

CHAPTER 1 – INTRODUCTION

1.1 At the request of Chairman Arthur Levitt of the Securities and Exchange Commission (SEC), the Public Oversight Board (POB) appointed the Panel on Audit Effectiveness in October 1998 to assess whether independent audits of the financial statements of public companies adequately serve and protect the interests of investors. The Panel reviewed and evaluated the way that audits are performed, and assessed recent trends in audit practices to determine whether they are in the public interest. It studied the audit policies, methodologies and other forms of guidance used primarily by the large audit firms, certain aspects of auditor independence and the auditing profession's self-regulatory structure. The Panel also focused on international developments affecting the auditing profession.

1.2 This chapter provides an introduction to independent audits of financial statements, the environment in which the auditing profession functions and the Panel's approach to the project. It also describes how the Panel's findings and recommendations in this report are organized by chapter. Finally, it discusses the Panel's consideration of the benefits and costs of its recommendations.

INDEPENDENT AUDITS OF FINANCIAL STATEMENTS

The Value of Audits

1.3 Public companies are required to file financial statements with the SEC that have been audited in accordance with generally accepted auditing standards (GAAS) promulgated by the Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA). Those standards require the auditor to obtain sufficient evidence to express an opinion on whether the entity's financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles (GAAP). The financial statements are the responsibility of the company's management; the auditor is responsible for expressing an opinion on those statements.

1.4 Financial statement audits are performed by certified public accountants in the private sector who must be independent of the entities whose financial statements they audit. Whether audits should be performed in the private sector or by government auditors was debated during the Senate hearings that preceded the Securities Act of 1933, and the resulting decision to rely on the private sector has not been challenged seriously in the intervening seven decades.

1.5 Audits improve the reliability of financial statements, make them more credible and increase shareholders' confidence in them. Auditors constitute the principal external check on the integrity of financial statements. As former SEC Commissioner Steven M. H. Wallman has noted, "Without accountants to ensure the quality and integrity of financial information, the markets for capital would be far less efficient, the cost of capital would be far higher, and our

standard of living would be lower.”¹ Accordingly, a fundamental assumption underlying the Panel’s study and recommendations is its belief that, for many reasons, the value of audits and the public’s need for effective audits remain undiminished and in fact may be greater than ever before.

Efficacy of the Audit Process

1.6 Over the past few years, several major instances of misstated earnings resulted in headlines reporting massive declines in market capitalization. If share prices decline when companies’ results fail to meet expectations, they decline even more precipitously when the market learns that previously issued audited financial statements are unreliable. This revelation frequently leads to restatements of those financial statements, suggesting that the financial reporting system may not, in fact, promote the most efficient allocation of capital. Restatements also raise the question, “Where were the auditors?” suggesting that there may be something wrong with the very concept of audits performed by private-sector auditors who are largely self-regulated.

1.7 At the same time, the SEC and others have expressed concerns about registrants’ overreaching in terms of permissible accounting treatments, as well as about alleged accounting abuses involving such matters as accounting for business combinations, revenue recognition and restructurings, along with alleged misuse of the materiality concept. This overreaching often is characterized as “earnings management.”

1.8 As a consequence, the SEC requested the POB to sponsor a thorough and objective examination of auditing, from top to bottom, in order to explore the efficacy of the audit process. In large part, the Panel was created in response to those concerns.

THE ENVIRONMENT AND THE AUDITING PROFESSION

1.9 The past decade has been one of unprecedented change in the global economy and capital markets. Key aspects of the current business environment include a globalized, highly competitive, expanding economy; explosive growth in the development and use of technology; dramatic increases in “new economy” service- and technology-based businesses with predominantly intangible assets; unparalleled expansion in the number of public entities; large increases in the number of individuals who directly or indirectly own equity securities; and unprecedented growth in the market value of those securities.

1.10 The growth in equity values over the past decade has introduced extreme pressures on management to achieve earnings, revenue or other targets. These pressures are exacerbated by the unforgiving nature of the equity markets as securities valuations are drastically adjusted downward whenever companies fail to meet “street” expectations. Pressures are further magnified because management’s compensation often is based in large part on achieving

¹ S. M. H. Wallman, “The Future of Accounting and Disclosure in an Evolving World: The Need for Dramatic Change,” *Accounting Horizons* (September 1995).

earnings or other financial goals or stock-price increases. These pressures on management, in turn, translate into pressures on how auditors conduct audits and in their relationship with audit clients.

