United States General Accounting Office

GAO

Report to the Ranking Minority Member, Committee on Energy and Commerce, House of Representatives

May 2002

THE ACCOUNTING PROFESSION

Status of Panel on Audit Effectiveness Recommendations to Enhance the Self-Regulatory System

G A O

Accountability ★ Integrity ★ Reliability

GAO-02-411

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Abbreviations

AAER	Accounting and Auditing Enforcement Release
AICPA	American Institute of Certified Public Accountants
ASB	Auditing Standards Board
CART	Committee Appointed Review Team
CPA	Certified Public Accountant
FAF	Financial Accounting Foundation
FASB	Financial Accounting Standards Board
GAAP	generally accepted accounting principles
GAAS	generally accepted auditing standards
ISB	Independence Standards Board
NASBA	National Association of State Boards of Accountancy
PEEC	Professional Ethics Executive Committee
PITF	Professional Issues Task Force
POB	Public Oversight Board
PRC	Peer Review Committee
QCIC	Quality Control Inquiry Committee
SEC	Securities and Exchange Commission
SECPS	SEC Practice Section
SOM	Summary Observation Memorandum
SQCS	Statements on Quality Control Standards

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Comptroller General
of the United States

United States General Accounting Office
Washington, D.C. 20548

May 17, 2002

The Honorable John D. Dingell
Ranking Minority Member
Committee on Energy and Commerce
House of Representatives

Dear Mr. Dingell:

This report responds to your request concerning the status of recommendations made by the Panel on Audit Effectiveness[1] (Panel) to enhance the accounting profession's self-regulatory system. The accounting profession maintains a voluntary, self-regulatory system through the American Institute of Certified Public Accountants (AICPA) that includes establishing professional standards, monitoring compliance with professional standards, disciplining members for improper acts and substandard performance, and conducting oversight of the system. You expressed concern about the effectiveness of the self-regulatory system and whether the Panel's recommendations would be implemented fully. Specifically, you requested that we (1) determine the status of the Panel's recommendations to address limitations of the self-regulatory system, and (2) identify any gaps in actions taken to implement the Panel's recommendations and their likely impact on overcoming the limitations of the self-regulatory system identified by the Panel.

The sudden failure of Enron Corporation, one of the nation's largest corporations, has, among other things, led to severe criticism of virtually all areas of the nation's financial reporting and auditing systems, which are fundamental to maintaining investor confidence in our capital markets. These areas include corporate governance, accounting standards and financial reporting, auditing, and regulation of the accounting profession and were beyond the scope of the Panel's study. Accordingly, proposals to overhaul or, in some cases, replace the current self-regulatory system will benefit by consideration of proposals to improve the effectiveness of controls in these other areas. These interrelated areas should be addressed in a comprehensive and integrated manner, and any actions taken should be guided by the fundamental principles of having the right incentives for the key parties to do the right thing, adequate transparency to provide reasonable assurance that the right thing will be done, and full

[1] *The Panel on Audit Effectiveness Report and Recommendations*, August 31, 2000.

accountability if the right thing is not done. Further, the components in the regulatory and corporate governance systems must proactively assess risks within the system that inhibit effectively protecting the public interest.

It is important to recognize that the Panel's study and recommendations were directed at enhancing the accounting profession's then-current self-regulatory system and, therefore, did not address alternative models of governing the accounting profession, the current financial reporting model, or various corporate governance issues.

On January 17, 2002, the Chairman of the Securities and Exchange Commission (SEC) outlined a proposed new regulatory structure to oversee the accounting profession. The SEC's proposal provided for creating an oversight body that would include monitoring and discipline functions, have a majority of public members, and be funded through private sources, although no further details were announced.[2] The existing oversight body, the Public Oversight Board (POB), was critical of the SEC's proposal and stated that it was not consulted about the proposal that the SEC evidently developed in consultation with the AICPA and the five largest accounting firms. On January 20, 2002, the POB passed a resolution of intent to terminate its existence no later than March 31, 2002.[3] In that respect, the SEC announced on March 19, 2002, that a Transition Oversight Staff, led by the POB's executive director, will carry out oversight functions of the POB, including monitoring the status of implementing the Panel's recommendations.[4] However, on April 2, 2002, the POB members voted to extend the POB through April 30, 2002,[5] to provide additional time solely to finalize certain POB administrative matters, including preparing a letter

[2] Subsequently, on March 21, 2002, the Chairman of the SEC in his statement before the Senate Committee on Banking, Housing, and Urban Affairs provided additional details in a working proposal for creating a new private-sector, independent body, subject to SEC oversight, to regulate the accounting profession in the areas of quality control reviews and disciplinary powers.

[3] While the SEC proposal, including the lack of consultation with the POB on the proposal, was the precipitating factor in the decision of the POB to terminate its existence, other considerations played a role, as discussed in the POB Chairman's statement before the Senate Committee on Banking, Housing, and Urban Affairs on March 19, 2002.

[4] The Transition Oversight Staff will carry out the work of the former POB through a memorandum of understanding signed by Transition Oversight Staff, the SEC, the AICPA, and the AICPA's SEC Practice Section.

[5] This date was subsequently extended by 1 day to May 1, 2002.

concerning transitioning for monitoring the implementation of the Panel's recommendations, and to facilitate a more orderly transition.

Although the POB has terminated its existence, the Panel's findings regarding limitations of the self-regulatory system and the status of actions to address those limitations should be instructive in not only considering the SEC's proposal, but other proposals that may result from the many Enron related inquires. Accordingly, as you requested, we are reporting on the status of the Panel's recommendations related to the accounting profession's current self-regulatory system.

Regarding the broad range of issues highlighted through the Enron failure, we have recently issued other products to assist the Congress. We held a forum on corporate governance, transparency, and accountability in February 2002 to discuss the effectiveness of the systems of regulatory control as well as other related areas such as pensions.[6] Also, we testified before the Congress to further elaborate on these issues, including considering alternatives to the current self-regulatory system of the accounting profession.[7] In addition, we issued significant changes to the auditor independence requirements under *Government Auditing Standards*, which apply to audits of federal entities and funds.[8] While the new standard deals with a range of auditor independence issues, the most significant change relates to the rules associated with nonaudit or consulting services provided to clients. These revisions were considered for several years, as auditor independence has been a longstanding concern, and were not a response specifically to address the various auditor independence issues raised by the Enron failure. On May 3, 2002, at the request of the Chairman of the Senate Committee on Banking, Housing, and Urban Affairs, we submitted for the record our views regarding what steps the Congress should consider taking to strengthen oversight of the accounting profession, auditor independence, and selected financial

[6] *Highlights of GAO's Forum on Corporate Governance, Transparency, and Accountability* (GAO-02-494SP, March 5, 2002).

[7] *Protecting the Public Interest: Selected Governance, Regulatory Oversight, Auditing, Accounting, and Financial Reporting Issues* (GAO-02-483T, March 5, 2002), and *Protecting the Public's Interest: Considerations for Addressing Selected Regulatory Oversight, Auditing, Corporate Governance, and Financial Reporting Issues* (GAO-02-601T, April 9, 2002).

[8] *Government Auditing Standards: Amendment No.3, Independence* (GAO-02-388G, January 2002).

reporting matters. The letter containing our views is included as appendix VI to this report.

Results in Brief

The Panel's recommendations were made within the context of the existing self-regulatory system of the accounting profession. Implementing actions taken or in process have addressed many of the Panel's recommendations. However, the Panel's recommendations did not fully address the limitations of the self-regulatory system which the Panel identified in its report. Also, some of the Panel's recommendations were either not accepted or are still under study. Additional experience is needed to evaluate the effectiveness of actions taken or planned; however, the overarching issues of a system that is fragmented, is not well coordinated, and has a disciplinary function that is widely perceived to be ineffective continue to exist.

The POB's authority was extended to oversight of auditing standards as recommended by the Panel, but gaps remained in the authority of the POB regarding oversight of setting auditor independence rules and disciplining members of the accounting profession. In addition, in contrast to the Panel's recommendation that the POB have sole authority to determine its budget and financial and other resources, and that the accounting profession be obliged to provide those resources, the POB's budget was capped at $5.2 million. Having a budget cap in the POB's charter could be perceived as a limitation of the accounting profession's support for effective oversight and could have delayed or otherwise hindered the operations of the POB. In response to the Panel's recommendations to improve communications, the POB established a coordinating task force within the self-regulatory system. However, with regard to the public regulatory systems (the SEC and the state boards of accountancy), no substantial actions were taken to improve communications. The SEC's January 17, 2002, announcement of a proposed new regulatory body without consulting with the POB demonstrates the continuing lack of effective communications as reported by the Panel, to jointly work together to protect the public interest.

Changes proposed by the Panel to the peer review program, which is the keystone of the present self-regulatory system, so that the program has a more risk-oriented approach for all firms and, in addition, continuous peer review and oversight of the large firms, have been tested by the AICPA. Implementation is planned for the 2002 peer review cycle. Further, the AICPA is considering other changes to the peer review standards, as recommended by the Panel. The AICPA, however, did not accept the

Panel's recommendation to have the POB considered as the client of the peer reviews. Consistent with the Panel's intentions, the POB's successor needs to have early involvement with draft peer review reports to ensure that root causes of problems are identified and effectively addressed and reported.

The self-regulatory system lacks the power to protect the confidentiality of investigative information regarding alleged audit failures or other disciplinary matters concerning members of the accounting profession. As the Panel reported, the lack of such protective power hinders the timing of investigations, which affects the public's perception of the self-regulatory system's effectiveness. The Panel recognized the need for legislation to address this issue, but given the uncertainty of obtaining it, the Panel recommended other actions, which the AICPA has taken, to protect the public interest when public accounting firms or their members overseen by the POB are named in litigation alleging an audit failure.

The Panel also reported that the public's perception of the self-regulatory system's effectiveness is affected by the need for improved transparency of disciplinary actions that have been taken. In response to the Panel's finding, a task force within the self-regulatory system has been formed to explore more informed reporting of disciplinary activities. The effectiveness of disciplinary actions, as reported by the Panel, remains an open issue.

We provided for comment a draft of this report to officials of the POB, the AICPA, the SEC, and the National Association of State Boards of Accountancy (NASBA), as well as to the Chair of the Panel on Audit Effectiveness. The comments we received were generally technical in nature and were considered as appropriate throughout the report.

Background

The Panel on Audit Effectiveness, a "Blue Ribbon Panel,"[9] was formed by the POB in response to a September 28, 1998, request from the SEC for an evaluation of whether recent changes in the audit process serve to protect

[9] The Panel on Audit Effectiveness was chaired by a former Chair of Price Waterhouse and included two former SEC Commissioners, a former Chairman and CEO of the American Stock Exchange, a former President of the American Stock Exchange, a Chair and CEO of CNA Insurance Companies, a professor of finance and law at Columbia University, and a professor of auditing at the University of Southern California.

the interest of investors. The SEC stated that the combination of changes in the audit process and high profile financial frauds have raised questions about the efficacy of the audit process. Accordingly, the Panel was formed to conduct a comprehensive review and evaluation of the way independent audits are performed and to assess the effects of recent trends in auditing on the public interest. The Panel's study included assessing the accounting profession's self-regulatory system. The Panel's study also addressed issues related to the interface of the accounting profession's self-regulatory system with the SEC and the state boards of accountancy (the public regulatory systems). Our work, as requested by the Ranking Minority Member, House Committee on Energy and Commerce, was directed at the status of the Panel's recommendations addressing the accounting profession's current governance system (the self-regulatory system and the public regulatory system).

