

## **CHAPTER 6 – GOVERNANCE OF THE AUDITING PROFESSION**

**6.1** This chapter describes the auditing profession’s current governance system,<sup>1</sup> the limitations of that system and the Panel’s recommendations for strengthening it. The chapter also discusses briefly the current relationship between the profession and the SEC.

### **OVERVIEW OF CURRENT GOVERNANCE**

**6.2** Auditors are subject to a system of controls that, taken as a whole, constitutes the regulation of the profession. The principal elements of that regulation are the Securities and Exchange Commission (SEC), state boards of accountancy, the American Institute of Certified Public Accountants (AICPA), the SEC Practice Section (SECPS) of the AICPA, the Independence Standards Board (ISB) and the Public Oversight Board (POB) – a combination of public regulation and self-regulation.

#### **Public Regulation**

**6.3** The state boards of accountancy and the SEC, with their statutory responsibilities to protect the public, both play important roles in regulating the profession.

**6.4** The profession has significant interaction with the SEC through the Office of the Chief Accountant (OCA) and the Division of Corporation Finance. The OCA is the principal advisor to the Commission on accounting and auditing matters. It works closely with domestic and international private-sector accounting and auditing standard-setting bodies and consults with registrants, auditors and other SEC staff regarding the application of accounting standards and financial statement disclosure requirements. The Division of Corporation Finance oversees the disclosure of important information to the investing public and routinely reviews the disclosure documents filed by public companies with the SEC.

**6.5** One of the powers and responsibilities delegated to the SEC is disciplining independent auditors of publicly held companies, among others. The Division of Enforcement investigates possible violations of the securities laws and recommends SEC action when it deems appropriate, either in a federal court or before an administrative law judge, and negotiates settlements on behalf of the SEC. All such investigations are conducted privately. The SEC has exercised its disciplinary power over the years, using prosecutorial discretion in deciding which cases to pursue. In addition, the Panel understands from a presentation by the heads of the Division of Enforcement and the OCA that for a variety of reasons, including limited resources, the SEC ordinarily pursues cases against accountants only if alleged reckless conduct is involved. The number of enforcement actions varies from year to year, depending on the

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<sup>1</sup> See Appendix C for a more detailed description of the current governance system.

SEC's allocation of resources among the many competing demands for enforcement efforts and on the number of cases in which the SEC believes the accountants were reckless.

**6.6** Although the profession enjoys a national image through the AICPA, CPA licenses are granted by the individual states (typically by the state board of accountancy), and the state boards are the only agencies that can revoke them.<sup>2</sup> States also register or license audit firms to practice within their jurisdictions.

### **Self-Regulation**

**6.7** A profession may be subject to varying degrees of self-regulation, for example, a statutory self-regulatory organization (SRO), like the National Association of Securities Dealers (NASD) or the New York Stock Exchange (NYSE), or a voluntary system of self-regulation, like the auditing profession. The auditing profession's self-regulatory system includes the bodies that set professional standards as well as those that monitor and discipline CPAs and audit firms. The profession's self-regulatory system supplements public regulation in some areas, for example, discipline, where it extends beyond the realm of the law and public regulation, while in other areas, such as standard setting, it largely takes the place of public regulation.

### ***Standard Setting***

**6.8** Professional standards for auditors include technical, ethical and quality control standards as well as standards for continuing professional education.<sup>3</sup> Those standards are set by the AICPA's Auditing Standards Board (ASB), the AICPA's Professional Ethics Executive Committee (PEEC) and the ISB. The ASB promulgates generally accepted auditing standards and quality control standards, while the PEEC is responsible for changes to and interpretations of the AICPA's Code of Professional Conduct. The ISB was established in 1997 by the SEC and AICPA to establish standards on auditor independence with respect to audits of public entities.<sup>4</sup>

### ***Monitoring and Discipline***

**6.9** The audit firms and the AICPA and its components carry out practice monitoring and discipline.

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<sup>2</sup> The Uniform CPA Examination, which is prepared and graded by the AICPA and must be passed before a CPA license can be obtained in any state, is an important contributor to the national image.

<sup>3</sup> Professional standards also include accounting standards that are promulgated by the Financial Accounting Standards Board (FASB), the Governmental Accounting Standards Board (GASB) and the Accounting Standards Executive Committee (AcSEC) of the AICPA. While this report includes recommendations to the FASB about accounting standards, it does not discuss or make recommendations related to the governance and structure of accounting standard-setting bodies.

<sup>4</sup> Independence standards for all AICPA members are established by the PEEC. Auditors of public entities must meet independence standards established by the PEEC, the ISB, the SEC and their state society and board of accountancy. The PEEC will treat any pronouncement passed by the ISB as authoritative for audits of public entities unless and until the PEEC announces that it will not view that pronouncement as authoritative.

**6.10** Audit firms establish, maintain and enforce quality control policies and procedures that are designed to provide each firm with reasonable assurance that it complies with professional standards, maintains its technical capabilities, applies the appropriate expertise on all audits and meets the SECPS membership requirements. Effective self-regulation by individual audit firms is an essential part of the profession's overall self-regulatory system.

**6.11** The AICPA bodies involved in the monitoring and disciplining of auditors include the Professional Ethics Division, the Joint Trial Board and the SECPS. The Professional Ethics Division and the Joint Trial Board enforce technical and ethical standards by investigating and adjudicating disciplinary charges against auditors. Unlike the SEC and state boards of accountancy, the Professional Ethics Division and the Joint Trial Board do not have subpoena power, their disciplinary authority extends only to a CPA's membership rights in the AICPA or a state society of CPAs, and their disciplinary proceedings are deferred while litigation or regulatory proceedings are in process.