1.11 The expanded use of technology in both the operating and financial systems of companies also has significantly affected the audit environment, forcing audit firms to recruit, train and deploy a large number of information technology specialists to support their audit efforts. It also has caused firms to reconsider their audit methods and techniques in an effort to harness technology to improve audit efficiency and effectiveness. Some have questioned, however, whether the increased efficiency may have come at the cost of reduced, not enhanced, effectiveness.

1.12 The technology explosion also has contributed significantly to the enormous growth in large audit firms' consulting practices, to the point where revenue from their audit practices has declined from 70% or more of total firm revenue 25 years ago to about half that today. This shift has led to concerns about the relative importance of the audit practice to firms and about auditor independence when significant non-audit services are performed for audit clients. These concerns come at a time when the importance of public confidence in auditing has never been greater.

1.13 Thus, examining the efficacy of the audit process alone is not the answer to assessing audit effectiveness. Understanding the environment in which audit firms operate and the factors that drive their business was an important feature of the Panel's efforts. Accordingly, the Panel studied not only how audits are conducted but also whether non-audit services provided to audit clients pose a threat to auditor independence and whether the system of governance of the auditing profession is adequate or in need of change.

THE PANEL'S APPROACH TO THE PROJECT

1.14 The Panel's investigation encompassed a wide range of activities. Its principal effort was its Quasi Peer Reviews (QPRs) – in-depth reviews of the quality of 126 audits of SEC registrants in 28 offices of the eight largest audit firms.² In addition to the engagement reviews, meetings with two focus groups were held in most of the 28 offices – one with seniors and the other with audit managers, most of whom work on audits of public companies. The QPR process also included in-depth interviews with the partner-in-charge of the office's audit practice. Panel members attended most of the QPRs, and the Panel staff planned and directed all of them. The QPRs are a major source of the Panel's findings and recommendations for improving the conduct of audits.

1.15 The Panel's other activities included:

- Meetings early in the project with the accounting and auditing leaders of each of the

² The eight largest firms are: Arthur Andersen LLP; BDO Seidman, LLP; Deloitte & Touche LLP; Ernst & Young LLP; Grant Thornton LLP; KPMG LLP; McGladrey & Pullen, LLP; and PricewaterhouseCoopers LLP (see Appendix B).

eight largest firms to gain an understanding of their audit methodologies, their views on the environment in which audits are performed and their views of the key issues requiring attention

- Eleven focus group meetings – one with chief financial officers and controllers, one with internal auditors, one with individuals who perform peer reviews of smaller firms and eight with representatives of the eight largest firms (each firm was represented in each focus group)
- A survey, distributed to over 500 selected individuals and organizations representing a wide range of constituencies, titled, “Request for Opinions on Issues of Audit Effectiveness Addressed to Thought Leaders and Key Stakeholders”
- Two days of public hearings before the Panel’s findings and recommendations were formulated, at which individuals from 21 organizations testified, including the SEC, auditors, financial statement preparers, analysts, plaintiffs’ and defendants’ attorneys, standard setters and educators
- Reviews of the eight largest firms’ audit methodologies, policies and procedures manuals and other guidance materials, information about their risk management and professional development activities, audit-related marketing publications, and policies and procedures for recruiting, evaluating, compensating and promoting audit personnel
- Meetings with representatives of the SEC and various private-sector bodies involved in the governance of the profession, such as the AICPA, ASB, SEC Practice Section (SECPS) Executive Committee, SECPS Peer Review Committee, SECPS Quality Control Inquiry Committee, POB and Independence Standards Board (ISB)
- Research, with the assistance of the SEC staff, into the causes and circumstances that led to recent SEC Accounting and Auditing Enforcement Releases involving the five largest firms or their clients
- Analysis of the academic, professional and regulatory literature on the effects of non-audit services on auditor independence
- Studies of the profession’s current governance structure and analysis of alternatives
- Collection of information on recent international initiatives to strengthen audit effectiveness on a global basis
- Two days of public hearings on the May 31, 2000, Exposure Draft of the Panel’s *Report and Recommendations* at which individuals from 18 organizations testified, including the SEC, auditors, state boards of accountancy, professional organizations,

standard setters and educators

- Analysis of 42 comment letters on the Exposure Draft received from the preceding types of organizations as well as from analysts and public companies

These activities are discussed in greater detail in the other chapters of this report.