The Panel's report stated that although the goals of self-regulation and public regulation are similar, that is, protecting the public interest, and that the two systems are intended to operate in concert with one another, there are important differences:

> Public regulation is conducted with the full power of the state in support of established requirements. Self-regulation has no equivalent authority. At most, it can exclude noncomplying members from whatever benefits group membership confers or impose whatever sanctions members have voluntarily agreed to accept. Such powers as the ability to subpoena records and witnesses are not available in self-regulation.[10]

Self-Regulatory System

At the time of the Panel's study, the self-regulatory system included the AICPA's SEC Practice Section (SECPS), principally devoted to monitoring the profession's compliance with membership requirements and standards. The SECPS's subcomponents included the SECPS Executive Committee, the Peer Review Committee (PRC), the Quality Control Inquiry Committee (QCIC), the SEC Regulations Committee, and the Professional Issues Task Force. The SECPS was overseen by the POB. In addition, the accounting profession's self-regulatory system included standards-setting activities carried out by the Auditing Standards Board (ASB), the Independence Standards Board (ISB), and the AICPA's Ethics Division's Professional

[10] Robert K. Mautz, "Self-Regulation: Perils and Problems," *Journal of Accountancy* (May 1983) (initially presented as an address at the AICPA's tenth national conference on current SEC developments [January 1983]).

Ethics Executive Committee (PEEC), which also performed disciplinary activities.

The SECPS was administratively created by the AICPA in 1977, in consultation with the SEC, and required member public accounting firms to subject their professional practices to peer review and oversight by the POB and the SEC. AICPA membership requires that members who provide attest services to an SEC client be employed by or affiliated with a public accounting firm that is an SECPS member. Within the SECPS, the

- SECPS Executive Committee responsibilities include establishing membership requirements, budget and dues requirements, determining sanctions for noncompliance with membership requirements, and appointing persons to its other committees and task forces.

- PRC oversees all aspects of the peer review program (audit firms review other firms' quality control systems for compliance with standards and membership requirements) and imposes corrective measures when deficiencies are found.

- QCIC conducts investigations of alleged audit failures involving SEC clients arising from litigation or regulatory investigations, including criminal indictments. The QCIC's investigation is focused on whether the member firm has deficiencies in its system of quality control or its compliance with the system, or whether there are deficiencies in professional standards relevant to matters in the case. The QCIC does not determine guilt related to the litigation of the subject firm. It does impose corrective measures related to its objectives and, where members may have violated professional standards, refers the cases to the Ethics Division for investigation and possible disciplinary action.

- SEC Regulations Committee acts as the primary liaison between the accounting profession and the SEC on technical matters relating to SEC rules and regulations.

- Professional Issues Task Force accumulates and considers practice issues that present potential audit concerns for practitioners and disseminates information addressing those concerns, including referrals to the profession's standard-setting bodies.

The SECPS's committees and task force are composed of volunteers, all of whom are certified public accountants and members of the AICPA.

The POB was formed simultaneously with the SECPS by the AICPA, in consultation with the SEC, to oversee the SECPS and represent the public interest on all matters that may affect public confidence in the integrity of the audit process. At the time of our study, the POB was comprised of five public members with a broad spectrum of business, professional, regulatory, and legislative experience that represents the public interest. SECPS member dues funded the POB and the SECPS. Based on the Panel's recommendations, the POB received enhanced oversight authority within the self-regulatory system that will be discussed later in this report. As discussed earlier in the report, the POB terminated on May 1, 2002.

The AICPA established the ASB to promulgate generally accepted auditing standards (GAAS), that are followed by independent auditors of financial statements, and to promulgate related standards governing attest services. The ASB also issues quality control standards that must be followed by AICPA member firms for their internal quality control system. The ASB consists of 15 members, with representatives from audit firms, academia, and government, that are approved by the AICPA Board of Directors.

The ISB was created in 1997 through an agreement between the SEC and the AICPA to, among other activities, develop auditor independence rules for auditors of SEC registrants. The ISB consisted of four public members and four members from the auditing profession. The ISB was terminated in 2001, which will be later discussed.

The AICPA's Ethics Division, through its PEEC, is responsible for setting auditor independence rules for all members of the AICPA and determining compliance with the independence rules and auditing standards when allegations of noncompliance are reported or otherwise brought to the PEEC's attention. The PEEC consists of 16 members from all areas of practice (public accounting, private industry, and government) and 5 public members (academia and the legal profession).

Public Regulatory System

The SEC, through its responsibilities for administering and enforcing the federal securities laws, is the primary federal agency involved in accounting and auditing requirements for publicly traded companies. The SEC has accepted accounting rules set by the Financial Accounting Standards Board[11] (FASB)—generally accepted accounting principles (GAAP)—as the primary standards for preparation of financial statements. The SEC has accepted rules promulgated by the ASB—GAAS—as the standards for independent audits. The stock exchanges, which are self-regulatory organizations approved by the SEC under the Securities Exchange Act of 1934, establish accounting and auditing regulations for listed companies, including requiring published annual reports containing financial statements prepared in accordance with GAAP and audited by independent public accountants. The SEC reviews and comments on registrant filings and issues interpretive guidance and staff accounting bulletins on accounting and auditing matters. The SEC oversees the peer review program administered by the SECPS by reviewing the POB's oversight of the program, selecting certain peer review workpapers for review, and reviewing the QCIC's summaries of closed cases.

State boards of accountancy, established by statute, regulate the practice of public accountancy within their jurisdictions. State boards have adopted rules of professional conduct, including compliance with auditing standards, and can take disciplinary action against licensees who violate these rules or standards. The individual state boards grant CPA licenses to practice, and they are the only agencies that can revoke them.

The Panel reported in August 2000 that the accounting profession's self-regulatory system, while extensive, suffered from various limitations, including:

- lack of sufficient public representation on the various self-regulatory bodies,
- lack of unified leadership of the various self-regulatory bodies,

[11] FASB, as part of the Financial Accounting Foundation (FAF), is a not-for-profit organization supported by proceeds from the sale of its publications and by contributions from accounting firms, corporations, and other entities that are interested in accounting issues. FASB consists of seven full-time members who are selected and approved by the FAF.

- constraints on effective communications with the SEC and among the various components of the self-regulatory system,

- differing interests and divergent views of the AICPA's priorities on the part of its diverse membership, and

- a disciplinary system that is perceived to be slow and ineffective.

The Panel believed that many of the limitations of the self-regulatory system could be mitigated by building on the POB's experience and reputation and by giving it increased authority and resources. The Panel's recommendations were directed at (1) enhancing the POB's independence and expanding its oversight authority and resources, (2) improving communication within the self-regulatory system and with the SEC and the state boards of accountancy (the public regulatory systems) through POB leadership, (3) improving the accounting profession's peer review program and the POB's oversight of that program, and (4) providing more timely remedies to protect the public interest when legal or regulatory actions allege audit failures.

Objectives, Scope, and Methodology

Our objectives were to

- determine the status of the actions taken in response to the recommendations to address the limitations of the accounting profession's self-regulatory system contained in chapter 6, "Governance of the Auditing Profession," of the Panel on Audit Effectiveness' August 31, 2000, report; and

- identify any gaps in actions taken to implement the Panel's recommendations and their likely impact on overcoming the limitations of the current self-regulatory system as identified by the Panel.

To determine the status of the actions taken to address the Panel's recommendations, we obtained an understanding of the various components of the accounting profession's governance system, their functions and responsibilities, their resources, and the interfaces among components, both at the time the Panel issued its report and after actions had begun to implement the Panel's recommendations. We arranged separate interviews with senior representatives from each system component to discuss their views regarding the Panel's findings and the limitations identified in the Panel report, their agreement with

recommendations contained in the report, any limitations of the effective execution of actions taken or planned, and their opinions on the likely effectiveness of these actions in response to the recommendations. For actions in process, we discussed timeframes for implementation and any possible issues to be resolved to implement the recommendations.

We also met with the former SEC Chief Accountant serving at the time of the Panel's report and NASBA representatives to discuss the Panel's recommendations either addressed to them or related to their responsibilities.

We conducted our review from June 2001 through April 2002 in accordance with generally accepted government auditing standards. We provided for comment a draft of this report to officials of the POB, the AICPA, the SEC, and the NASBA, as well as to the Chair of the Panel on Audit Effectiveness. The comments we received were generally technical in nature and were considered as appropriate throughout the report.

We discussed our observations included in this report with senior representatives of the various entities and incorporated their comments in this report as appropriate.

The following sections discuss substantially all of the Panel's findings and recommendations, identify those areas of the self-regulatory system where actions to address the Panel's recommendations were either not taken, did not fully address the recommendations, or are incomplete, and provide our observations where further actions are needed to address the Panel's recommendations. See appendix I for the complete status of the Panel's recommendations affecting the provisions of the POB's charter and appendix II for the complete status of the Panel's other recommendations for improving the self-regulatory system. Appendixes III, IV, and V contain comment letters from the POB, the AICPA, and the NASBA, respectively. Appendix VI contains our May 3, 2002, letter to the Chairman of the Senate Committee on Banking, Housing, and Urban Affairs regarding what steps the Congress should consider taking to strengthen oversight of the accounting profession, auditor independence, and selected financial reporting matters.

POB's Oversight Authority, Independence, and Leadership Role

In the mid-1970s, reports of U.S. companies paying bribes to foreign officials and several highly publicized corporate bankruptcies resulted in congressional hearings over these matters and the role of independent auditors. A central focus of the hearings was whether additional regulation of public accountants was necessary or whether the system of self-regulation was sufficient. In response, in 1977 the AICPA, in consultation with the SEC, created the SECPS,[12] mandatory peer review to check compliance with standards, and the POB to conduct oversight of the SECPS. The POB did not have a formal charter but instead operated under the SECPS's Organization Document and its own bylaws.

A central focus of the Panel's recommendations was for the POB, the AICPA, the SECPS, and the SEC to work together on a charter for the POB that would commit all parties to an expanded POB oversight role and system of self-regulation as recommended by the Panel. On February 9, 2001, the AICPA Board of Directors approved a charter for the POB that, in all material respects, incorporated the POB's Bylaws and the SECPS's Organization Document provisions pertaining to the POB.

In addition to incorporating the previous oversight authority of the POB and its operating practices, the POB charter provided the POB with new authority related to overseeing the setting of auditing and independence standards, conducting special reviews of the profession, establishing activities to improve communication within the self-regulatory system and with the public regulatory systems through POB leadership, evaluating the effectiveness of the self-regulatory components overseen by the POB and the effectiveness of the POB, and strengthening POB membership requirements.

While actions were taken to implement many of the Panel's recommendations, the overarching problems of a system that is fragmented and not well coordinated continue to exist. Further, significant gaps remain in the POB's oversight authority, funding limitations exist, and communications problems continue.

[12] Initially membership in the SECPS was voluntary. In 1988, the AICPA changed its by-laws to mandate that members of the AICPA who provide attest services to SEC clients be affiliated with a CPA firm that is an SECPS member. There are about 1,300 member firms in the SECPS that collectively audit more than 99 percent of all U.S.-based SEC registrants.

POB's Oversight Authority

Prior to the Panel's report, the POB's oversight authority was limited to the SECPS, including oversight of peer review of members of the SECPS and the QCIC's activities. The Panel recommended extending the POB's oversight authority to the ASB, the ISB, and the auditor independence standard-setting activities of the PEEC that relate to audits of public companies. The POB received oversight authority over the ASB and the ISB, but did not get oversight authority over the PEEC's auditor independence standard-setting activities with respect to public companies. Notwithstanding the responsibilities of the ISB, in November 2000, the SEC issued auditor independence rules for auditors of SEC registrants. The former SEC Chief Accountant, who served in that position when the SEC's auditor independence rules were issued, stated that the SEC was dissatisfied with the progress of the ISB and, therefore, issued the rules itself. Subsequently, on July 17, 2001, the SEC and the AICPA agreed that the ISB would be terminated and the SEC would resume responsibility for setting auditor independence rules for auditors of SEC registrants. With the SEC assuming auditor independence responsibilities and the POB not having received any oversight authority over the PEEC's independence standard-setting activities, the POB was left with no oversight authority over the setting of auditor independence rules—exactly where it was before the Panel's recommendations.

The PEEC Chairman stated that since the SEC sets auditor independence rules for auditors of SEC registrants, the independence rules set by the PEEC essentially govern those members of the AICPA who do not audit SEC registrants. Therefore, the PEEC Chairman believes the auditor independence standard-setting activities of the PEEC are outside the basic authority of the POB, which was limited to oversight of SECPS member firms. Further, the PEEC Chairman believes that POB oversight was unnecessary because the PEEC added five public members who can serve to protect the public interest. However, SEC officials told us it might consider independence standards established by the PEEC in reaching a decision on an issue that is not covered by the SEC's rules.