**6.12** The SECPS was created to improve the quality of audit firms' practice before the SEC by establishing requirements for member firms and a program for monitoring compliance with those requirements and professional standards. SECPS members must undergo peer reviews of their accounting and auditing practice every three years, or at such additional times as determined by the SECPS Executive Committee, which governs the SECPS's activities. The SECPS Peer Review Committee (PRC) establishes the *Standards for Performing and Reporting on Peer Reviews*, oversees the SECPS peer review program, accepts peer review reports and determines the appropriateness of firms' actions in response to those reports. The peer review process is overseen by the POB. In addition, certain peer review working papers and the related reports (masked to protect the confidentiality of individual registrants) are made available for review and oversight by the staff of the SEC's OCA.

**6.13** The Quality Control Inquiry Committee (QCIC) of the SECPS conducts an investigation when allegations of an audit failure are made against a member firm with respect to an audit of an SEC registrant. The purpose of the investigation is to determine whether there are deficiencies in the firm's system of quality control, in its compliance with that system or in professional standards. QCIC also serves a disciplinary function in that it may require remedial action if it finds deficiencies in a firm's system or in the firm's compliance with it. Member firms are required to report to QCIC, within 30 days of being served, all matters of alleged audit failures arising from litigation, regulatory investigations and criminal indictments. The QCIC process begins almost immediately after a matter is reported; it is not deferred while legal or regulatory proceedings are in process. The QCIC process is overseen by the POB as well as by the SEC. The POB participates in all aspects of QCIC's analysis, investigation and closing of each matter, while the SEC reviews QCIC's closed case summaries and the POB's oversight files.

**6.14** The POB oversees and reports on the activities of the SECPS. Its objective is to safeguard, and act as an advocate of, the public interest. The POB consists of five members, primarily non-accountants, with a broad spectrum of business, professional, regulatory and legislative experience. Besides overseeing the peer review and QCIC processes, the POB may commission special reviews by

*ad hoc* bodies created to investigate and report on issues involving the quality of practice. Examples of special reviews include reports by the Advisory Panel on Auditor Independence<sup>5</sup> and the Panel on Audit Effectiveness.

## **Limitations of the Current Governance System**

**6.15** While the auditing profession's system of voluntary self-regulation is extensive, it suffers from certain limitations, some of which are inherent in any voluntary system. Those limitations, which are discussed in this chapter, include:

- Lack of sufficient public representation on the various self-regulatory bodies
- Lack of unified leadership of the various self-regulatory bodies
- Constraints on effective communications with the SEC and among the various entities in the current system
- Differing interests and divergent views of the AICPA's priorities on the part of its diverse members
- A disciplinary system that is perceived to be slow and ineffective

**6.16** As SEC Chairman Arthur Levitt asked in his remarks to the Panel at its public hearings, "...has the accounting profession become so big and complex that perhaps we need a full-time SRO? Are the alphabet of regulatory bodies, the POB, the AICPA's PEEC, the SECPS, the ASB and the ISB, really workable?"

**6.17** These limitations have resulted in a less effective governance structure and erosion of confidence in the independent auditor. The Panel's recommendations are intended to strengthen the profession's voluntary self-regulatory system by minimizing the limitations while enabling the public and the profession to benefit from the strengths of a voluntary system.

## **PROPOSED SYSTEM OF GOVERNANCE**

**6.18** The Panel believes that many of the limitations of the current self-regulatory system can be mitigated by building on the POB's experience and reputation and giving it increased authority. The recommendations in this chapter are designed to provide for a strengthened, unifying oversight body to

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<sup>5</sup> *Strengthening the Professionalism of the Independent Auditor*, Report to the Public Oversight Board of the SEC Practice Section, September 1994.

help ensure that the governance system works more effectively and that the public is the system's primary beneficiary.

**6.19** To be effective, the profession's self-regulatory system should include establishing professional standards, monitoring and measuring performance, ensuring accountability for improper acts and substandard performance through an effective disciplinary system, and identifying and addressing emerging issues and changes in the environment and the profession on a timely basis. In the Panel's proposed self-regulatory system, as in the existing system, the Auditing Standards Board, the Independence Standards Board and the Professional Ethics Executive Committee will perform the standard-setting function; the SECPS Peer Review Committee will perform the monitoring function; the Quality Control Inquiry Committee, the Professional Ethics Executive Committee and the Joint Trial Board will perform the disciplinary function; and the aforementioned bodies and special review panels convened by the POB and others will address major emerging issues and changes in the environment and the profession.

**6.20** To command the public's respect, the POB, which will oversee the system, should:

- Have a majority of public members whose primary responsibility is to serve the public
- Maintain independence from both the profession and regulatory authorities
- Develop an environment of mutual respect and confidence with regulatory authorities
- Report periodically to the public regarding its activities

**6.21** During its 23-year history, the POB has been a clear voice for enhancing quality in auditing and financial reporting, strengthening the professionalism of the independent auditor and safeguarding the public. The Panel believes that the POB should continue in that capacity, but with an expanded oversight and leadership role in a more unified governance system. To do so, the POB will need a charter, now being developed, that commits the firms, SECPS, AICPA and SEC to the POB's expanded role and to the new system of self-regulation.

**6.22** For the POB to succeed in this new expanded role, the present system of governance needs to be revised. The revised system is described in the following recommendations and depicted in the chart following paragraph 6.36.

