss the proceeding. In certain circumstances, the SEC may direct that the record under review be supplemented with additional evidence. In any case, the SEC conducts a de novo review of each matter.

In arriving at its decision the SEC is required by statute to apply a two-tiered standard of review. In connection with the first tier, the SEC must review the record to determine if the findings of violations by the NASD are supported by the evidence. If the SEC determines that the applicant did not in fact exhibit such conduct as found or that the conduct did not violate the designated rule, then the SEC must set aside the action taken by the NASD or remand the matter to the NASD

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for further proceedings. Conversely, if the SEC finds that the applicant engaged in the conduct found by the NASD and that such conduct violated the NASD rules designated or the federal securities laws, then the SEC proceeds to the second level of its review process. Under the second tier, if the SEC finds the sanction imposed by the NASD imposes any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act, or is excessive or oppressive, it may reduce, cancel, or require the remission of such sanction.

Any final order of the SEC is released to the press and to the NASD membership by the NASD, upon receipt by the NASD of the SEC order.

**c. Appeal to the Courts**

Any person aggrieved following a decision by the SEC may appeal the decision to the appropriate United States Court of Appeals. Three such appeals were filed in 1991. Such appeals must be filed within sixty days after entry of the SEC's order.

**B. Relationship to the SEC**

The Exchange Act provides the SEC with the following powers over the NASD: (1) to review any disciplinary action imposed by the NASD; (2) to abrogate any rule of the NASD or require the NASD to adopt a rule of the SEC; (3) to disapprove any change in the rules proposed by the NASD; and (4) to suspend or revoke the NASD's registration if it fails to enforce compliance with its own rules.

The SEC has no regular program for the examination of broker-dealers. The SEC, however, monitors the NASD's examination process. In addition, the SEC has on occasion chosen to conduct its own examinations or conduct joint examinations with the NASD upon discovery of widespread or systematic problems in the industry. A recent example occurred in 1991, when the SEC and the NASD conducted, on a cooperative basis, special examinations of the activities of franchise offices of certain penny-stock broker-dealers.

The SEC also receives copies of every decision rendered by the NASD and may call up for review any disciplinary action taken by the NASD. Finally, the SEC reviews annually the NASD's assessment schedule to determine whether it is fair and equitable.

## APPENDIX D

### NATIONAL TRANSPORTATION SAFETY BOARD

The National Transportation Safety Board (the "NTSB" or the "Board") is an independent agency that determines the "probable cause" of transportation accidents and promotes transportation safety through the issuance of safety recommendations.<sup>31</sup>

The NTSB also conducts safety studies; evaluates the effectiveness of other government agencies and transportation safety programs; and reviews appeals of adverse actions by the United States Department of Transportation involving pilot and mariner certificates and licenses.

In an attempt to prevent accidents, the NTSB develops and issues safety recommendations to other government agencies, industry and other organizations that it believes are in a position to improve transportation safety. The recommendations are always based on the NTSB's investigations and studies.

The NTSB is responsible for investigating all aviation accidents. In some cases, the NTSB delegates the investigation to the Federal Aviation Administration (the "FAA"). The NTSB, however, remains responsible for determining the "probable cause" of the accident.

#### Structure

##### ■ Management

The NTSB is managed by five board members, who are assisted by the offices of the managing director, public affairs, congress-

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<sup>31</sup> The National Transportation Safety Board (the "NTSB") has the statutory authority to, among other things, make: "[P]eriodic reports to the Congress, Federal, State, and local agencies concerned with transportation safety, and other interested persons recommending and advocating meaningful responses to reduce the likelihood of recurrence of transportation accidents similar to those investigated by the Board and proposing corrective steps to make the transportation of persons as safe and free from risk of injury as is possible, including steps to minimize human injuries from transportation accidents; . . . special studies and special investigations on matters pertaining to safety in transportation including human injury avoidance; [and] . . . techniques and methods of accident investigation and prepare and publish from time to time recommended procedures for accident investigations. . . ."