As will be discussed later, the Panel identified significant limitations of the self-regulatory disciplinary function, recommended measures to protect the public interest following a legal or regulatory action alleging an audit failure, but did not address in its report whether the POB should have authority over the AICPA's Ethics Division's disciplinary activities. The Panel advised us that they viewed disciplinary actions against SECPS members as primarily a function of the SEC and the courts. The PEEC Chairman, whose committee is part of the AICPA's Ethics Division and is

responsible for investigating and disciplining members of the AICPA concerning violations of standards, stated that its cases involving SECPS members are a relatively small percentage of its total cases and that having public members on the PEEC adequately protects the public interest without POB oversight.

The Panel recommended that the professional staff of the SECPS, the ASB, and the PEEC remain employees of the AICPA. The Panel advised us that consideration was given to whether the functions of these components of the self-regulatory system should be under the POB, which would be similar to the United Kingdom model for regulation of the auditing profession, but at that time the United Kingdom model was relatively new and not fully operational. Also, the Panel stated that concerns were raised about whether having these functions under the control of the POB would be in conflict with the POB's oversight role. Therefore, the Panel recommended that no changes be made.

The Panel was concerned that the differing interests and divergent views of the AICPA's priorities on the part of its diverse members could affect the resources of the components of the self-regulatory system. Therefore, the Panel recommended that 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. The AICPA did not accept this recommendation, as it believed human resource decisions are management functions and would be in conflict with the POB's oversight role. However, the POB under its charter is responsible for overseeing the adequacy of the ASB's and SECPS's resources. Further, the POB believed that if staffing issues were to arise, its oversight activities would have put it in a position to raise the problem for resolution.

The Panel recommended that (1) the POB approve appointments to the ASB, the SECPS Executive Committee, and the ISB, and that (2) the SECPS Executive Committee retain responsibility for approving appointments to the various SECPS committees that report to it, namely the PRC, the QCIC, the SEC Regulations Committee, and the Professional Issues Task Force. The AICPA accepted the latter recommendation but did not accept the former recommendation. The POB's charter provides that the POB shall be consulted on appointments of members to the ASB and the SECPS Executive Committee, and that its concurrence on the chair of the ASB and the SECPS Executive Committee should not be unreasonably withheld. The POB believed that the consultative role in its charter with respect to the appointment of committee chairs and members would lead to the same

outcome as the approval role recommended by the Panel. The POB believed that if a problem were to arise, the AICPA would reasonably consider the POB's views.

In addition to the gaps in the POB's authority for oversight of the self-regulatory system highlighted in the Panel's study, the POB's oversight authority was limited to those firms that are members of the SECPS. Although the 1,300 firms that are members of the SECPS audit SEC registrants, which are the nation's largest companies, there are thousands of other public accounting firms that are also members of the AICPA that provide audit and attest services that businesses, creditors, and investors rely on in making business and financial decisions. As members of the AICPA, these firms are subject to peer review through the AICPA's peer review program for auditors of non-SEC clients, rather than the SECPS and, therefore, are outside the oversight authority of the POB.

Funding the POB and Its Activities

The POB was funded through the membership dues of the SECPS. The Panel recommended that the POB's charter should provide the POB with sole authority to determine its budget and financial and other resources, and the accounting profession's obligation to provide those resources. The Panel strongly believed that such "no-strings-attached" funding was absolutely essential if the POB was to be effective and independent of the accounting profession and if the self-regulatory system was to be viable. The Panel's recommendation was not fully accepted. The POB charter provides for the POB to submit its budget to the SECPS Executive Committee, and, if the AICPA Board requests, to the AICPA Board, for consultation. The POB advised us that its charter essentially formalized and continued the budget process that it previously followed, except for a cap on its budget, which attaches an additional "string" on the POB's funding.

The POB charter contains a new provision capping the POB's annual budget at $5.2 million. The charter does contain provisions for supplemental requests subject to the above review process and adjusting the ceiling for inflation. Further, the POB charter provides that the SECPS Executive Committee and the AICPA Board may raise the budget ceiling based on consideration of all the circumstances and public interest at any time during the year.

The POB stated that the principal players who developed the concept of a budget ceiling were one or more of the five largest public accounting firms

and the AICPA, and the concept was then agreed to by the SEC Chairman. The SEC Chief Accountant at that time told us that the SEC was having difficulty getting the largest public accounting firms to agree on a charter for the POB, and at the same time, there was some reluctance by one or more of the firms to fund the POB to arrange for review of the largest public accounting firms' internal systems for compliance with auditor independence rules. He stated that the SEC Chairman viewed the budget cap as a way to get the firms to agree on a charter for the POB. The POB Chairman told us he did not support the budget cap, and had initiated actions, including the additional provisions discussed above in the POB charter, to mitigate the impact of a ceiling provision on its operations and independence.

The POB believes it did not have sole authority to determine its budget, financial, and other resources in light of the ceiling in its charter. The POB believes that notwithstanding the restrictive budget provisions in the charter, the provisions should not have impeded its ability to operate. The POB and the Panel believe that because funding problems for the POB could be made public, there was a strong incentive for the SECPS to meet the funding needs of the POB and not have such issues aired in public.

In July 2001, the POB told us it believed it had the resources to conduct the enhanced oversight role as provided for in its charter. The POB's budget data for its recurring expenditures show that the $5.2 million budget ceiling represents more than a 50 percent increase over its fiscal years 2000 and 2001 budget and 2002 preliminary budget expenditures. However, the POB budget data for fiscal year 2000 show that when nonrecurring expenditures, such as special studies, are included, the budget total is within about $700,000 of the $5.2 million ceiling.[13] In addition, it clearly did not have the funding autonomy called for by the Panel.

[13] The POB charter provides that the $5.2 million limit does not include expenditures by the POB for the reviews of the Big 5 firms conducted pursuant to the "Term Sheet for Independence Look-Back Testing Program" entered into by the SEC and those firms in June 2000.

Communications Within the Self-Regulatory System and With the Public Regulatory Systems

Constraints on effective communication with the SEC and among the various entities in the self-regulatory system were among the overarching limitations of the accounting profession's governance system identified by the Panel. Given the multiple components of the governance system, the Panel believed that the POB should serve as a strengthened, unifying oversight body to whom the SEC, the state boards of accountancy, the accounting profession, and the public should look to for leadership. The Panel intended for the POB to enhance communications among the components of the accounting profession's governance system in order to facilitate the profession's continuous improvement efforts and to identify and resolve important issues on a timely basis.

The Panel's recommendations included that (1) the POB establish an advisory council to advise the POB on issues related to projects on its agenda, (2) the POB establish a coordinating task force of the chairs of each body within the POB's oversight, (3) the POB and the SEC acknowledge the need to maintain a mutual respect and confidence, and increase the public's respect for the profession and its role in the capital markets, and (4) the POB and state boards of accountancy, perhaps through the NASBA, determine how best to facilitate meaningful continuing dialogue between the POB and state boards.

The POB charter provides for a coordinating task force as recommended by the Panel, but does not establish an advisory council. The POB charter instead provides for the POB to hold an annual outreach meeting to solicit views and recommendations about the accounting profession's self-regulatory program and the POB's oversight process. Further, the POB charter provides that the effectiveness of the annual outreach meeting and whether it alleviates the need for an advisory council be included in the 3-year evaluation of the POB's effectiveness required by its charter.

The POB advised us that it planned to have periodic meetings with the SEC. Also, the POB planned to begin a dialog with the NASBA and several state boards of accountancy to explore ways to improve communications. However, on January 20, 2002, the POB passed a resolution expressing its intent to terminate its existence. In the resolution, the POB Chairman was critical of the SEC for not consulting with the POB on the SEC's plans for a new body to govern the accounting profession's discipline and quality control functions. The POB's resolution stated, in relevant part,

Be it resolved, after due consideration of the importance of effective self-regulation as one aspect of the oversight of the accounting profession, but with recognition of the obstacles to achieving this goal which have been encountered in recent years, and given the proposal of the SEC in consultation with the AICPA and the SECPS Executive Committee, without input from the POB, to reorganize the self-regulatory structure, the POB intends to terminate its existence pursuant to Section IX of the POB Charter no later than March 31, 2002.[14]

Peer Review Program

The structure of the SECPS peer review program has evolved since its inception in response to many studies of the program over the years. The latest study of the peer review program, conducted in March 1999 by the Peer Review Process Task Force, identified areas of the peer review program that needed improvements.[15] The formation of the Peer Review Process Task Force and the need to reexamine the peer review program was encouraged by the PRC, the POB, and the SEC, which were seeking enhancements in the reporting of the results of peer reviews; improvements in the effectiveness of peer reviews; comprehensive governance and oversight of the peer review process; and peer reviews performed by appropriately qualified and trained reviewers. A Panel staff member participated in the Peer Review Process Task Force's deliberations. In its report, the Panel recommended that all of the Peer Review Process Task Force's recommendations be implemented and made additional recommendations to the SECPS, the POB, the ASB, and the SEC to strengthen the peer review process and expand oversight of peer reviews. Both the work of the Peer Review Process Task Force and the Panel was limited to improving the peer review program within the existing self-regulatory system and therefore did not consider a different body for conducting or overseeing the program.

[14]As discussed previously, the POB ultimately extended its existence solely for administrative purposes through May 1, 2002.

[15] The Peer Review Process Task Force's report, which was issued in January 2000, is included in Exhibit 4 of the Panel's report, *The Panel on Audit Effectiveness Report and Recommendations*, August 31, 2000.

In January 2001, the SECPS Executive Committee approved a pilot test of a plan to modify the approach to conducting and reporting on peer reviews, including expanding the oversight of peer reviews. The pilot program incorporates almost all of the recommendations made by the Peer Review Process Task Force and the Panel. The peer review program currently being piloted places a greater emphasis on obtaining an understanding of the audit team's approach to the audit, including the team's thought processes and identification and testing of emerging issues and high-risk areas, as well as better insight into the knowledge, skills, training, and experience of the audit team. The pilot program separates SECPS member firms into two tiers primarily based on the firm's size and requires the larger firms[16] to undergo "continuous" peer reviews, that is, some level of review each year. The PRC has also approved new reporting standards for peer reviews, effective June 30, 2001, that require peer review reports to be more descriptive to enable users to better understand the peer review findings and peer review process. In addition, the POB's oversight of the peer reviews of the largest firms was expanded to include more timely and extensive visits to the offices that are being reviewed.

Other than approving new reporting standards, the AICPA has not finalized these enhancements to the SECPS peer review program. Also, there are certain recommendations made by the Peer Review Process Task Force and the Panel to strengthen peer review that either were not addressed or were not fully implemented at the time of our study. These recommendations concern revisions to the standards governing peer review; the qualifications and training of peer reviewers; consideration of the POB as the primary client of peer review; and the development, analysis, and reporting of performance measures, performance indicators, and other data that may be useful to users of peer review reports.

Quality Control Standards

The Peer Review Process Task Force believes that one of the root causes of some of the criticisms of the peer review process relates to the lack of specificity of the quality control standards.[17] In the Panel's view, the quality

[16] Large firms are defined as those firms with 30 or more SEC clients and at least 100 accounting and auditing professionals.

[17] The AICPA's ASB issues quality control standards that provide that firms have a system of quality control for their accounting and auditing practice and broadly describes elements of quality control and other matters essential to the effective design, implementation, and maintenance of the system.

control standards are broad and general, making it difficult to critique compliance against the standards; thus, the Panel believes that firms with weaker practices can still receive unqualified peer review opinions. The Panel recommended that the quality control standards be made more specific and definitive for firms with public clients, especially for the largest firms.