## **Recommendations**

***To the Public Oversight Board, the AICPA, the SEC Practice Section and the SEC:***

**6.23** The Panel recommends that the auditing profession's system of governance be unified under a strengthened, independent POB that oversees the profession's activities with respect to standard setting,

monitoring, discipline and special reviews. Accordingly, the POB should oversee the ASB, the ISB, the SECPS Executive Committee, QCIC, the SECPS Peer Review Committee, the Professional Issues Task Force (PITF), the SEC Regulations Committee and the standard-setting activities of the PEEC that relate to audits of public companies. The POB should serve as the oversight body to whom the SEC, the state boards of accountancy, the auditing profession and the public should look for leadership. This leadership position is intended to enhance communications among the profession's self-regulatory bodies in order to facilitate the profession's continuous improvement efforts and identify and resolve important issues on a timely basis.

**6.24** The Panel recommends that the POB, AICPA, SECPS and SEC work together to create and implement a formal charter for the POB that would include the responsibilities and powers enumerated in this report. The POB, AICPA, SECPS, SEC and major firms should agree to the charter and cooperate in facilitating its implementation.

**6.25** The Panel believes the charter should cover the following matters:

- ***The POB's sole authority to determine its budget and financial and other resources, and the profession's obligation to provide those resources.*** The Panel strongly believes that such "no-strings-attached funding" is absolutely essential if the POB is to be effective and independent of the profession and if the profession's self-regulatory system is to be viable. The profession must not be able to control or cut off the POB's financial resources and thereby cause irreparable harm to the profession's self-regulatory system by destroying the POB's independence and others' confidence in it. The POB's annual statement of expenditures should be audited and included in the POB's Annual Report to evidence its financial accountability.
- ***The POB's authority to oversee the activities of the ASB, the ISB, the SECPS Executive Committee, QCIC, the SECPS Peer Review Committee, the PITF, the SEC Regulations Committee and the standard-setting activities of the PEEC that relate to audits of public companies.*** The POB should approve all appointments to the ASB, SECPS Executive Committee and ISB's Independence Issues Committee (IIC), as well as the ISB members who represent the public accounting profession. Annually the POB should evaluate whether the resources that the AICPA and the SECPS provide to the ASB and the SECPS are sufficient for those bodies to meet their mandates. In addition, the POB should oversee the AICPA's evaluation, compensation, hiring and promotion decisions with respect to its employees who constitute the ASB and SECPS staffs.
- ***Term limits for POB members.*** POB members should be limited to two five-year terms, with staggered terms to ensure continuity.
- ***A nominating committee responsible for identifying and nominating new POB members.*** The nominating committee should be appointed by the POB from names

suggested by public and private institutions that are most concerned with the quality of audits and financial reporting.

- ***An advisory council to advise the POB on issues related to projects on its agenda, new agenda items, project priorities and related matters.*** The POB should appoint the council members, whose service should be limited to two three-year terms. The council should comprise nine to fifteen people selected from the constituencies that are concerned with audit quality and financial reporting matters, thus ensuring the broadest spectrum of participants in the self-regulation of the auditing profession. Council members should serve on a voluntary, part-time basis and be available to meet with the POB at regularly scheduled intervals (e.g., two to four times a year).
- ***A coordinating task force of the chairs of each body within the POB's oversight.*** This task force would be responsible for sharing information related to each body's activities. It should meet periodically (e.g., two to four times a year) to ensure effective communications among the bodies subject to POB oversight. For example, the task force would provide a formal means for QCIC and the PRC to communicate to the ASB, ISB and PEEC their findings and the resulting implications for changes in standards.
- ***The POB's authority to commission special reviews related to significant professional matters that affect the public's confidence in the profession.*** One such matter is the perceived lack of candid and timely public reporting of why and how highly publicized audit failures and frauds occurred, together with an analysis of the effectiveness of generally accepted auditing standards in such circumstances and the actions that have been taken or will be taken to ensure that such problems do not recur.

**6.26** The Panel recommends that the POB, SEC, AICPA, SECPS and major firms promptly agree to a charter for the POB. The Panel understands that there are two matters in the August 22, 2000, draft charter that are still under negotiation: (1) the POB's role in the appointment of the chairs of the ASB and the SECPS Executive Committee, and (2) the procedures for amending the charter. Upon the successful conclusion of these negotiations, the Panel believes the charter will result in a major step forward in the governance of the profession. The draft charter includes a provision for the POB to conduct an annual "outreach" meeting with representatives from the constituencies that are concerned with audit quality and financial reporting matters. While this may alleviate the need for a nominating committee and advisory council, the Panel recommends that this issue be addressed in three years as part of the POB's review of the effectiveness of the self-regulatory oversight process as contemplated in the draft charter.

#### ***To the Public Oversight Board and the SEC:***

**6.27** The Panel recommends that the POB and SEC acknowledge the need to maintain a continuing dialogue that will foster a cooperative relationship, protect and enhance mutual respect and confidence, and increase the public's respect for the profession and its role in the capital markets.



***To the Public Oversight Board and State Boards of Accountancy:***

**6.28** The Panel recommends that the POB and state boards of accountancy, perhaps through the National Association of State Boards of Accountancy, determine how best to facilitate meaningful continuing dialogue between the POB and state boards.