CHAPTERS CONTAINING FINDINGS AND RECOMMENDATIONS

1.16 This section describes how the Panel’s findings and recommendations are organized in this report.

Improving the Conduct of Audits

1.17 Chapter 2, “Improving the Conduct of Audits,” discusses the profession’s standards that provide guidance on how audits of financial statements should be conducted, the Panel’s findings on how those audits actually are conducted and the Panel’s recommendations for improving the conduct of audits. Because of the importance of earnings management and fraud, a separate chapter is devoted to those subjects.

1.18 Chapter 2 includes an overview of the conceptual foundation for audits of financial statements, referred to as the “audit risk model,” and the profession’s standards underpinning audits of financial statements, referred to as “generally accepted auditing standards.” These are important concepts for readers of this report because they provide the context for the qualitative assessments made in the QPR. The QPR itself tracked the audit risk model created by the ASB to drive the auditor’s decision-making process, and it focused on certain important audit areas, notably, assessing inherent and control risks (including clients’ use of technology), analytical procedures, auditing revenue, auditing estimates and judgments, considering materiality and waived adjustments, and detecting fraud.

1.19 Each of the audit areas is addressed individually. The findings from the QPR and the Panel’s analysis of them, together with information gathered from its other activities, form the basis for its recommendations. In large part, those recommendations are derived from three major themes:

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

1.20 There are three major constituencies to whom the recommendations for improving the conduct of audits are made, namely, the ASB, the firms that audit the financial statements of public entities and the SEC Practice Section of the AICPA. (In certain areas, recommendations also have been made to the SEC, the AICPA, the POB, the Financial Accounting Standards Board and audit committees.)

1.21 The Panel also discusses its conclusions about the appropriateness of the audit risk model, and it provides recommendations to the ASB on establishing auditing standards and to the ASB and the POB on the priorities, timetable and process for addressing the Panel's recommendations.

Earnings Management and Fraud

1.22 Chapter 3, "Earnings Management and Fraud," focuses on the auditor's responsibility with respect to earnings management and fraud. It discusses the profession's standards that define fraud and that provide guidance to the auditor on detecting fraud. It also explores the concepts of earnings management and the quality of earnings, and how earnings management may lead to or constitute fraud.

1.23 The QPR findings in the areas of fraudulent financial reporting and misappropriation of assets are provided, and the Panel's broader consideration of fraud is described. Importantly, the Panel discusses certain perspectives about the responsibilities of auditors and others that it took into consideration in framing its recommendations. The recommendations are addressed to the ASB, audit firms, the SEC Practice Section of the AICPA (more specifically to the SECPS Peer Review and Quality Control Inquiry Committees) and audit committees.

Audit Firms

1.24 Chapter 4, "Audit Firms," addresses the Panel's study of the overall professional leadership in the audit firms (the "tone at the top"), the professional development of auditors (both collegiate and continuing professional education), the performance measures the firms use to evaluate audit personnel, time pressures on auditors and other issues. The Panel focused primarily, but not exclusively, on the eight largest firms.

1.25 The Panel's findings and recommendations to audit firms fall into four areas: professional leadership – tone at the top; professional development; personnel management; and time pressures on auditors. The Panel also makes certain recommendations to the AICPA designed specifically to benefit smaller firms.

Auditor Independence

1.26 Chapter 5, "Auditor Independence," discusses the historical background and evolution of non-audit services by audit firms, and the potential for conflict when an auditor provides such services to a public audit client. It addresses the process for assessing the effects of non-audit services on audits, including the findings from the QPR. The Panel's wide-ranging perspectives about the issue of non-audit services also are discussed, and statements of views supporting and

opposing an exclusionary ban on non-audit services to public audit clients are provided. Finally, the subject of former firm personnel in client management is discussed and the Panel's findings are disclosed.