An AICPA task force (made up of the ASB, the PRC, the QCIC, and other AICPA groups), which was established to consider the Panel's recommendation concerning the quality control standards, has tentatively concluded that given the variety of attest services covered by the standards and the various sizes of public accounting firms that follow the standards, the Panel's recommendations can best be addressed by providing more specificity to a guide that accompanies the standards.[18] Through its process of updating the guide, the AICPA task force plans to consider whether any guidance should be elevated from the guide to a standard.

Qualifications and Training of Peer Reviewers

Peer reviews are performed by public accounting firms that have received an unqualified report on their own peer review. The PRC issues standards describing the qualifications and training requirements for peer reviewers[19] and in each peer review, the PRC evaluates the peer reviewer's competence and performance. The PRC has the authority to reject a firm that has been engaged to perform a peer review. The Peer Review Process Task Force believes the current training courses and approach to training peer review team captains and reviewers needs to be enhanced to meet the needs of the peer review program. The Peer Review Process Task Force also believes there are additional measures that should be taken to promote independence and objectivity of peer reviewers.

The Peer Review Process Task Force made several recommendations to improve the performance and independence of peer reviewers including recommending that the PRC (1) establish a standing task force that will oversee the peer review training programs, (2) develop a system for evaluating the performance of the team captains, and (3) limit the peer review team captains for the reviews of the largest firms to two

[18] *Guide for Establishing and Maintaining a System of Quality Control for CPA Firm's Accounting and Auditing Practice.*

[19] *Standards for Performing and Reporting on Peer Reviews.*

consecutive triennial reviews of the same firm and a total of three consecutive reviews as an engagement team member. The Panel recommended that the POB should review the qualifications of the peer review firm and the peer review captain.

The PRC has acted on the recommendations concerning qualifications and training of peer reviewers; however, not all actions are finalized. For example, the PRC told us it plans to revise the peer review standards in the spring of 2002 to enhance peer reviewer independence and objectivity such as to limit the peer review team captains for the reviews of large firms to two consecutive reviews of the same firm and a total of three consecutive reviews as engagement team members. The AICPA told us that the large firms have already voluntarily complied with the related planned changes to the standards. Also, the POB indicated that it has always reviewed the qualifications of the peer reviewers and the peer review team captains, and when it believes appropriate, makes suggestions for changes.

Primary Client of Peer Review

Peer reviews are performed to enhance the public's confidence in independent auditors. The Panel felt that the POB, as the public's representative, should be viewed as the principal stakeholder in the peer review process and accordingly recommended that it should be made clear to peer reviewers that the POB, not the firm being reviewed, is the primary client. The Panel wanted the peer reviewers to have the "mind-set" that peer reviews are performed in the best interest of the public, and not solely for the benefit of the reviewed firm. By considering the POB as the primary client, the Panel hoped the peer reviewers would bring the POB more into the process up front and continue to keep them apprised of issues throughout the review. The POB could then be in a better position to monitor and oversee the reporting of peer review results.

The AICPA did not accept the Panel's recommendation that the POB should be the primary client of the peer review because the PRC, not the POB, is responsible for maintaining and administering the peer review program. The AICPA did adopt a related Peer Review Process Task Force recommendation to address the peer review reports to both the PRC and the reviewed firm. The Peer Review Process Task Force made this recommendation because it felt that the PRC serves as an "audit committee" and that including the PRC as an addressee on the peer review report would emphasize to peer reviewers and reviewed firms that they should consider the PRC as the "audit committee." However, the Panel told us that including the PRC as an addressee on the peer review report does

not satisfy the intent of its recommendation to have the POB be the primary client of peer review. The Panel acknowledged that the new pilot program now underway, which includes greater involvement by the POB on a continuous, real-time basis, should help the POB gain insight early on as to any quality control issues that should be reflected in the peer review report. However, the Panel cautioned that until the pilot procedures are made final, it is uncertain the POB would have continued with its real-time oversight of peer review.

Peer Review Reporting Model

The Peer Review Process Task Force believes that in order to best serve the public interest, the peer review reporting model, in addition to communicating matters identified during peer reviews, should also provide for the communication of best practices, constructive suggestions that go beyond the professional standards, and matters for the attention of standard setters. To address these points, the Peer Review Process Task Force recommended that the SECPS study whether there are key quantitative and qualitative performance indicators that would be useful to users of SECPS member firms' annual reports or peer review reports. The Panel further recommended that the SECPS 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. The AICPA has told us that it has not been able to identify indicators that are relevant, objective, or measurable; however, the PRC has established a standing task force to continuously consider ways of improving the peer review process including the identification of such quantitative matters.

Accounting Profession's Disciplinary Process

The Panel found that the public perceives the self-regulatory system's disciplinary process to be slow and ineffective and to suffer from a number of limitations. Specifically, the Panel reported that

- the Ethics Division has limited investigative powers as it cannot issue subpoenas or compel testimony; therefore, it must rely on the cooperation of the individual being investigated but cannot talk to the plaintiff or the client company involved;

- investigative proceedings are not timely because the Ethics Division's policy is, in the interest of fairness to the member, to defer its investigation until all litigation or regulatory actions are concluded;

- discipline proceedings are confidential and, therefore, the public cannot determine the reason why a sanction was imposed or, in some cases, whether a sanction was imposed at all; and

- the Ethics Division can impose only limited sanctions, such as requiring continuing professional education or suspending or revoking AICPA membership, because the Division's authority extends only to membership rights.

The Panel found that the QCIC process suffers from many of the same limitations, although its investigations are timely. QCIC corrective actions imposed on firms are not made public. In addition to lacking subpoena power, both the QCIC and the Ethics Division lack protective power for their investigative files.

The Panel found that some state boards of accountancy have not been effective in disciplining substandard conduct due to limited budgets and the lack of effective means to investigate allegations and impose disciplinary measures. Similarly, the Panel found that competing demands on the SEC's resources and its own prosecutorial priorities limit its enforcement activities.

The Panel concluded that while the self-regulatory system is not totally satisfactory, the profession has made a significant effort to make it as workable as practicable given its inherent limitations. The Panel also concluded that the self-regulatory system needs protective power over its disciplinary activities if it is to resolve disciplinary matters on a timely basis, but that such protective powers are obtainable only through legislation. The Panel believed that there was little assurance that such legislation was attainable at the time of its study or in the foreseeable future. Therefore, the Panel made various recommendations to improve the disciplinary process to provide greater protection to the public without recommending legislative changes necessary to provide protective powers. The Panel's recommendations, instead, were directed at protecting the public interest, the timing of investigations, the transparency of information reported on investigations and disciplinary actions, and leveraging the results of investigations.

The Panel's recommendations were largely made to components of the self-regulatory system, although some recommendations were made to the SEC regarding resources and leveraging information from its investigations. The Panel did not recommend extending the POB's authority to oversee

disciplinary functions other than to have the POB involved with the QCIC in reviewing certain firm's actions when there is an allegation of audit failures as discussed below. In addition, the Panel did not make any recommendations to the state boards of accountancy in the area of the profession's disciplinary process. The Panel recommended that the POB and the SECPS review the results of implementing its recommendations over a 2- to 3-year period to determine their effectiveness. The Panel recommended that if the POB and the SECPS subsequently find that actions taken in response to the Panel's recommendations to improve the disciplinary process have not satisfactorily protected the public, the POB, in cooperation with the SEC, should seek legislation to achieve the protections necessary to make the disciplinary process more effective.

Immediate Disciplinary Actions When Members Named in Litigation

In accordance with the Panel's recommendation, the SECPS membership requirements were revised as follows when civil litigation or a criminal or public regulatory investigation contains allegations of an audit failure:

- The firm is required to conduct an internal review of the subject engagement to evaluate the performance of the senior engagement personnel.

- The QCIC should conduct its usual inquiry. If the QCIC believes that standards may have been violated and, accordingly, refers the case to the Ethics Division, the firm would be notified that the Ethics Division is deferring its investigation pending the completion of the litigation.

- The firm is then required to take one of the following options to apply to the partner during the period of deferral, if the individual is still associated with the firm: (A) terminate or retire the individual from the member firm, (B) remove that individual from performing or supervising audits of public companies until the Ethics Division's enforcement process is completed, or (C) subject that individual to additional oversight on all public company audit engagements in which that individual is involved. Additional oversight is defined to mean for at least 1 year, the individual will perform such audits subject to oversight by a senior technical partner appointed by the member firm's Managing Partner/CEO. The senior technical partner oversight of such engagements, at a minimum, will meet the SECPS's concurring partner review membership requirement and procedures prescribed for engagements defined as high risk. Thereafter, the individual must remain under the additional oversight that the firm's Managing

Partner/CEO determines, in light of that person's evaluation of the individual's performance, is necessary to protect the public interest.

The member firm has the responsibility of deciding on the selection of one option A, B, or C above. The implementation of the option selected is subject to review in the member firm's peer review and by the POB. In the event that the partner in question joins another SECPS member firm, the new firm must apply one of the above options to the partner until the Ethics Division completes its investigation. However, should the partner in question join a firm that is not a member of the SECPS, no such restrictions on the partner's activities would apply during the course of the litigation or the Ethics Division's investigation. The POB and the SECPS advised us that the above options are effectively "career ending actions" for the members.

Reducing the Time for Ethics Division and SEC Investigations

The Panel recommended that the Ethics Division devote more resources to its investigations in order to decrease the time it takes to conduct an investigation after a deferral is lifted. The Panel also recommended that the SEC allocate additional resources to its enforcement activities directed at allegations of failed audits.

Because the Ethics Division lacks protective power, the Ethics Division's policy is to defer its investigation pending the outcome of litigation or regulatory enforcement actions in fairness to the AICPA members. Accordingly, the Ethics Division defers cases involving SEC registrants, generally for 2 to 3 years, until litigation or regulatory enforcement actions are completed. The Ethics Division stated that if it had protective power, deferral of the investigation would be unnecessary and the timeliness of the disciplinary process would be significantly enhanced because the legal or regulatory enforcement and ethics disciplinary processes could proceed simultaneously.

The lack of protective power not only contributes significantly to the length of time before the Ethics Division commences its investigations, but also results in other regulatory bodies not being willing to share investigative information, which also adds to the time required to complete the Ethics Division's investigation. The Ethics Division believes that having subpoena power would allow its staff to investigate cases more effectively once it begins an investigation. However, the ability to issue subpoenas would not likely result in significant improvements to the timeliness of the process.

The lack of protective power may also affect the Ethics Division's ability to work cooperatively with the state boards of accountancy on investigations. The Ethics Division has entered into cooperative investigative agreements with four states that, with the member's consent, allow it to conduct investigations and share the results with the four state boards of accountancy. The Ethics Division stated it will attempt to expand this type of cooperative agreement to other states, but states previously have expressed little interest in such an arrangement.

The Ethics Division told us that, in the past few years, it had difficulty recruiting qualified staff with expertise in SEC accounting and reporting matters, which resulted in excessive caseloads for existing staff. However, the Ethics Division currently believes it now has the necessary resources to complete investigations involving SEC registrants in an effective and timely manner as a result of the SECPS providing funding for three additional staff members. The Ethics Division told us that, in the past, its average time to complete an investigation was 18 months after a deferral was lifted; however, it now estimates that such cases will be completed in about 11 to 14 months.

In response to the Panel's recommendation that the SEC allocate additional resources to its enforcement activities directed at allegations of failed audits, the SEC believes that its recently created Financial Fraud Task Force will improve the timeliness of SEC enforcement actions, which usually take 2 to 3 years or longer to investigate. The SEC also believes that encouraging companies to engage in cooperative measures that are both preventive and remedial will allow the SEC to maximize the use of its enforcement staff.

Lack of Coordination Within the Disciplinary Process

NASBA officials told us that neither the SEC nor the AICPA share information involving disciplinary matters freely with the state boards, which delays the timing of disciplinary actions the state boards can take and therefore allows auditors to continue to practice at the potential risk to the public.[20] NASBA officials believe the AICPA's lack of protective powers has inhibited it from sharing information with the state boards of accountancy; however, the NASBA officials stated that even though the

[20] NASBA officials stated that in some cases where a violation is obvious, state boards are able to get the practitioner to surrender his/her license or to agree to a monitoring agreement while the AICPA or the SEC investigation proceeds.