***To the Public Oversight Board:***

**6.29** The Panel recommends that the POB:

- Enhance its resources, including augmenting its staff with additional qualified technical professionals, in order to implement the POB's expanded oversight role. Among other matters, the augmented staff would assist the POB in overseeing the peer reviews of the largest firms. The POB should identify such professionals as soon as possible.
- Review its charter periodically to ensure its continuing adequacy in the light of changing circumstances and, if appropriate, work with the AICPA, SECPS and SEC to amend it
- Review periodically the effectiveness of the ASB, the ISB, the SECPS and other groups that it oversees and include its findings and conclusions in its Annual Report
- Summarize in its Annual Report the status of all AICPA Ethics Division investigations of audits of SEC registrants when the civil litigation and public regulatory investigations have been concluded (see the fourth recommendation to the AICPA below)
- Increase its public communications to expand the public's awareness of the POB, its activities and its value to the capital markets

***To the Public Oversight Board and the SEC Practice Section:***

**6.30** The Panel recommends that the SECPS and POB staffs compile data from their oversight of peer reviews and QCIC investigations that will enhance the diagnostic value of the peer review and QCIC findings to standard setters and audit firms. The data should be communicated to the profession and, when appropriate, to the public in the POB's Annual Report. The data might include the following:

- Disciplinary measures taken by member firms resulting from substandard performance
- The audit firms' fraud risk assessments and related responses, if any, on audits where fraud is subsequently discovered
- Data related to emerging issues that identify needed modifications to professional standards or best practices guidance

- Data on non-audit services provided to the audit clients encompassed by peer reviews and QCIC investigations

***To the AICPA:***

**6.31** The Panel recommends that:

- The constituencies (both practitioners and non-practitioners) represented on the ASB remain unchanged; however, at least a majority of the members should be from CPA firms that provide attest services to SEC clients
- The AICPA provide the resources necessary for the ASB to meet its mandates
- The AICPA provide the resources necessary for the SECPS to meet its staffing needs, including providing QCIC with the resources needed to enable it to act quickly in investigating alleged audit failures and thereby preserve the candid dialogue with SECPS member firms that presently adds to the effectiveness of the QCIC process
- The Ethics Division take all necessary actions to ensure timely processing of investigations involving audits of SEC registrants when the civil litigation and public regulatory investigations have been concluded. The Ethics Division should establish reasonable time frames for these matters and report the status of all such matters to the POB semiannually.
- The ASB, SECPS and PEEC staffs remain employees of the AICPA

***To the SEC Practice Section:***

**6.32** The Panel recommends that:

- The SECPS Executive Committee retain its responsibility for approving members of the PRC, the QCIC, the SEC Regulations Committee and the PITF
- The preceding four groups continue to report to the Executive Committee
- The SECPS continue to fund the ISB

***To the SECPS Quality Control Inquiry Committee:***

**6.33** The Panel recommends that QCIC establish a panel of industry specialists and experts whose members would be drawn from the practicing profession and industry and who would be available to QCIC members and the POB and SECPS staffs for consultation on various matters, such as industry issues and the application of accounting standards.

***To Member Firms of the SECPS Represented on the SECPS Executive Committee:***

**6.34** The Panel recommends that each member firm ensure that its representative on the SECPS Executive Committee has sufficient authority and responsibility to commit the firm to the protection of the public interest when this conflicts with a more favorable business position, and ensure that the public interest remains the paramount objective in the representative's decision making and voting.

***To the Independence Standards Board:***

**6.35** The Panel recommends that:

- The ISB reconstitute its membership to include four members representing the public and three members representing the public accounting profession (currently the membership is four and four)
- The public members retain responsibility for the selection of their replacements, with the POB being consulted on the selections
- Two of the members representing the public accounting profession be selected by the SECPS Executive Committee from member firms, with the third member continuing to be the AICPA president or his or her designee
- The ISB retain sole authority to determine its budget and other resources
- The ISB retain its staff and the responsibility for their hiring, supervision and compensation