## NATIONAL TRANSPORTATION SAFETY BOARD

sional and intergovernmental relations, safety recommendations and general counsel.

### ■ Board Members

The board members are full-time federal governmental employees appointed for five year staggered terms by the President with the advice and consent of the Senate. No more than three board members may be of the same political party. Moreover, at least three of the five board members must have some expertise in the fields of accident reconstruction, safety engineering, human factors, transportation safety or transportation regulation. The duties of all board members include: (1) establishing policy on transportation safety issues and problems, and on Board goals, objectives and operations; (2) reviewing and approving all accident reports and safety recommendations; and (3) presiding over hearings and testifying before congressional committees.

The President with the advice and consent of the Senate also designates individual board members to serve as chairman and vice chairman of the NTSB for two year terms. The chairman is the chief executive officer of the NTSB. The responsibilities of the chairman include: (1) appointing and supervising personnel employed by the NTSB; (2) distributing NTSB business among personnel and among administrative units of the NTSB; and (3) the use and expenditure of NTSB funds. The vice chairman acts as chairman in the event of the absence or incapacity of the chairman or in the case of a vacancy in the office of the chairman.

### ■ Office of Managing Director

The office of managing director implements the NTSB's programs by coordinating the day-to-day operations of the NTSB staff. Responsibilities include: (1) scheduling and managing the board members' review of major reports; and (2) providing executive secretarial services.

### ■ Office of Public Affairs

The office of public affairs is responsible for keeping the public informed on the work of the NTSB and its efforts to improve transportation safety. Responsibilities include: (1) answering questions from the public, the news media, and the transportation industry; (2) coordinating media coverage of major accident sites; and (3) disseminating safety information to increase public awareness of the NTSB's activities.

### ■ Office of Congressional & Intergovernmental Relations

## NATIONAL TRANSPORTATION SAFETY BOARD

The office of congressional & intergovernmental relations keeps Congress and federal, state, and local government agencies informed on the NTSB's efforts to improve transportation safety. Responsibilities include: (1) responding to oral and written inquiries and addressing problems and concerns raised by the Congress and other governmental entities; and (2) preparing testimony for board member participation at Congressional hearings and providing various information on legislation at the federal, state and local government levels.

### ■ Office of Safety Recommendations

The office of safety recommendations helps to ensure the NTSB issues appropriate and effective recommendations for enhancing safety in all transportation modes. This includes: (1) coordinating various safety recommendation programs; and (2) developing other programs to increase acceptance of the NTSB recommendations.

### ■ Office of General Counsel

The office of general counsel provides legal advice on policy, legislation, the NTSB rules, and other legal matters. This includes: (1) assisting the Department of Justice in representing the NTSB in court proceedings; and (2) providing legal assistance and guidance to the above offices regarding hearings, appearances as witnesses and the taking of depositions.

## The Party System

Investigations are conducted by the "party system." Under the party system the NTSB staff directs the investigation, but allows all parties with a legitimate interest in the investigation (excluding lawyers) to participate in the process. For example, if the investigation involves an airplane crash in which engine failure is a possible cause, members of the investigative team may include representatives of (1) the manufacturer of the engine; (2) the manufacturer of the airplane; (3) the air traffic controllers union; and (4) the pilots union. All parties are present during each step in the investigation and receive copies of all factual information produced.

On occasion, the NTSB will contract with a third party to assist in the investigation. For example, if the NTSB's lab is unavailable, it may hire an independent lab to assist in the examination. The work of any independent party, however, is directly supervised by the staff and observed by the other members of the party system.

## NATIONAL TRANSPORTATION SAFETY BOARD

### The Investigation

As an investigation begins for the NTSB, the staff in charge instructs all members of the party system (the "Parties") that opinions and speculation as to the cause of the accident are not to be discussed. At the conclusion of each day of the on-site investigation, the Parties attend progress meetings in which they are provided the opportunity to share information. The NTSB staff prevents the discussion from including opinions or speculation as to the causes of the accident.