SEC has protective powers, it still does not share information freely. The SEC told us that both during and after an investigation, the SEC enforcement staff may discuss cases with state board investigators. The SEC also said it sends information pertaining to an enforcement case to the relevant state board along with a draft access request that the board may use to contact the SEC. Further, the SEC stated it had recently discussed with the representatives of the NASBA and of several state boards ways in which the state boards might gain access to the SEC's investigative records while the investigation is still in process in order to improve the timeliness of the state boards' access to SEC records. The Panel did not recommend any specific actions for the SEC, the AICPA, or the state boards of accountancy to better facilitate coordination of investigations and disciplinary actions between them. However, the Panel indicated it would support legislation giving the self-regulatory bodies protection through the right of privilege over their disciplinary activities if this would ensure more timely resolution of alleged audit failures.

Transparency of Disciplinary Actions

To improve the public's perception of the effectiveness of the self-regulatory disciplinary system, the Panel recommended that the POB (1) summarize in its annual report the status of all Ethics Division investigations of AICPA members when civil litigation and public regulatory investigations related to audits of SEC registrants have been concluded, and (2) report 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.

The AICPA advised us that the Ethics Division's PEEC has appointed a Statistical Reporting Task Force and a Disciplinary Task Force with the objectives of improving statistical reporting and making the information more descriptive and informative. A representative of the POB attends the ongoing meetings of the Statistical Reporting Task Force aimed at addressing the Panel's recommendations.

Leveraging the Results of Disciplinary Investigations

The Panel recommended that the POB leverage the knowledge it gains through oversight to determine whether changes in professional standards or further guidance is needed and communicate these findings to the appropriate standard setter or authoritative bodies. The POB has formed a coordinating task force, comprised of the heads of each of the components of the self-regulatory system, that will be used to share and leverage information. The staff director of the Transition Oversight Staff (see

footnote 4) informed us that the coordinating task force will continue to exist after the POB's termination.

The Panel recommended that the SEC should periodically undertake studies of its Accounting and Auditing Enforcement Releases (AAER) and disseminate the results. The Panel also recommended that the SEC 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 the enforcement action. However, the SEC did not accept these recommendations as it believes its enforcement actions are sufficiently analyzed and publicly discussed by the SEC and others and that the marginal benefits of additional study would not justify the use of limited staff resources and other costs. Also, the SEC stated it already reviews the conduct of auditors in virtually every enforcement investigation involving materially misstated financial statements. The SEC further stated that if it finds that the auditor's work constitutes a violation of the securities laws or professional standards, the SEC documents its findings in public proceedings, AAERs, or press releases. The SEC staff question the advisability of discussing, in public enforcement releases, the conduct of accountants that is not deemed to violate the securities laws or professional standards, as such discussions may be viewed as tantamount to the SEC writing auditing standards.

Observations

The Panel's recommendations were made within the context of the existing self-regulatory system and the actions taken by the various parties enhanced the self-regulatory system that existed at that time. On balance though, the overarching problems of the self-regulatory system remain. The system continues to be fragmented, and communications and coordination problems continue. The disciplinary function has limited investigative powers and sanctions, lacks transparency, is not timely, and is widely perceived to be ineffective.

Significant gaps continued to exist in the authority of the POB to oversee the functions of setting auditor independence rules and disciplining members of the auditing profession. These functions are fundamental to the self-regulatory system and therefore should be included as part of the oversight function. Further, we believe such oversight authority should extend to ensuring that the standard-setting bodies of the self-regulatory system address areas of concern about the adequacy of the standards and that revisions to the standards effectively protect the public interest.

Improvements recommended by the Panel for the accounting profession's peer review program are being focused on an approach to more directly address the public accounting firms' consideration of the audited entity's risks and ensure the appropriate resources of the firm are involved with the audit work. Further, the continuous peer reviews of the large firms, together with real time oversight, have the potential to more timely identify and effectively address problems. However, the AICPA has not finalized these enhancements and experience will be needed to judge their effectiveness in enhancing the peer review program.

On a related issue, consistent with the Panel's recommendation, the POB's successor needs to ensure that the final peer review report reflects the problems identified by peer review and that the root cause is effectively addressed, which could be within the public accounting firm, accounting and auditing standards, or with quality control standards. Further, as the Panel recommended, the ASB needs to ensure that the quality control standards are sufficiently clear to provide for meaningful and consistent application and enforcement.

The independence of the POB's successor needs to be assured. The POB did not receive sole authority to determine its budget and resources, and the accounting profession's obligation to provide them, as recommended by the Panel. It is not unreasonable for the SECPS to expect that the POB would be accountable for funds received and expended. However, capping the POB's budget in its charter could be perceived as a limitation of the accounting profession's support for effective oversight to protect the public interest. Further, necessary work by the POB's successor may be delayed if it needs to seek funds for special studies or other matters. If funding for the POB's successor is to continue to come from the accounting profession, then as the Panel stated, the profession must not be able to control or cut off resources, which would potentially destroy the oversight body's independence and others' confidence in it.

Experience with the SECPS's new membership requirements that may "effectively bench" members named in litigation alleging an audit failure is needed to judge its ultimate effectiveness. However, as recognized by the Panel, the self-regulatory system must also have the necessary powers to timely and effectively address alleged noncompliance with professional standards. The Ethics Division's investigations without protective powers will continue to take years to complete after an allegation of an audit failure is initially made through litigation and will perpetuate the Panel's

findings that the public's perception is that the disciplinary process of the self-regulatory system is not timely or effective.

Providing powers to the self-regulatory system to protect the confidentiality of investigation files raises difficult issues regarding the lack of a statutory basis of the self-regulatory system and whether fundamental changes to the self-regulatory system will be needed if the powers are provided. As the Panel reported, this issue needs to be resolved by the POB's successor working cooperatively with the AICPA, the SEC, and other stakeholders. Further, the Panel recognized the limited disciplinary measures that exist within the self-regulatory system. The effectiveness of disciplinary actions taken by the self-regulatory system remains an open issue.

It is too early to evaluate whether the SEC's task force approach to investigations will significantly reduce the time for investigations. Similarly, the SEC needs to gain experience with its efforts to encourage companies to engage in preventive and remedial measures. If resource limitations continue to affect the SEC's timeliness for investigations, as well as the number of cases it can effectively process simultaneously, then the SEC, as recommended by the Panel, should pursue obtaining the necessary resources.

Although the SEC did not accept the Panel's recommendations for leveraging the results of every disciplinary investigation, the successor to the POB's coordinating task force could fill this void by ensuring that SEC enforcement actions are discussed by the task force, with the SEC participation, for consideration of whether changes in professional standards or further guidance is needed.

As the Panel recognized, the transparency and completeness of disciplinary actions could be enhanced by relating the AICPA's disciplinary actions to disciplinary actions of regulators, so that the public has a more complete picture of the disciplinary actions of the self-regulatory and public regulatory systems. Further, transparency could be improved by providing more detailed information about the case, such as naming the firm, individuals involved by position, the standards violated, and the disciplinary action taken.

The action by the SEC and the AICPA, working with the largest public accounting firms to develop a proposed change to the self-regulatory system without involving the POB, demonstrates the seriousness of the

communication problems that exist within the self-regulatory system and the lack of effective relationships between the POB and the SEC. The SEC, as a public regulator under the Securities Act of 1933 and the Securities Exchange Act of 1934, has significant responsibilities related to accounting and auditing rules and the accounting profession's self-regulatory system. The SEC needs to work cooperatively with the POB's successor to support the self-regulatory system and leverage SEC activities to enhance the effectiveness of the self-regulatory system to support the public interest.

The POB's successor, the AICPA's Ethics Division, and the SEC also need to build effective working relationships with the state boards of accountancy. Although these parties have common interests, they generally work separately and information is not freely shared, which contributes to the public perception that the disciplinary function of the accounting profession is not timely or effective. As discussed above, this issue is complicated by jurisdictional issues as well as the lack of powers within the self-regulatory system to protect the confidentiality of investigative information, all of which limit actions that can be taken to improve the disciplinary process. Legislation will likely be necessary to effectively resolve this problem since the self-regulatory system lacks a statutory foundation.

Agency Comments and Our Evaluation

We provided the POB, the AICPA, the NASBA, the SEC, and the former Chair of the Panel on Audit Effectiveness, with a draft of our report for review and comment.

The POB commented that the draft report provided useful information concerning the status of the Panel's recommendations. The POB also stated that it would be helpful to readers of the report to include not only any differences between the Panel's recommendations and the actions, taken or proposed, to implement those recommendations, but also (1) an explanation for the differences, and (2) an evaluation of the reasonableness of such differences. We believe that we have identified all significant differences and provided observations on such differences. The POB provided one example of where it believed a gap existed between the Panel's recommendation and the AICPA's implementing action. The POB stated that the AICPA's response to the Panel's recommendation only addressed the POB's authority to review the implementation of a firm's action against a partner when legal action is taken against the partner resulting from the audit. The POB pointed out that the Panel also recommended that the POB review the firm's process for deciding its

action against the partner. The AICPA advised us that the POB had the authority to also review the firm's decision as recommended by the Panel.

The AICPA commented that it does not believe the POB oversight over the PEEC's standard-setting activities was necessary given the level of public representation on the PEEC and given that the SEC is the primary independence standard-setter for public company auditors. However, we continue to support the Panel's recommendation that the POB's successor should have oversight over the PEEC's independence standard-setting activities, particularly in light of the SEC's point made in its comments on our draft report. The SEC's Chief Accountant, who provided comments on the draft report, explained that in some instances the PEEC independence rules can apply to SEC registrants. For example, in situations where a PEEC ruling addresses an area that is not covered by the SEC's rules and is not inconsistent with the general policies underlying the SEC's rules, the SEC staff might consider the PEEC ruling in reaching its decision on an issue.

The AICPA also commented that it has always supported independent public oversight with fiscally accountable "no strings" funding. However, in the POB Chairman's recent statement during a congressional hearing,[21] he specifically mentioned that the current system of self-regulation of the accounting profession has significant problems, including the fact that POB funding is subject to control by the firms through the SECPS. He pointed out that in the past, the SECPS cut off that funding in an effort to restrict POB activities. In addition, the AICPA and the SECPS insisted on a cap on the POB funding when the new POB charter was created.

The AICPA commented that although the Panel report recommended that peer review reports be addressed to the POB rather than the firm subject to peer review,[22] the PRC fully considered this recommendation and concluded that it would have no affect on the quality of the peer review or the content of the peer review reports. The PRC further concluded that the peer review reports would be more appropriately addressed to the PRC as the body responsible for maintaining and administering the peer review program. As discussed in our report, we continue to believe that

[21] *Statement of the Honorable Charles A. Bowsher, Chairman, Public Oversight Board, Before the Senate Banking Committee* (March 19, 2002).

[22] Technically, the Panel report contained a recommendation that the POB be the primary client of the peer review.

addressing the peer review report to the PRC does not satisfy the intent of the Panel's recommendation to have the POB be the primary client of the peer review. The Panel wanted the peer reviewers to have the "mind-set" that peer reviews are performed in the best interest of the public, and not solely for the benefit of the reviewed firm. By considering the POB as the primary client, the Panel hoped the peer reviewers would likely bring the POB more into the process up front and continue to keep them apprised of issues throughout the review. In its comments on the draft, the POB also expressed concerns that peer review reports are addressed to the PRC rather than the POB. The POB stated that it believes that the PRC, which has responsibility for maintaining and administering the peer review program, is more like a management function rather than an audit committee function and, therefore, should not be the primary client of the peer review process.