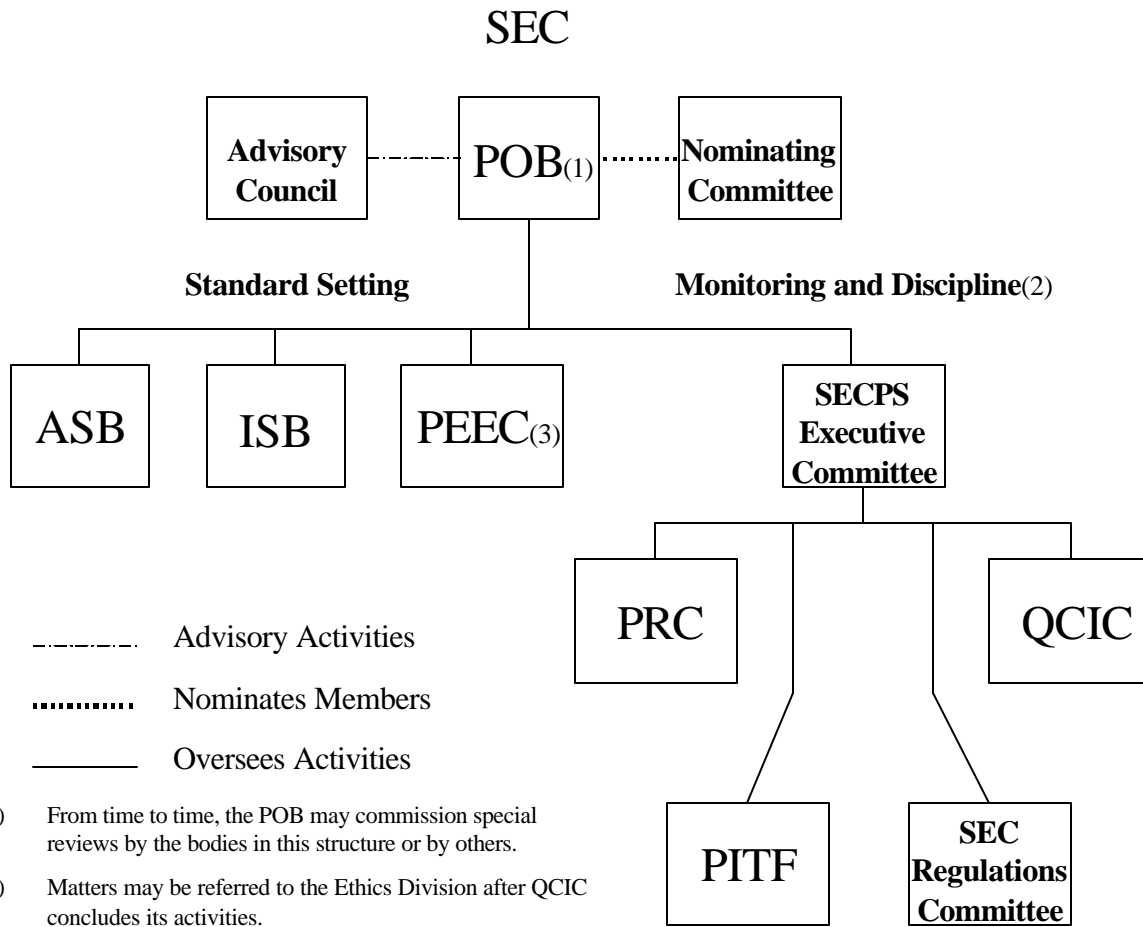
***To the SEC:***

**6.36** The Panel recommends that the SEC, as the statutory overseer of the quality of audits of SEC registrants:

- Encourage and support the ISB in carrying out its mission, recognizing that the SEC retains ultimate authority over auditor independence with respect to SEC registrants
- Support the IIC and work with the ISB to clarify the IIC's role
- Assist in implementing the POB's activities contemplated by the charter
- Support the POB's authority as enumerated in its charter to enable the POB to serve as an independent, effective, unifying leader of the profession's voluntary self-regulatory process

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## PROPOSED GOVERNANCE STRUCTURE



## ENHANCING PEER REVIEWS

**6.37** From the inception of the SECPS, its peer review program has been the cornerstone of its self-regulatory activities. During its formative and developing years, the SECPS enjoyed success and public respect, due in no small part to the effectiveness of its peer review program. Its structure and operating rules evolved as experience was gained in implementing previously untried concepts and procedures. No program can maintain its vitality and relevance, however, without identifying, addressing and resolving challenges that are certain to arise.

**6.38** To its credit, the SECPS generally has addressed and met those challenges. Its Executive Committee formed a Peer Review Process Task Force (the Task Force) in March 1999 to determine ways of improving the effectiveness of peer reviews conducted under the SECPS peer review program. A Panel staff member participated in the deliberations of the Task Force, which issued its report in January 2000.<sup>6</sup> The Panel acknowledges the efforts and contributions of the Task Force. The objective of continuous improvement should be a major driver of the peer review process. For this reason, the SECPS periodically should consider reconvening the Task Force.

**6.39** Many of the Task Force's recommendations resulted from experiences gained during the Quasi Peer Reviews. The Task Force's principal recommendations are:

- Provide for differences between the reviews of the largest firms and other firms, in recognition of the greater public interest in the largest firms' audit practices
- Perform some portion of the review of the largest firms each year and furnish an annual report to the PRC and the POB. (A triennial report would continue to be available to the public.)
- Integrate the reviews more thoroughly with the firms' internal inspection programs
- Place more emphasis on important issues that currently are facing the profession, the industry and the entity whose audit is being reviewed
- Put more emphasis on the qualitative aspects of the functional areas (elements of quality control) and engagements reviewed, and less on the routine, objective compliance aspects
- Conduct focus groups of seniors and managers within the offices reviewed and increase the emphasis on interviewing members of the engagement teams whose audits are being reviewed
- Expand the peer review report to provide more information about the scope and results of

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<sup>6</sup> The Task Force's report is included in Exhibit 4.

the review performed

- Use the peer reviews to identify best practices and matters for the attention of standard setters regarding important issues facing the profession, and then disseminate this information
- Enhance the training and quality of team captains and reviewers by establishing a standing task force that would oversee the peer review training programs
- Enhance the evaluation of peer review team captains by establishing a formalized system of evaluations
- Increase the frequency with which peer review guidance materials (checklists, etc.) are revised so they address important new issues as soon as the issues are identified, and provide easier access to these materials via the Internet

## **Recommendations**

### ***To the SEC Practice Section:***

**6.40** The Panel recommends that the SECPS substantially improve the peer review process by implementing all of the Task Force's recommendations and the following additional recommendations. Implementing the recommendations will require changes to the SECPS *Standards for Performing and Reporting on Peer Reviews*. The SECPS should:

- Make clear to peer review team captains and reviewers that the POB, not the firm being reviewed, is the primary client. Peer reviews are performed to enhance the public's confidence in independent auditors; the POB, as the public's representative, should be viewed as the principal stakeholder in this process.
- Emphasize the types of issues described in this report that affect audit quality, including the more judgmental and less objective issues, such as the "tone at the top." As noted elsewhere in this report, continuous quality improvement stems from a culture that is created and nurtured by senior management. While cultural and environmental matters are difficult to measure, their presence is evident and will affect the effectiveness of a firm's audits and quality control system.
- Require additional qualitative evaluations of the information obtained during peer reviews. For example, with respect to the selected engagements, the reviews should include assessing whether management's representations and responses to inquiries were adequately corroborated. In addition, the reviews should include assessing the adequacy of the training materials distributed and available to all professionals.