1.27 The Panel makes recommendations to the SEC, the ISB and audit committees with respect to the provision of non-audit services to public audit clients.

Governance of the Auditing Profession

1.28 Chapter 6, "Governance of the Auditing Profession," describes the auditing profession's current governance system, the limitations of that system and the Panel's recommendations for strengthening it. It also discusses briefly the current relationship between the profession and the SEC.

1.29 The Panel's recommendations are addressed to a number of constituencies, including most importantly the POB, which appointed the Panel. Other constituencies to whom recommendations are addressed include the AICPA, ISB, SEC Practice Section and SEC.

International

1.30 Chapter 7, "International," describes how the Panel's project sought information on issues of audit significance from a global perspective. However, the Panel did not make a comprehensive review of audit effectiveness on a global basis.

1.31 The chapter focuses on audit firms and the international organizations that play key roles in the international setting. The goal of transparency is discussed. Recent developments in international accounting standards, auditing, regulation and the governance of the profession are described. The Panel makes recommendations to the International Federation of Accountants relating to the global self-regulatory structure of the international auditing profession and to audit firms. It also makes a recommendation to the ASB and the International Auditing Practices Committee.

Looking Ahead

1.32 Chapter 8, "Looking Ahead," contains the Panel's vision about some issues that pose a challenge to the auditing profession's development in the years ahead and some final thoughts.

BENEFITS AND COSTS

1.33 The Panel believes that its recommendations are necessary to improve audit effectiveness. However, it recognizes that implementing those recommendations will increase audit costs for most entities. The Panel expects that those to whom the recommendations are addressed will attempt to analyze the added benefits and costs, when practicable.

1.34 The benefits of more effective audits include improving the reliability of financial statements, enhancing the credibility of and investors' confidence in those financial statements, improving management decision making, lowering entities' cost of capital, and increasing the effectiveness of the capital markets in allocating resources. More effective audits also deter misstatements in financial reporting. Therefore, the benefits also include reducing the costs of investigating fraudulent financial reporting and prosecuting its perpetrators, reducing litigation and related costs to both auditors and their clients, reducing the costs of both public and private regulatory systems aimed at preventing fraudulent financial reporting, and reducing the billions of dollars in losses incurred by those who have invested in entities that have issued fraudulent financial reports.³ Finally, more effective audits also should enhance the "reputational capital" of audit firms.

1.35 The Panel has not tried to quantify the benefits of implementing its recommendations to increase audit effectiveness, nor does it believe that such an analysis is feasible. Many of those benefits are in the nature of foregone costs, improved self-regulation of the profession, more effective resource-allocation decisions, and clients' reduced costs of capital. None of these factors is measurable.

1.36 The costs of more effective audits include developing, applying, maintaining, monitoring and enforcing policies and procedures to enhance effectiveness. Thus, implementing the Panel's recommendations includes the costs of additional audit procedures and of enhancing the profession's system of self-regulation – for example, the expenses of the POB to strengthen its role in the governance of the profession and the costs of the ASB to develop new or revised auditing standards. Also, firms will incur costs to develop related guidance and train personnel in the new standards.

1.37 Some of those costs may be measurable – for example, the costs incurred by standard-setting and oversight bodies in implementing the Panel's recommendations. Some costs are non-recurring, and some may be offset at least in part by eliminating ineffective or unnecessary audit procedures or using technology more effectively.

1.38 While recognizing that difficult issues arise when assessing benefits and costs, the Panel believes that the benefits to the public and to other participants in the financial reporting process from implementing its recommendations, and thereby enhancing audit effectiveness, will justify the additional costs, producing a net benefit over time to all participants.

³ For example, at the Panel's public hearings in July 2000, the SEC noted that, based on amounts reported in *Public Accounting Report*, audit fees for the top seven firms were approximately \$9.5 billion in 1999, while CNBC reported in 1999 that investors lost \$32 billion as a result of restatements of the financial statements of five companies. (The Panel recognizes that the amounts of any losses will vary significantly from year to year and that the \$32 billion is not a representative or average amount of annual losses.)