Prior to the conclusion of the on-site investigation, each specialized group within the investigation party prepares a "group report" summarizing the factual information discovered, which is shared with all of the Parties. The NTSB monitors the content of the reports to ensure that they exclude any opinions or speculation as to the cause of the accident.

The analysis of the accident, the findings, the determination of probable cause and the letters of recommendations resulting from the investigation are prepared by the NTSB staff, and are approved by the NTSB board before becoming publicly available. Of these items, only a draft of the analysis and letters of recommendation may be shared with the Parties before they are finalized and made available to the public. Any member of the party system who disagrees with the NTSB board's analysis or recommendations may prepare a written dissent, which is made publicly available.

### The Public Docket

The "public docket" for each investigation is stored on microfiche and available for public viewing at the public inquiries office of the NTSB. All confirmed factual information including the group reports, witness statements, mechanical reports, interviews and other materials obtained from the investigation is placed in the public docket.<sup>32</sup> Such information, as well as any other factual information resulting from the investigation, is generally admissible as evidence in litigation.

As noted above, the analysis of the accident, the determinations of probable cause and the letters of recommendation are done solely by the NTSB staff. This is true even when the investigation is delegated to the FAA. Once approved by the NTSB, the analysis, the determination of

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<sup>32</sup> Prior to being placed in the "public docket" this information is made available to the public at the scene of the accident in connection with daily news briefings conducted by the NTSB.

## NATIONAL TRANSPORTATION SAFETY BOARD

probable cause and the recommendations become part of the Board's final report and are also included in the public docket. This part of the report, however, generally is not admissible as evidence in actions for damages.

### The NTSB Reports

Every NTSB investigation results in a final report.<sup>33</sup> The reports are generally disseminated to the public through the press.<sup>34</sup>

The NTSB also distributes the reports to hundreds of government agencies, associations, manufacturers, operators and others who the Board believes would be in a position to prevent the recurrence of the accident.<sup>35</sup> Each division of the NTSB maintains a database of potential report recipients.

### Effects of the NTSB With Respect to Litigation

NTSB activities have been claimed to reduce litigation. The NTSB believes that its open process puts pressure on all parties to fix problems which may lead to accidents. Thus, they believe that as problems are corrected, accidents decrease, and litigation becomes less frequently necessary.

Uncertainty exists as to the effect of the Board's probable cause determinations on the outcome of private litigation. Examples do exist when the party found responsible by the NTSB was exonerated by the court. One example is the Exxon Valdez accident. Although the NTSB report found that Captain Hazelwood's impairment from alcohol intoxication was a factor in the "probable cause" of the accident, at trial the jury acquitted Hazelwood of the charge of operating a vessel while intoxicated.

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33 The NTSB report may consist of as little as a two-page summary if the investigation has been delegated to the FAA.

34 To provide a sense of this information, a NTSB aircraft accident report may include sections entitled: Factual Information; Analysis; Conclusions including Findings and Probable Cause; and Recommendations. The "Factual Information" may include the crew's composition, relevant medical factors, communication issues, injuries to persons and previous Board actions, among other topics. The "Analysis" may include information from the relevant manufacturer and various considerations by the NTSB.

35 For example, a report concerning a highway accident may include distribution to the National Association of Driver's Education Instructors and to auto insurance companies.

## APPENDIX E

### AUDIT COMMITTEE GUIDELINES

**T**he Report of the National Commission on Fraudulent Financial Reporting (Treadway Commission) contained recommendations to improve the effectiveness of audit committees.

This appendix includes practical tools that audit committees may find useful in evaluating the scope and adequacy of their oversight activities to ensure that they are as comprehensive as recommended by the Treadway Commission.

The first portion of the appendix is drawn from proposals contained in the Treadway Commission's report and the remaining portion is based on appendices I and K of that report.