- Include in a peer review the business aspects of the reviewed firm’s practice that are closely related to the firm’s professional practice
- Increase the emphasis on which professionals perform various aspects of the audit, including who makes the risk assessments, and whether they have the necessary knowledge and skills. Other areas that should be emphasized include:
  - Engagement risk assessment (client acceptance and continuance)
  - Knowledge and understanding of the client’s industry and business
  - Inherent risk assessment
  - Control risk assessment
  - Linkage of risk assessments to tests of controls and substantive audit procedures
  - Sufficiency and competency of evidence obtained
  - Appropriateness and effectiveness of analytical procedures
  - Timeliness of the risk assessments, resolution of issues, supervisory reviews and other work
- Develop specific performance measures, to be included in the peer review report, that relate to the quality of the firm’s practice/effectiveness of audits. (See the Panel’s recommendations to audit firms in the section “Personnel Management” in Chapter 4.)
- Require a review of the peer-reviewed firm’s (the firm) review of selected financial reports/filings of foreign registrants that are audited by the firm’s foreign-associated firms and for which the firm reviews the filings in accordance with the membership requirements of the SECPS. The peer review should include interviewing the “filing reviewers.”

***To the Public Oversight Board:***

**6.41** The Panel recommends that the POB, by using its augmented staff (see paragraph 6.29), expand its oversight throughout the peer reviews of the largest firms on a “real-time” basis. The expanded role should include, at a minimum:

- Reviewing the qualifications of the peer review firm and the review team captain
- Attending important meetings, focus groups and interviews with firm personnel
- Reviewing the draft peer review reports before they are provided to others
- Overseeing the following:
  - The planning of the review
  - The review of the internal inspection program
  - The practice office and National office reviews
  - The debriefing of engagement reviewers at the conclusion of the reviews

- The resolution of issues that arise during the reviews

***To the SEC Practice Section and the Auditing Standards Board:***

**6.42** The Panel recommends that the ASB, in collaboration with the Peer Review Committee and QCIC, review the quality control standards and make them more specific and definitive for firms with public clients, especially for the largest firms. The Panel also recommends that the three groups establish a mechanism for ongoing monitoring of the standards to keep them current. (See the Panel’s recommendations to the ASB on *Auditing Standards and Quality Control Standards Generally* in the section in Chapter 2 on “Establishing Auditing Standards.”)

***To the SEC:***

**6.43** The Panel recommends that the SEC mandate that all firms that audit SEC registrants be enrolled in a peer review or similar monitoring program that includes public oversight. With respect to foreign-based audit firms, the requirement should extend to the peer review or similar monitoring programs or processes in their foreign locations. (See the Panel’s recommendations to the International Federation of Accountants on *Quality Assurance over Auditing* in Chapter 7.)

## **ENHANCING THE DISCIPLINARY PROCESS**

### **Current Disciplinary System**

**6.44** Self-regulation includes identifying violations of professional standards, establishing appropriate consequences for those violations, and enforcing the standards through disciplinary measures in a fair, consistent and timely manner. The profession’s current system for investigating violations and disciplining the violators includes two vehicles: the AICPA’s Ethics Division (with respect to allegations of improprieties against individual members)<sup>7</sup> and QCIC (with respect to allegations of improprieties against member firms related to audits of SEC clients). While the profession’s current disciplinary system is not totally satisfactory, the profession has made a significant effort to make it as workable as practicable given its inherent limitations.

**6.45** Typically, the profession’s disciplinary process involving audits of SEC clients begins after the filing of civil litigation or the public issuance of findings by a public regulatory body (e.g., an Accounting and Auditing Enforcement Release [AAER] issued by the SEC). Civil litigation generally names the firm as a defendant, while an AAER may name one or more individuals or the firm. Upon learning of these events, QCIC and the Ethics Division open their respective case files.<sup>8</sup> In accordance with a

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<sup>7</sup> The Ethics Division is responsible for investigating allegations against all AICPA members; however, the Panel’s focus is on allegations that involve audits of SEC clients.

<sup>8</sup> A SECPS member firm must report such events to QCIC within 30 days of being served with the original complaint or the publication of findings.

Memorandum of Understanding between QCIC and the Ethics Division, the Ethics Division defers its activities until QCIC has concluded its investigation and reported its findings to the Ethics Division.

**6.46** The QCIC investigation focuses primarily on the effectiveness of the member firm's system of quality control and whether the audit engagement team complied with the system. The QCIC investigation generally results in a determination of whether the allegations concerning substandard performance *might* have merit. This determination is reflected in QCIC's ratings and recommendations.

**6.47** QCIC assigns a rating of 1 to 4 to each concluded case.<sup>9</sup> The Ethics Division has agreed to close its case file on those cases rated a 1 or 2. For those cases rated a 3, the Ethics Division forms a panel to review the QCIC files and case summaries to determine whether it should commence an investigation or close its file. With respect to those cases rated a 4, the Ethics Division will commence an investigation.

**6.48** Ethics Division investigations and findings are not privileged and are subject to subpoena. Therefore, as a matter of fairness, the Ethics Division historically has granted individual members the right to request a deferral of an ethics investigation while civil litigation or a criminal investigation related to the subject matter is in process. As a voluntary membership organization, the AICPA believes its members would be unwilling to participate in an investigation while civil litigation or a criminal prosecution is in process. QCIC's files also are subject to subpoena.<sup>10</sup>

**6.49** The most powerful disciplinary measure available to the Ethics Division is the authority to expel an individual member from the AICPA and to publish this action (which includes the individual's name, city and state, and violations of the Code of Professional Conduct) in *The CPA Letter*, an AICPA publication for its members. Public regulatory bodies that have more drastic disciplinary powers (e.g., the SEC and state boards of accountancy) monitor these notices.

## Discussion

**6.50** State boards of accountancy can revoke a practitioner's or a firm's license. Because of limited budgets and the lack of effective means to investigate allegations and impose discipline, some boards have not been effective in disciplining substandard conduct. Similarly, competing demands on the SEC's resources and its own prosecutorial priorities limit its enforcement activities.