In comments on the draft report, NASBA officials reiterated the importance of communication, coordination, and sharing of information between the various components of the regulatory structures and the state boards of accountancy to better protect the public interest. For example, NASBA officials believe that for peer review to be effective, it has to be more clearly linked to the regulatory process, which would include forwarding to all state boards modified or adverse peer review reports so that licenses could be limited when appropriate, suspended, or revoked. In addition, firm registration renewal in many states depends on having completed a peer review, but the results of those reviews, in most cases, are not provided to the state boards. NASBA officials also stated that state boards operate on a complaint-driven system. Accordingly, NASBA officials believe that, to protect the public interest, the PEEC should directly make referrals, whether or not they relate to members of the SECPS, to state boards. We share the NASBA's concerns related to the need to improve working relations between the state boards and the other components of the regulatory structure. As stated in our report, we believe that the POB's successor, the Ethics Division, and the SEC need to build effective working relationships with the state boards of accountancy. Although these parties have common interests, they generally work separately and information is not freely shared, which contributes to the public perception that the disciplinary function of the accounting profession is not timely or effective.

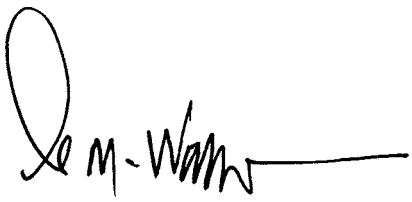
The comments of the Chair of the Panel on Audit Effectiveness were provided orally and were in agreement with our findings and observations. The SEC Chief Accountant's comments were primarily technical comments, which are incorporated as appropriate. The POB, the AICPA,

and the NASBA, also provided technical comments, which we incorporated as appropriate. Written comments from the POB, the AICPA, and the NASBA are included in appendices III through V, respectively.

As agreed upon with your office, unless you announce its contents earlier, we plan no further distribution of this report until 30 days after its issuance. At that time, we will send copies of this report to officials of the Public Oversight Board, the American Institute of Certified Public Accountants, the Panel on Audit Effectiveness, the Securities and Exchange Commission, the National Association of State Boards of Accountancy, and other interested parties. We will make copies available to others upon request.

For additional information, please contact Jeffrey C. Steinhoff, Managing Director, Financial Management and Assurance, at 202-512-2600 or *steinhoffj@gao.gov*. Robert W. Gramling, Cheryl E. Clark, and Michael C. Hrapsky made key contributions to this report.

Sincerely yours,



David M. Walker
Comptroller General
of the United States

POB Charter Provisions Responding to the Panel on Audit Effectiveness' Recommendations

Recommendations Related to the POB Charter Contained in the Panel on Audit Effectiveness Report	Provisions in the POB's Charter Responding to the Panel's Recommendations
1.1) The POB charter should address its sole authority to determine its budget and financial and other resources, and the profession's obligation to provide those resources. (Paragraph 6.25)	The POB's funding shall be provided by the SECPS and its members through the AICPA. The POB must submit an annual budget to the SECPS Executive Committee, and to the AICPA Board if requested, for consultation. The budget shall not exceed $5.2 million. Provisions are made for unanticipated oversight reviews by submitting a supplemental budget that is also subject to the above review process. Once this consultive process is done, the SECPS Executive Committee and the AICPA are not to withhold funding for any reason. The annual budget ceiling is indexed to the Consumer Price Index. The POB is required to monitor its expenses and report any material variations likely to occur to the SECPS Executive Committee and the AICPA.
1.2) The POB's annual statement of expenditures should be audited and included in the POB's Annual Report to evidence its financial accountability. (Paragraph 6.25)	In furtherance of financial accountability, the POB is required to have its expenses audited annually and included in its annual report.
2.1) The POB charter should address its authority to oversee the activities of the ASB, the Independence Standards Board, the SECPS Executive Committee, the QCIC, the SECPS Peer Review Committee, the Professional Issues Task Force, the SEC Regulations Committee, and the standard-setting activities of the PEEC that relate to audits of public companies. (Paragraph 6.25)	The POB's charter provides oversight authority with respect to the ASB, Independence Standards Board, SECPS Executive Committee, QCIC, SECPS Peer Review Committee, Professional Issues Task Force, and the SEC Regulations Committee, but not the PEEC.
2.3) The POB should approve all appointments to the ASB, SECPC Executive Committee, and the Independence Standards Board's Independence Issues Committee, as well as Independence Standards Board members who represent the public accounting profession. (Paragraph 6.25)	For the ASB and the SECPS, the POB is to be consulted for nominations for members and concur in the selection of the chairs; such concurrence is not to be unreasonably withheld. Regarding the Independence Standards Board, the POB is to consult and advise on all nominations.
2.4) The POB should annually 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. (Paragraph 6.25)	The POB's charter provides for the POB to evaluate the adequacy of resources provided to the ASB and the SECPS, and to set forth its evaluation in its annual report.
2.5) The POB should oversee the AICPA's evaluation, compensation, hiring and promotion decisions with respect to employees who constitute the ASB and SECPS staffs. (Paragraph 6.25)	Not addressed in the POB's charter.
3.1) The POB charter should establish term limits for POB members. (Paragraph 6.25)	The term of a member is 5 calendar years ending on December 31. A member may be reappointed by a two-thirds vote of members in office, but shall not serve for more than two full terms plus the balance of any term filled by that member as a result of a vacancy.
3.2) POB members should be limited to two 5-year terms, with staggered terms to ensure continuity. (Paragraph 6.25)	As stated above, members terms are limited to two 5-year terms. The POB's charter provides that members terms shall be staggered to ensure continuity so that the term of one member shall expire each year.

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Recommendations Related to the POB Charter Contained in the Panel on Audit Effectiveness Report	Provisions in the POB's Charter Responding to the Panel's Recommendations
4.1) The POB charter should address establishing a nominating committee responsible for identifying and nominating new POB members. (Paragraph 6.25)	The POB's charter provides for a nominating committee consisting of three persons with the authority to nominate new members for the POB for each vacancy on the POB caused by resignation, removal, or death, consistent with the eligibility requirements in section 11. A. of the charter, which provides that members shall be drawn from among prominent individuals of integrity and reputation, including, but not limited to, former public officials, lawyers, bankers, non-practicing CPAs, securities industry executives, educators, economists, and business executives.
4.2) 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. (Paragraph 6.25)	The nominating committee is to consist of the POB chair or his/her designee from among the members, a former public member of the AICPA Board to be selected by the AICPA Board, and a person from the private sector. The POB chair or his/her designee and the former public member of the AICPA Board will, in turn, jointly select the third member of the nominating committee from the private sector.
5.1) The POB charter should address establishing an advisory council to advise the POB on issues related to its agenda, new agenda items, project priorities, and related matters. (Paragraph 6.25)	The POB's charter does not provide for establishing an advisory council. The charter does provide for the POB to hold an annual outreach meeting to solicit views and recommendations about the accounting profession's self-regulatory program and the POB's oversight process.
5.2) The POB should appoint the council members, whose service should be limited to two 3-year terms. (Paragraph 6.25)	The POB's charter does not provide for establishing an advisory council.
5.3) The council should comprise 9 to 15 people selected from the constituencies that are concerned with audit quality and financial matters, thus the broadest spectrum of participants in the self-regulation of the auditing profession. (Paragraph 6.25)	The POB's charter does not provide for establishing an advisory council.
5.4) 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). (Paragraph 6.25)	The POB's charter does not provide for establishing an advisory council.
6.1) The POB charter should address establishing a coordinating task force of the chairs of each body within the POB's oversight. (Paragraph 6.25)	The POB's charter provides that the POB may have a Coordinating Task Force which would be a standing committee consisting of the chairs of each body within the POB's oversight or their designees and which would be responsible for exchanging information relating to each body's activities. Footnote 19 of the charter provides for the POB to monitor the agenda of the SEC and the PEEC to identify rule-making, regulatory, and standard-setting activities that relate to the audit of public companies for the purpose of communicating information relating to such activities to the Coordinating Task Force for appropriate consideration.
6.2) The coordinating task force should meet periodically (e.g., two to four times a year) to ensure effective communications among bodies subject to POB oversight. (Paragraph 6.25)	The POB's charter provides for the coordinating task force to meet periodically, but at least semiannually.

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Recommendations Related to the POB Charter Contained in the Panel on Audit Effectiveness Report	Provisions in the POB's Charter Responding to the Panel's Recommendations
7.1) The POB charter should address its authority to commission special reviews related to significant professional matters that affect the public's confidence in the profession. (Paragraph 6.25)	The POB's charter provides authority for the POB to take any action related to its oversight activities, including authorizing any oversight reviews it may determine to be appropriate in order to carry out its responsibilities, while noting the factor of confidentiality and having consulted with the SECPS Executive Committee. In that respect, the charter further provides among the POB activities that it may conduct oversight reviews and undertake other projects and actions, after consulting the SECPS Executive Committee, on matters covered by the POB's activities that the POB deems appropriate to protect the public interest.
8.1) The POB, SEC, AICPA, SECPS, and major firms should promptly agree to a charter for the POB. (Paragraph 6.26)	The POB's charter is dated February 2, 2001. The POB issued an accompanying news release stating that the POB and the AICPA have formally approved the charter after extensive discussions between both organizations, the SECPS, the large auditing firms, and the SEC. The AICPA Board of Directors passed a resolution dated February 9, 2001, stating that it approves the proposed POB charter dated February 2, 2001 and that it recognizes the good work of the POB and that it looks forward to many more years of the POB's observations and comment.
9.1) The POB charter should address the POB's role in the appointment of the chairs of the ASB and the SECPS Executive Committee. (Paragraph 6.26)	See above comment that describes the POB's consultive role rather than appointment authority.
10.1) The POB charter should address the procedures for amending the charter. (Paragraph 6.26)	The POB's charter provides that the charter may be amended by a vote of two-thirds of members in office at a meeting duly called for that purpose, with the concurrence of the AICPA Board.
11.1) The draft charter should include 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 rather than establishing 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. (Paragraph 6.26)	See above comments that describe that the POB's charter provides for an annual outreach meeting and establishing a nominating committee, but does not include an advisory council. The POB's charter provides for the POB to arrange for a review and issuance of a written report by a panel containing an evaluation of the effectiveness of the POB's oversight role and process at the end of three years after the adoption of the charter and periodically thereafter, for purposes of evaluating the POB's accountability. The report is to include a review of the effectiveness of the annual outreach meeting provided for in section VIII.H of the charter and whether this annual outreach meeting alleviates the need for an advisory council.

Actions Responding to Panel on Audit Effectivesness' Recommendations

Issue: Governance System			
Findings From Panel Report	**Recommendations Contained in Panel Report**	**Actions Taken as of September 2001 (as Reported by the POB, AICPA, SEC, and NASBA)**	**Recommendations Directed to**
1) There is a lack of sufficient public representation on the various self-regulatory bodies. (Paragraph 6.15)	1.1) The POB should have a majority of public members whose primary responsibility is to serve the public. (Paragraph 6.20)[a]	The POB consists of 5 members, all of whom are public members with a broad spectrum of business, professional, regulatory, and legislative experiences.	POB
	1.2) The constituencies (both practitioners and non-practitioners) represented on the ASB remain unchanged; however, at least a majority of the members represented on the ASB should be from CPA firms that provide attest services to SEC clients. (Paragraph 6.31)	A majority of the members represented on the ASB provide attest services to SEC clients. The ASB is a 15-member board, all of whom are CPAs, comprising representatives from each of the Big 5 firms, 2 members from other national firms, 6 non-national firm representatives, 1 representative from academia, and 1 representative from a government audit position.	AICPA
	1.3) The ISB should reconstitute its membership to include four members representing the public and three members representing the public accounting profession. (Paragraph 6.35)	The ISB ceased operations in July 2001.	ISB
	1.4) ISB's public members should retain responsibility for the selection of their replacements, with the POB being consulted on the selections.(Paragraph 6.35)	The ISB ceased operations in July 2001.	ISB
	1.5) Two of the members of the ISB that are representing the public accounting profession should 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. (Paragraph 6.35)	The ISB ceased operations in July 2001.	ISB
	1.6) The ISB should retain sole authority to determine its budget and other resources. (Paragraph 6.35)	The ISB ceased operations in July 2001.	ISB
	1.7) The ISB should retain its staff and the responsibility for their hiring, supervision, and compensation. (Paragraph 6.35)	The ISB ceased operations in July 2001.	ISB