TREADWAY COMMISSION PROPOSALS	BENEFITS	COMMENTARY	RECOMMENDED ACTION
<p><b>1. Code of Corporate Conduct</b>  <i>Recommendation:</i> Public companies should develop and enforce written codes of corporate conduct. Codes of conduct should foster a strong ethical climate and open channels of communication to help protect against fraudulent financial reporting. As a part of its ongoing oversight of the effectiveness of Internal controls, a company's audit committee should review annually the program that management establishes to monitor compliance with the code.</p>	<p>Establishes a "tone-at-the-top."  Creates a process by which all employees are encouraged to conduct themselves properly and annually reinforces such encouragement. Audit committee monitoring adds further importance to policy.</p>		
<p><b>2. Internal Auditor Involvement at the Corporate Level</b>  <i>Recommendation:</i> Management and the audit committee should ensure that the internal auditors' involvement in the audit of the entire financial reporting process is appropriate and properly coordinated with the independent public accountant.</p>	<p>Ensures that internal audit process is effective by establishing top management support for function and ensuring direct access to Audit Committee.</p>		

TREADWAY COMMISSION PROPOSALS	BENEFITS	COMMENTARY	RECOMMENDED ACTION
<p><b>3. Mandatory Independent Audit Committee</b>  <i>Recommendation:</i> The boards of directors of all public companies should be required by a rule adopted by the Securities and Exchange Commission ("SEC") to establish audit committees composed solely of independent directors.</p>	<p>Ensures that audit committee members have no conflicts of interest when reviewing adequacy of financial reporting and monitoring internal and outside auditors.</p>		
<p><b>4. Informed, Vigilant and Effective Audit Committees</b>  <i>Recommendation:</i> Audit committees should be informed, vigilant and effective overseers of the financial reporting process and the company's internal controls.</p>	<p>Safeguards against inadequate financial reporting. Ensures that directors discharge their responsibilities. Treadway suggested Good Practice Guidelines be considered.</p>		
<p><b>5. Written Charter</b>  <i>Recommendation:</i> All public companies should develop a written charter setting forth the duties and responsibilities of the audit committee. The board of directors should approve the charter, review it periodically and modify it as necessary.</p>	<p>Establishes a framework to enhance the effectiveness of the audit committee. Periodic review of the charter requires a re-evaluation of the proper role the audit committee should play in the financial process.</p>		

<b>TREADWAY COMMISSION PROPOSALS</b>	<b>BENEFITS</b>	<b>COMMENTARY</b>	<b>RECOMMENDED ACTION</b>
<p><b>6. Resources and Authority</b>  <i>Recommendation:</i> Audit committees should have adequate resources and the authority to discharge their responsibilities.</p>	<p>Provides the audit committee with any required in-house staff or administrative support ensures their ability to discharge its responsibilities.</p>		
<p><b>7. Review of the Public Accountant's Independence</b>  <i>Recommendation:</i> The audit committee should review management's evaluation of factors related to the independence of the company's public accountant. Both the audit committee and management should assist the public accountant in preserving the auditor's independence.</p>	<p>Committee oversight ensures that independence is closely monitored and is an essential feature of the audit relationship.</p>		
<p><b>8. Issue Related to the Public Accountant's Independence</b>  <i>Recommendation:</i> Before the beginning of each year, the audit committee should review management's plans for engaging the company's independent public accountant to perform management advisory services during the coming year, considering both the types of services that may be rendered and the projected fees.</p>	<p>Ensures that the audit committee participates in the evaluation of whether nonaudit services or any other relationships impact the public accountant's independence.</p>		