**6.51** The profession's disciplinary system also suffers from a number of limitations. The Ethics Division has limited investigative powers; it cannot issue subpoenas or compel testimony; it must rely on the cooperation of the individual being investigated; and it cannot talk to the plaintiff or the client company involved. As previously noted, its proceedings are not timely since, as a matter of fairness to the accused, all litigation must be concluded before an investigation can begin. The Division's disciplinary proceedings are confidential, and thus the public cannot determine what went wrong when a sanction is imposed, and in some cases whether a sanction was imposed. Finally, the Division is able to

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<sup>9</sup> See Appendix C for a detailed description of the QCIC process, including the rating system.

<sup>10</sup> One federal district court recently upheld a plaintiff's subpoena of a QCIC case file (*In the Matter of Mercury Finance Company of Illinois*, No. M8-85, S.D.N.Y. Dec. 21, 1999), while another federal district court refused to order production of QCIC materials (*In re Health Management, Inc.*, CV 96-0889, slip op. [E.D.N.Y. Sept. 25, 1999]).

impose only limited sanctions, such as suspension or expulsion from the AICPA. The QCIC process suffers from many of the same limitations, although generally its investigations are quite timely. The corrective actions it imposes on firms are not made public.

**6.52** The preceding limitations, especially the Ethics Division's deferral, help to create public frustration with the current system. They create a belief that the profession is not dealing with audit failures on a timely basis, since the judicial and public regulatory processes may, and often do, encompass many years. Thus, ethics investigations typically commence and conclude long after the public's memory of the matter has faded. The SEC staff recently has expressed concerns regarding these delays and their effects on the public's confidence in, and respect for, the profession's self-regulatory system.

**6.53** Market discipline may be as effective or more effective than more formal disciplinary processes in dealing with substandard auditing. For example, reputation-damaging publicity surrounding civil litigation, together with the potential for significant monetary damage awards, provides a powerful deterrent to substandard performance. Thus, enlightened self-interest has led firms to emphasize the importance of quality control and to discipline professionals who depart significantly from firm and professional standards. Firm-imposed disciplinary measures typically are not deferred while civil litigation is in process, nor are they made public.

**6.54** The Panel has concluded that the profession's self-regulatory system needs protection through the right of privilege over its disciplinary activities if it is to resolve disciplinary matters on a timely basis – protection that is obtainable only through legislation. The Panel would support such legislation if it would ensure more timely resolution of alleged audit failures. There is no assurance, however, that such legislation is attainable now or in the foreseeable future.<sup>11</sup>

## **Recommendations**

**6.55** The Panel believes the profession's current disciplinary process can be improved to provide greater protection to the public without legislation and without any diminution of the current fair treatment of firms and individuals. These improvements would require changes in the SECPS membership requirements and in the QCIC process. The Panel's recommendations to strengthen the profession's disciplinary process, many of which are based on the efforts of a joint AICPA/Big 5 firms task force, follow.

### ***To audit firms, the SEC Practice Section, the AICPA and the Public Oversight Board:***

**6.56** The Panel recommends the following procedures when civil litigation or a criminal or public regulatory investigation contains allegations of an audit failure:

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<sup>11</sup> In 1995 the accounting profession supported federal legislation (Senate Bill 240) that would have established a Public Auditing Self-Disciplinary Board with certain protections against civil discovery of certain investigatory materials by third parties. The proposed legislation was not enacted.

1. Firms should continue to report cases in accordance with QCIC's current requirement, but the AICPA should devote more resources to QCIC to speed up the process.
2. A firm should, as soon as reasonably possible after the commencement of the litigation against the firm, conduct an internal review of the subject engagement to evaluate the performance of the senior engagement personnel. In addition, in its meeting with the QCIC committee member and staff and the POB staff, the firm would respond to a standard question regarding whether the firm had conducted such a review. A person who is knowledgeable, or one who has become knowledgeable, about the circumstances of the engagement should be present at the meeting to discuss the engagement.
3. QCIC should conduct its usual inquiries. If QCIC assigns a 3 rating and there is a subsequent Ethics Division investigation, or assigns a 4 rating, the Ethics Division would open a case file.<sup>12</sup> The Ethics Division would then inform the firm that its consideration of the matter was being deferred in accordance with the Ethics Division's policy, pending the termination/completion of the litigation or public regulatory investigation, or the end of the threat of litigation.
4. Upon notification by the Ethics Division regarding its deferral, and in order to protect the public, the firm would select one of the following three options, if it had not already done so, to apply to the engagement partner<sup>13</sup> during the period of the deferral, if the partner was still with the firm:
  - A. Terminate or retire the partner
  - B. Remove the partner from all public company audit engagements until the Ethics Division's process is completed
  - C. Perform an additional second partner review of all public company audit engagements completed by the partner in the 12 months prior to the deferral. The firm would report the results of such review to both QCIC and the POB.

Subject the partner to additional oversight on all public company audit engagements for at least one year by requiring that the concurring partner review be performed by an experienced senior technical partner appointed by the firm's managing partner/CEO. In addition to the required concurring

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<sup>12</sup> See Appendix C for a description of the QCIC rating system.