(Continued From Previous Page)

Issue: Governance System			
Findings From Panel Report	**Recommendations Contained in Panel Report**	**Actions Taken as of September 2001 (as Reported by the POB, AICPA, SEC, and NASBA)**	**Recommendations Directed to**
2) There is a lack of unified leadership of the various self-regulatory bodies. (Paragraph 6.15)	2.1) The POB should oversee the profession's activities with respect to standard setting, monitoring, discipline, and special reviews. The POB should oversee the ASB, the ISB, the SECPS Executive Committee, QCIC, the SECPS Peer Review Committee, the Professional Issues Task Force, the SEC Regulations Committee, and the standard-setting activities of the PEEC that relate to audits of public companies. (Paragraph 6.23)	The POB Charter gives the POB oversight responsibilities for the ASB, and maintains its oversight responsibility for the SECPS Executive Committee, QCIC, Peer Review Committee, PITF, and the SEC Regulations Committee. The ISB has recently been dissolved; accordingly there will be no POB oversight. The POB charter does not give POB oversight of PEEC, however, the POB staff attend all PEEC meetings and monitor the agendas and activities of the PEEC.	POB, AICPA, SECPS
	2.2) The POB should report periodically to the public regarding its activities. (Paragraph 6.20)[a]	The POB issues an annual report that discloses its activities.	POB
	2.3) The POB should maintain independence from both the profession and the regulatory authorities. (Paragraph 6.20)[a]	The POB's new charter discloses that the POB was created by the AICPA, in consultation with the SEC, as an independent board. The charter stresses that the POB's role is oversight and not management. Members and staff of the POB must abide by the POB's Conflict of Interest Guidelines.	POB
	2.4) The POB, AICPA, SECPS, and SEC should work together to create and implement a formal charter for the POB that would include the responsibilities and powers enumerated in the Panel's report. The POB, AICPA, SECPS, SEC, and major firms should agree to the charter and cooperate in facilitating its implementation. (Paragraphs 6.24 and 6.26)	The POB and the AICPA's Board of Directors adopted the charter in February 2001, after discussions with the SEC, the SECPS, and the large auditing firms. Refer to Appendix I for an analysis of the POB' s charter.	POB, AICPA, SECPS, SEC, and major firms
	2.5) The POB should enhance its resources in order to implement the POB's expanded oversight role. The augmented staff would assist the POB in overseeing peer reviews of the largest firms. (Paragraph 6.29)	The POB hired additional staff members (from 6 staff in 1999 to 13 staff in 2002) and has increased its budget (from $2.5 million in 1999 to $3.5 million in 2002) in order to implement its expanded oversight role.	POB

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Issue: Governance System			
Findings From Panel Report	**Recommendations Contained in Panel Report**	**Actions Taken as of September 2001 (as Reported by the POB, AICPA, SEC, and NASBA)**	**Recommendations Directed to**
	2.6) The POB should review its charter periodically to ensure its continuing adequacy, and, if appropriate, work with the AICPA, SECPS, and SEC to amend it. (Paragraph 6.29)	The POB plans to review and reassess its charter on a periodic basis to assure its continuing adequacy and relevancy in the light of changing circumstances and, if appropriate, take steps to amend it. The charter may be amended by a vote of two-thirds of members in office at a meeting duly called for that purpose, with the concurrence of the AICPA Board.	POB
	2.7) The POB should review periodically the effectiveness of the ASB, ISB, SECPS, and other groups that it oversees and include its findings and conclusions in its Annual Report. (Paragraph 6.29)	The POB's new charter includes responsibility for reviewing the effectiveness of these groups and reporting the results of its reviews in its annual report. The ISB ceased operations in 2001.	POB
	2.8) The POB should 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. (Paragraph 6.29)	The POB plans to include in its next annual report summary statistics of the (i) status of all AICPA Professional Ethics Division investigations on audits of SEC registrants when the civil litigation and public regulatory investigations have been published and concluded; and (ii) the actions taken by and reported to the POB by SECPS member firms with respect to the foregoing.	POB
	2.9) The POB should increase its public communications to expand the public's awareness of the POB, its activities, and its value to the capital markets. (Paragraph 6.29)	The POB will hold an annual meeting open to the public, and will also issue an annual report and make public such other written reports as the POB may deem necessary with respect to its activities. The POB will also hold an annual outreach meeting to solicit views and recommendations about the accounting profession's self-regulatory program and the POB's oversight process.	POB

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Issue: Governance System			
Findings From Panel Report	**Recommendations Contained in Panel Report**	**Actions Taken as of September 2001 (as Reported by the POB, AICPA, SEC, and NASBA)**	**Recommendations Directed to**
3) There are constraints on effective communications with the SEC and among the various entities in the current system. (Paragraph 6.15)	3.1) The POB should serve as an oversight body to whom the SEC, the state boards of accountancy, the auditing profession, and the public should look to 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. (Paragraph 6.23)	The POB charter includes expanded responsibility for improving communication among the various bodies that make up the self-regulatory system. A Coordinating Task Force has been created and the POB will hold an Annual Meeting open to the public. The POB will also hold an annual outreach meeting to solicit views and recommendations about the accounting profession's self-regulatory program and the POB's oversight process. This meeting may include, among others as appropriate, representatives from the private sector, accounting profession, government, professional organizations and public. Reference to such meetings will be made in the POB's annual report. The POB will also establish liaisons with national and international organizations regarding setting national and international auditing and independence standards, and other matters relevant to the cooperative self-regulation of the profession.	POB, AICPA, SECPS, and SEC
	3.2) The POB and SEC should 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. (Paragraph 6.27)	The SEC recently met with the POB in one of its first outreach meetings. The POB stated that it meets frequently with the staff of the SEC Chief Accountant's office and other SEC staff as deemed necessary to discuss issues of concern to the SEC.	POB and SEC
	3.3) The POB and state boards of accountancy, perhaps through the National Association of State Boards of Accountancy, should determine how best to facilitate meaningful continuing dialogue between the POB and state boards. (Paragraph 6.28)	The POB plans to meet occasionally with the individual state boards of accountancy and also to have ongoing discussions with NASBA, as the representative of the state boards.	POB and state boards of accountancy

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Issue: Governance System			
Findings From Panel Report	**Recommendations Contained in Panel Report**	**Actions Taken as of September 2001 (as Reported by the POB, AICPA, SEC, and NASBA)**	**Recommendations Directed to**
	3.4) Restore the relationship between the profession and the SEC to its historic level of candor, trust, and respect. (Paragraphs 6.64 and 6.20)[a]	The AICPA and SEC have enjoyed a longstanding working relationship with the mutual goal of protecting the public interest. The AICPA is committed to continually strengthen the profession's self-regulatory activities through a cooperative working relationship with the SEC.	SEC and the accounting profession (including the POB)
	3.5) The SEC should 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. (Paragraph 6.36)	The ISB ceased operations in July 2001.	SEC
	3.6) The SEC should support the IIC and work with the ISB to clarify the IIC's role. (Paragraph 6.36)	The ISB ceased operations in July 2001.	SEC
	3.7) The SEC should assist in implementing the POB's activities contemplated by the charter. (Paragraph 6.36)	According to the SEC, it has cooperated with the AICPA and others on the disbanding of the ISB, and met with the AICPA's SEC Regulations Committee to discuss items of mutual interest. Further meetings are scheduled with other AICPA committees. The SEC also recently met with the POB in one of its first outreach meetings. The SEC staff speaks at various AICPA conferences, including the SEC Developments Conference. The SEC also anticipates further meetings with the AICPA and POB in the coming months.	SEC
	3.8) The SEC should 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. (Paragraph 6.36)	See action taken to recommendation 3.7 above.	SEC

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Issue: Governance System			
Findings From Panel Report	**Recommendations Contained in Panel Report**	**Actions Taken as of September 2001 (as Reported by the POB, AICPA, SEC, and NASBA)**	**Recommendations Directed to**
4) There are differing interests and divergent views of the AICPA's priorities on the part of its diverse members. (Paragraph 6.15)	4.1) The AICPA should provide the resources necessary for the ASB to meet its mandates. (Paragraph 6.31)	The AICPA has provided and is committed to providing the financial and human resources necessary for the ASB to meet its mandates. There are continual and close communications between the chair of the ASB and AICPA staff regarding the assignment of staff to projects. The major financial components are for staff salaries, member compensation, and reimbursements for meeting and travel expenses. The major human resource components are volunteer hours and paid staff. Staff salaries are adjusted annually to be competitive for the skills the staff member possesses. Turnover of ASB staff has been very low. Meeting and travel expenses are budgeted based on current and expected projects.	AICPA
	4.2) The AICPA should 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. (Paragraph 6.31)	The AICPA has provided and is committed to providing the financial and human resources necessary for the SECPS, including the QCIC, to meet its mandates. There are continual and close communications between the chair of the SECPS, QCIC and AICPA staff regarding the assignment of staff to projects. The major financial components are for staff salaries and reimbursements for meeting and travel expenses. The major human resource components are volunteer hours and paid staff. Staff salaries are adjusted annually to be competitive for the skills the staff member possesses. Meeting and travel expenses are budgeted based on current and expected projects.	AICPA
	4.3) The ASB, SECPS, and PEEC staffs remain employees of the AICPA. (Paragraph 6.31)	ASB, SECPS, and PEEC staff are AICPA employees.	AICPA

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Issue: Governance System			
Findings From Panel Report	**Recommendations Contained in Panel Report**	**Actions Taken as of September 2001 (as Reported by the POB, AICPA, SEC, and NASBA)**	**Recommendations Directed to**
	4.4) The SECPS Executive Committee retains its responsibility for approving members of the PRC, QCIC, the SEC Regulations Committee, and the PITF; the preceding four groups continue to report to the Executive Committee; and the SECPS continues to fund the ISB. (Paragraph 6.32)	The SECPS Executive Committee has the responsibility for approving members of the PRC, QCIC, SEC Regulations Committee, and the PITF. These groups continue to report to the SECPS Executive Committee. The SECPS continued to fund the ISB until it ceased operations in July 2001.	SECPS
	4.5) The QCIC should establish a panel of industry specialists and experts and specialists whose members would be drawn from 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. (Paragraph 6.33)	The QCIC maintains an inventory of QCIC member industry and technical skills. In the event that a QCIC, POB, or SECPS staff member responsible for a particular review considers consultation outside the review team to be necessary, the first consultation source is with another QCIC member with identified industry skills. The review team initiates consultation beyond QCIC membership. This consultation is coordinated by the SECPS staff through contact with the Big-5 firm representative of the SECPS Executive Committee. The Executive Committee member identifies a specific experienced and highly qualified partner within his or her firm to consult with the review team.	SECPS QCIC
	4.6) Each member firm should 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. (Paragraph 6.34)	All members of the Executive Committee have sufficient authority to commit their firms to the protection of the public interest, and each representative has the public interest as the paramount objective in fulfilling his or her committee obligations. In selecting committee member replacements, the SECPS staff and the Executive Committee review resumes of prospective members prior to appointment and all nominations are made in consultation with the POB. (See POB charter section VII.A.1.c.)	Member firms of the SECPS represented on the SECPS Executive Committee

[a]This was not a formal recommendation in the Panel's report; however, this was mentioned in the text of the Panel's report.