TREADWAY COMMISSION PROPOSALS	BENEFITS	COMMENTARY	RECOMMENDED ACTION
<p><b>9. Audit Committee Chairman's Letter</b>  <i>Recommendation:</i> All public companies should be required by an SEC rule to include in their annual reports to stockholders a letter signed by the chairman of the audit committee describing the committee's responsibilities and activities during the year.</p>	<p>Clarifies the audit committee's role in the financial reporting process and reinforces its responsibility to properly discharge its duties.</p>		
<p><b>10. Seeking a Second Opinion</b>  <i>Recommendation:</i> Management should advise the audit committee when it seeks a second opinion on a significant accounting issue.</p>	<p>Provides visibility on significant accounting issues being dealt with by management and insight into management's relationship with the independent accountants.</p>		
<p><b>11. Quarterly Report</b>  <i>Recommendation:</i> Audit committees should oversee the quarterly reporting process.</p>	<p>Extends audit committee oversight responsibilities in order to ensure the integrity of the quarterly reporting process.</p>		

TREADWAY COMMISSION'S GOOD PRACTICE GUIDELINES	PRESENT PRACTICE	COMMENTARY	RECOMMENDED ACTION
<b>A. GENERAL</b>			
<p><i>Size and Term of Appointment.</i> An audit committee normally should consist of not fewer than three independent directors. The maximum size may vary, but the committee should be small enough so that each member is an active participant. The term of appointment is at the discretion of the board of directors, but it is desirable to have terms arranged to maintain continuity while bringing fresh perspectives to the work of the committee.</p>			
<p><i>Meetings.</i> The committee should meet on a regular basis and special meetings should be called as circumstances require. The committee should meet privately with the internal auditor and the independent public accountant.</p>			
<p><i>Reporting to the Board of Directors.</i> The committee should report its activities to the full board on a regular basis, such as after each meeting, so that the board is kept informed of its activities on a current basis.</p>			
<p><i>Expand Knowledge of Company Operations.</i> A systematic and continuing learning process for audit committee members will increase their effectiveness. One way is to review various financial aspects of the company on a planned basis.</p>			

TREADWAY COMMISSION'S GOOD PRACTICE GUIDELINES	PRESENT PRACTICE	COMMENTARY	RECOMMENDED ACTION
<p><i>Company Counsel.</i> The committee should meet regularly with the company's general counsel, and outside counsel when appropriate, to discuss legal matters that may have a significant impact on the company's financial statements. In a number of companies the general counsel and/or outside counsel attend meetings.</p>			
<p><i>Audit Plans.</i> The committee should review with the chief internal auditor and the independent public accountant their annual audit plans, including the degree of coordination of the respective plans. The committee should inquire as to the extent to which the planned audit scope can be relied upon to detect fraud or weaknesses in internal controls.</p>			
<p><i>Electronic Data Processing.</i> The committee should discuss with the internal auditor and the independent public accountant what steps are planned for a review of the company's electronic data processing procedures and controls and inquire as to the specific security programs to protect against computer fraud or misuse from both within and outside the company.</p>			

TREADWAY COMMISSION'S GOOD PRACTICE GUIDELINES	PRESENT PRACTICE	COMMENTARY	RECOMMENDED ACTION
<p><i>Other Auditors.</i> The committee should inquire as to the extent to which independent public accountants other than the principal auditor are to be used and understand the rationale for using them. The committee should request that their work be coordinated and that an appropriate review of their work be performed by the principal auditor.</p>			
<p><i>Officer Expenses and Perquisites.</i> The committee should review in-house policies and procedures for regular review of officers' expenses and perquisites, including any use of corporate assets, inquire as to the results of the review and, if appropriate, review a summarization of the expenses and perquisites of the period under review.</p>			
<p><i>Areas Requiring Special Attention.</i> The committee should instruct the independent public accountant and the internal auditor that the committee expects to be advised if there are any areas that require its special attention.</p>			
<b>B. Selection of an Independent Public Accountant</b>			
<p><i>Issues related to this audit: Opinions on the performance of the public accounting firm by appropriate management and the chief internal auditor.</i></p>			

TREADWAY COMMISSION'S GOOD PRACTICE GUIDELINES	PRESENT PRACTICE	COMMENTARY	RECOMMENDED ACTION
The proposed audit fee and the independent public accountant's engagement letter; explanations for fee changes.			
The expected level of participation by the partner and other management personnel in the audit examination, the mix of skills and experience of the staff and staff rotation policy.			
If a new public accounting firm is being considered, the steps planned to ensure a smooth and effective transition.			
<i>Issues related to the firm generally:</i> The report of the public accounting firm's latest peer review conducted pursuant to a professional quality control program.			
Any significant litigation problems or disciplinary actions by the SEC or others.			