<sup>13</sup> There may be instances in which these options should apply to other members of the engagement team in addition to, or instead of, the engagement partner.

partner review procedures,<sup>14</sup> this review must include, at a minimum, timely involvement in:

- Significant planning activities
- Determination of risk assessments and the design of tests of controls and substantive audit procedures

Thereafter subject the partner to those additional oversight procedures that the firm's managing partner/CEO determines are necessary to protect the public, based on the firm's evaluation of the partner's performance

5. The processes implemented by SECPS member firms when they choose Option C should be subject to peer review and oversight by the POB. At least one engagement to which Option C is being applied should be a mandatory selection in the firm's peer review and annual inspection program. If the POB disagrees with a member firm's selection or method of applying Option C, it should promptly make its views known to the firm, SECPS committee representatives and the SEC through its normal communication channels, and to the public through its Annual Report and other publications.
6. The POB should report on these activities in its Annual Report on an aggregate, no-name basis, including matters that are concluded through the retirement of the partner, Ethics Division decisions or settlement of litigation.
7. SECPS member firms should apply one of the foregoing options to a professional that joins a member firm while subject to one of the options at his or her former firm.
8. If the Ethics Division becomes aware of a matter (e.g., through a complaint letter or newspaper report) involving the financial reporting of an SEC registrant in which the SECPS member firm has not been made a party, and the Division otherwise would open an investigation, it instead should refer the matter to QCIC for further action, and the firm should be notified of such referral.

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<sup>14</sup> The SECPS membership requirements provide that the concurring partner's responsibility is fulfilled by performing the following procedures:

- Discussing significant accounting, auditing and financial reporting matters with the audit engagement partner;
- Discussing the audit engagement team's identification and audit of high-risk transactions and account balances;
- Reviewing documentation of the resolution of significant accounting, auditing and financial reporting matters, including documentation of consultation with firm personnel or resources external to the firm's organization (such as standard setters, regulators, other accounting firms, the AICPA and state societies);
- Reviewing a summary of unadjusted audit differences;
- Reading the financial statements and auditors' report; and
- Confirming with the audit engagement partner that there are no significant unresolved matters.

9. QCIC frequently may not have sufficient information to proceed in connection with matters in which the firm has not been made a party. In such cases, QCIC should close the matter without prejudice, and the Ethics Division should not open a case on the matter. However, QCIC would retain the right to reopen the matter if it obtained additional information. If the matter ends without the firm having been made a party, it would remain closed. If the firm becomes a party at a later date, the QCIC reporting requirement should be reduced to 15 days for the matter.
10. Once an Ethics Division deferral is lifted, the Ethics Division should expedite its investigation of the matter. The AICPA should allocate additional resources to both QCIC and the Ethics Division to enable both bodies to perform their responsibilities promptly and effectively.

**6.57** The Panel recommends that the POB and SECPS review the results of implementing these recommendations over a two- to three-year period to determine their effectiveness. If the POB determines that these recommendations have not satisfactorily protected the public, the Panel recommends that the POB, in cooperation with the SEC, then seek legislation to achieve the protections necessary to make the disciplinary process more effective.

***To the Public Oversight Board:***

**6.58** The Panel recommends that the POB, concurrent with its oversight of the disciplinary process outlined above, leverage the knowledge it gains to determine whether changes in professional standards or further guidance is needed and communicate these findings to the appropriate standard setters or authoritative bodies.

***To the SEC:***

**6.59** The Panel recommends that the SEC allocate additional resources to its enforcement activities directed at allegations of failed audits. The Panel recognizes that a finite budget imposes limitations on the SEC's ability to apply its investigative resources wherever needed. A larger budget allocation to enforcement efforts directed at allegations of failed audits would have salutary effects on the accounting profession, and reassure the investing public that the main "cop on the beat" recognizes the critical importance of audits and the deterrent effects of vigorous enforcement.

**6.60** Because the Panel believes the study of the AAERs described in Appendix F was very useful and provided valuable information to supplement the evidence obtained from other activities, the Panel recommends that the SEC:

- Periodically, such as annually or biennially, undertake a similar study and disseminate the results

- Document information on the auditors' work in every enforcement investigation involving materially misstated financial statements, not just those in which the auditor is named in an AAER. (In making this recommendation, the Panel recognizes that the SEC staff routinely examines the auditors' involvement in each case.) The SEC staff may wish to employ the Panel's questionnaire as a guide in identifying the types of information to be documented.<sup>15</sup>

## **THE RELATIONSHIP BETWEEN THE PROFESSION AND THE SEC**

**6.61** The federal securities laws require that the financial statements of public companies be audited by independent auditors. Congress gave the SEC the broad authority to establish accounting standards used by public companies as part of its mandate to administer and enforce the provisions of the federal securities laws. However, the SEC has relied principally on accounting standards established in the private sector, currently by the FASB. Similarly, the SEC has the statutory authority to modify or supplement auditing standards, but it has looked to the ASB as the principal source of auditing standards.

**6.62** Since the enactment of the federal securities laws, the unique relationship between the profession as auditor and standard setter, on the one hand, and the SEC as regulator, on the other, has been one of the key features of the success of the American capital markets. The Panel believes that the relationship has helped engender extraordinary credibility in those markets and that continuing a healthy working relationship is critical to maintaining that credibility.

**6.63** While one would expect occasional tensions, the current relationship between the profession and the SEC seems under unusual stress. The Panel views this situation as counterproductive to continued improvement in financial reporting – a shared goal of both the profession and the SEC.

**6.64** As in any relationship under stress, each participant typically has contributed to the pressure points. Thus, there is undoubtedly merit to the concerns of each party. The Panel believes that this important relationship must be restored to its historic level of candor, trust and respect. A revitalized relationship can facilitate progress in improving audit effectiveness and can enable the participants to work in harmony for the public interest.

**6.65** The Panel has recommended a strengthened POB as an effective oversight body to whom the SEC, the state boards of accountancy, the auditing profession and the public can look for leadership. The Panel believes that the POB can play an important role in ensuring a strong, healthy working relationship between the profession and the SEC.

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<sup>15</sup> The questionnaire was designed to gather the data discussed in Appendix F. The questionnaire has been provided to the SEC staff.