<b>TREADWAY COMMISSION'S GOOD PRACTICE GUIDELINES</b>	<b>PRESENT PRACTICE</b>	<b>COMMENTARY</b>	<b>RECOMMENDED ACTION</b>
The public accounting firm's credentials, capabilities and reputation and a list of clients in the same industry and geographical area.			
<b>C. Post-audit Review</b>			
The committee should obtain from management explanation for all significant variances in the financial statements between years. (This review may be performed at a meeting of the entire board.) The committee should consider whether the data are consistent with the Management's Discussion and Analysis (MD&A) section of the annual report.			
The committee should request an explanation from financial management and the independent public accountant of changes in accounting standards or rules promulgated by the Financial Accounting Standards Board, the SEC or other regulatory bodies that have an effect on the financial statements.			
The committee should inquire about the existence and substance of any significant accounting accruals, reserves or estimates made by management that had a material impact on the financial statements.			

<b>TREADWAY COMMISSION'S GOOD PRACTICE GUIDELINES</b>	<b>PRESENT PRACTICE</b>	<b>COMMENTARY</b>	<b>RECOMMENDED ACTION</b>
The committee should inquire of management and the independent public accountant if there were any significant financial reporting issues during the accounting period and if so how they were resolved.			
The committee should meet privately with the independent public accountant discuss the accountant's opinion on various matters to including the quality of financial and accounting personnel and the internal audit staff.			
The committee should ask the independent public accountant to identify the accountant's greatest concerns and discuss with the committee anything else that the accountant believes should be discussed but has not been raised or covered elsewhere.			
The committee should review the letter of management representations given to the independent public accountant and inquire whether the accountant encountered any difficulties in obtaining the letter or any specific representations therein.			

TREADWAY COMMISSION'S GOOD PRACTICE GUIDELINES	PRESENT PRACTICE	COMMENTARY	RECOMMENDED ACTION
<p>The committee should discuss with management and the independent public accountant the substance of any significant issues raised by in-house and outside counsel concerning litigation, contingencies, claims or assessments. The committee should understand how such matters are reflected in the company's financial statements.</p>			
<p>The committee should determine the open years on federal income tax returns and whether there are any significant items that have been or might be disputed by the Internal Revenue Service and inquire as to the status of the related tax reserves.</p>			
<p>The committee should review with management the MD&amp;A section of the annual report and ask the extent to which the independent public accountant reviewed the MD&amp;A section. The committee should inquire of the independent public accountant if the other sections of the annual report to stockholders are consistent with the information reflected in the financial statements.</p>			
<p>The committee and the board of directors should consider whether the independent public accountants should meet with the full board to discuss any matters relative to the financial statements and to answer any questions that other directors may have.</p>			



TREADWAY COMMISSION'S GOOD PRACTICE GUIDELINES	PRESENT PRACTICE	COMMENTARY	RECOMMENDED ACTION
<b>D. Audit Committee Chairman's Letter</b> <b>Among other subjects, the audit committee chairman's letter could discuss:</b>			
The composition of the audit committee.			
The identity of each audit committee member, unless disclosed elsewhere.			
The audit committee's purpose, objectives and responsibilities.			
The activities of the audit committee during the past year including matters such as the number of meetings held and the significant topics discussed with management, the internal auditors or the independent public accountants.			



**PUBLIC OVERSIGHT BOARD**

*One Station Place  
Stamford, CT 06902*

*(203) 353-5300  
Fax: (203) 353-5311*