Issue: Peer Review			
Findings From Panel Report	**Recommendations Contained in Panel Report**	**Actions Taken as of September 2001 (as Reported by the POB, AICPA, SEC, and NASBA)**	**Recommendations Directed to**
5) The peer review reporting model should be more transparent in order to better facilitate the communication of matters identified during peer reviews that should be addressed by the reviewed firm and the profession. (Exhibit 4, page 4)	5.1) The PRC should revise the standard peer review report to more fully describe the peer review process and matters relevant to the specific peer review. (Task Force Recommendation 2a.)	The peer review reporting standards were revised, effective for peer reviews completed on or after June 30, 2001, to more fully describe the peer review process and to streamline the reporting of matters relevant to the specific peer review. Specifically, to assist users of the peer review report in understanding the peer review process, each report is now accompanied by an attachment that provides the following: The objectives of a peer review. An overview of the peer review process, including how peer reviews are planned and performed and the roles of the PRC, POB, and the public file. In the case of a modified report, readers will no longer have to refer to the letter of comments to understand the reasons for the modification. Both the reasons and the recommendations to cure deficiencies are now in the report itself. The reviewed firm's response will address the deficiencies and recommendations in both the report and the letter of comments. In the case of an adverse report, all of the deficiencies identified are required to be included in the peer review report. The reviewed firm's response will address the deficiencies and recommendations identified in the report. The PRC also reviewed the SECPS peer review standards that address the specific matters to be reported as a result of a peer review. The PRC concluded, and the POB staff concurred, that no changes to the criteria set forth in the *Standards* were needed.	PRC

Issue: Peer Review			
Findings From Panel Report	**Recommendations Contained in Panel Report**	**Actions Taken as of September 2001 (as Reported by the POB, AICPA, SEC, and NASBA)**	**Recommendations Directed to**
6) The PRC needs to consistently consider the sufficiency and adequacy of the information it receives concerning peer review results in order to perform its function effectively. (Exhibit 4, page 4)	6.1) The SECPS should study whether there are key quantitative and qualitative performance indicators that would be useful to users of SECPS member firms' annual reports or peer review reports. (Task Force Recommendation 1b.)	To date, the SECPS Executive Committee and PRC have not been able to identify indicators that are relevant, objective, or measurable. However, the PRC has established a standing task force to continuously consider ways of improving the peer review process, including the identification of such quantitative measures.	SECPS
	6.2) Peer review reports should be addressed to the reviewed firm and the PRC to emphasize that peer reviewers and reviewed firms should consider the PRC as the "audit committee." (Task Force Recommendation 2b.)	Effective for peer reviews completed on or after June 30, 2001, the peer review report will be addressed to both the reviewed firm and the PRC.	PRC
	6.3) Require a Summary Observation Memorandum (SOM) be prepared on all peer reviews that describes the peer reviewer's observations regarding best practices, constructive suggestions that go beyond professional standards, and matters for the attention of standard-setters. The SOM should be submitted to the PRC. The SOM should not be made available for public distribution, but should be used as a basis for preparing the PRC annual report. (Task Force Recommendation 2c.)	The PRC is pilot testing a more qualitative, subjective approach to the review of emerging issues and higher-risk areas during the peer review process. It is expected that the findings from these procedures will result in observations and recommendations regarding best practices, constructive suggestions that go beyond professional standards, and matters for the attention of standard-setters that can be included in a SOM. The SOMs for all of the peer reviews performed during the year and significant, recurring findings in peer review reports and letters of comments will be the primary source for the PRC's annual report. The SOMs will not be publicly distributed.	PRC

Issue: Peer Review			
Findings From Panel Report	**Recommendations Contained in Panel Report**	**Actions Taken as of September 2001 (as Reported by the POB, AICPA, SEC, and NASBA)**	**Recommendations Directed to**
	6.4) SECPS and POB staff should 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. For example, data on disciplinary measures taken by member firms resulting from substandard performance; data on the audit firms' fraud risk assessments and related responses on audits where fraud is subsequently discovered; data related to emerging issues that identify needed modifications to professional standards or best practices guidance; and data on nonaudit services provided to the audit clients encompassed by peer reviews and QCIC investigations. (Paragraph 6.30)	The SECPS has provided information to the POB regarding QCIC and peer review activities for reporting in its annual report. The QCIC has and continues to report its findings to standard-setters as well as to the PITF. (The PITF issues Practice Alerts that are disseminated through the CPA Letter and Technical Practice Aids to CPAs in public practice.) Starting in 2001, QCIC staff automated its previous manual information database to assist in analyzing issues that should be brought to the attention of standard-setters and the PITF. The POB intends to monitor the preparation and analysis of the information contained in this database and comment on the monitoring process in its annual report. The PRC is pilot testing an enhanced peer review process, a by-product of which is to develop recommendations to standard-setters and audit firms (see actions taken in recommendation 6.3 above regarding preparation of an SOM).	SECPS and POB
7) Any changes to the peer review reporting model need to continue to provide appropriate access to information for SEC staff to assess the effectiveness of the peer review program. (Exhibit 4, page 4)	7.1) The SECPS should continue to maintain a file that provides for public access to peer review reports, letters of comments, and the firms' responses to the letters of comments. (Task Force Recommendation 1a.)	The SECPS has a file that provides for public access to peer review reports, letters of comments, and the firms' responses to the letters of comments. The SECPS is in the process of converting the public files to provide for electronic access to the information. The website is expected to be fully operational in the fall of 2001.	SECPS
	7.2) The SEC staff should have access to the PRC annual report and to the SOM (described above under recommendation 6.3 above) on a no-name basis. (Task Force Recommendation 2c.)	The PRC annual report will be a public document, whose primary recipients will be the accounting profession, standard-setters, and regulators. The POB will have access to all SOMs and the SEC will have access to all SOMs on a "no name" basis.	PRC

Issue: Peer Review			
Findings From Panel Report	**Recommendations Contained in Panel Report**	**Actions Taken as of September 2001 (as Reported by the POB, AICPA, SEC, and NASBA)**	**Recommendations Directed to**
8) The peer review standards are common to all SECPS member firms and do not provide for differences in firm size and types of practices. (Exhibit 4, page 5)	8.1) There should be a prescribed differentiation of the SECPS member firms, based on the effectiveness and objectivity of the firms' internal inspection programs. Tier A firms should be those that do not have an internal inspection program that meets specifically defined criteria for a Tier B firm. Tier B firms should be those firms that have an effective internal inspection program that meets specifically defined criteria. The effectiveness of a reviewed firm's internal inspection program should be determined by the peer reviewer. The PRC, with the POB's oversight, should concur with the classification of firms. (Task Force Recommendation 3a.)	The PRC is pilot testing a two-tiered peer review program. Tier B firms consist of larger member firms meeting certain size criteria, i.e., firms with 30 or more SEC clients and 100 or more accounting and auditing professionals. Those firms are required to have an effective internal inspection. Tier B firms are being subjected to a continuous review process with prescribed procedures being performed during the interim 2 years between peer review public reporting years. All other SECPS member firms are considered Tier A firms and are not subject to the continuous review process.	PRC
	8.2) The peer reviews of Tier A firms should be systems- and compliance-oriented but place greater emphasis on the reviews of engagements, while the peer reviews of Tier B firms should involve reviews of engagements but place greater emphasis on systems and compliance. (Task Force Recommendation 3b.)	The peer review procedures for the Tier B firms are being better integrated with the firm's internal inspection programs and the reviews of some engagements were enhanced to generate more qualitative, subjective, and judgmental considerations and findings by the reviewers. The approach being tested includes: obtaining an in-depth understanding of the engagement team's approach to the audit and their knowledge, skills, training, and experience; developing observations regarding the quality of the engagement team's performance in certain areas prescribed by the PRC, including both best practices and areas for improvement; assessing the engagement team's application of the firm's policies, guidance, procedures, and practice aids, including best practices and areas for improvement; and providing recommendations that would improve the firm's policies, guidance, procedures, practice aids, or training programs and/or professional standards. Peer review standards for Tier A firms will be more compliance oriented and place greater emphasis on the reviews of engagements.	PRC

Issue: Peer Review			
Findings From Panel Report	**Recommendations Contained in Panel Report**	**Actions Taken as of September 2001 (as Reported by the POB, AICPA, SEC, and NASBA)**	**Recommendations Directed to**
	8.3) Tier B firms should be required to engage their peer reviewers to annually perform certain limited review procedures, in addition to the peer review performed on a triennial basis. (Task Force Recommendation 3c.)	As indicated above, Tier B firms will engage their peer reviewers to perform certain limited review procedures developed by the PRC in the years they are not subjected to their triennial reviews. These limited review procedures will result in reports to the PRC, with oversight by the POB and SEC access. A full scope peer review continues to be required on a triennial basis, with a report available to the public.	PRC
	8.4) The POB should conduct oversight of the annual limited procedures engagement discussed in recommendation 8.3 above. (Task Force Recommendation 3c.)	The POB will conduct on-site oversight of the Tier B firms' annual reviews.	POB
	8.5) The triennial peer review for Tier B firms should be integrated with the reviewed firm's internal inspection program in that year and focus on emerging issues and higher-risk areas, while relying on the internal inspection to review routine and compliance areas. The reviewed firm's internal inspection program should become an integral part of the peer review in that the peer reviewer should review and approve the inspection review procedures, review materials and questionnaires, and office and engagement selections made for the inspection program, and form joint teams of internal inspectors and peer reviewers for certain reviewed offices. (Task Force Recommendation 3d.)	Under the pilot test program, the PRC is testing different approaches to integrating peer review and the reviewed firm's internal inspection program.	PRC
9) The peer review process should place greater emphasis on assessing auditor performance (versus evaluating documentation) to determine compliance with quality control systems and professional standards. (Exhibit 4, page 5)	9.1) The review materials and questionnaires should be revised to generate more qualitative, subjective, and judgmental considerations and findings by peer reviewers. Peer reviewers should also conduct focus group sessions with professional personnel at various levels in the organization in order to obtain candid feedback regarding critical matters pertaining to the accounting and auditing practice. (Task Force Recommendation 3e.)	In addition to the matters described above, the pilot test program includes using supplemental checklists at the firm level and for some engagement reviews that address certain emerging/high-risk areas identified by the PRC, and conducting focus group sessions in some offices being reviewed that include separate groups of seniors and managers.	PRC

Issue: Peer Review			
Findings From Panel Report	**Recommendations Contained in Panel Report**	**Actions Taken as of September 2001 (as Reported by the POB, AICPA, SEC, and NASBA)**	**Recommendations Directed to**
	9.2) The SECPS should emphasize the types of issues described in the Panel's report that affect audit quality, including the more judgmental and less objective issues, such as the "tone at the top." (Paragraph 6.40)	See actions described in response to findings 6, 8, and 9 that are being pilot tested during 2001.	SECPS
	9.3) The SECPS should 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. (Paragraph 6.40)	The pilot test program includes placing increased emphasis on interviewing members of the engagement teams whose audits are being reviewed.	SECPS
	9.4) The SECPS should require additional qualitative evaluations of the information obtained during peer reviews (e.g., assess whether management's representations and responses to inquiries were adequately corroborated; assess adequacy of the training materials distributed and available to all professionals). (Paragraph 6.40)	The peer review process has historically included qualitative evaluations of the information obtained during peer reviews, such as review of working papers for corroboration of management's representations. However, one of the objectives of the pilot test, through more in-depth interviews of the engagement team, is to enable the peer reviewers to be in a better position to assess this element of the audit rather than just relying on reviewing working papers. See actions described in recommendation 8.2 above that are being pilot tested during 2001.	SECPS
	9.5) The SECPS should 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. (Paragraph 6.40)	See actions described above to finding 6.	SECPS
	9.6) The SECPS should include in a peer review the business aspects of the reviewed firm's practice that are closely related to the firm's professional practice. (Paragraph 6.40)	For the most part, peer reviewers don't include the business aspects of the reviewed firm's practice in a peer review. However, there are elements of this in current peer reviews, for example, when a peer reviewer considers whether sufficient time was devoted to the audit or specific audit areas. This was then expanded with the pilot by way of the focus group sessions (see recommendation 9.1 above) because many of the topics relate to operational issues such as sufficiency of staffing, time being devoted to audit areas, emphasis on achieving time budgets, emphasis on training, etc. that are important matters to consider by the peer reviewer.	SECPS

Issue: Peer Review			
Findings From Panel Report	**Recommendations Contained in Panel Report**	**Actions Taken as of September 2001 (as Reported by the POB, AICPA, SEC, and NASBA)**	**Recommendations Directed to**
	9.7) The SECPS should require a review of the peer-reviewed firm's review of selected financial reports/filings of foreign registrants that are audited by the firm's reviewed foreign-associated firms and for which the reviewed firm reviews the filing in accordance with the membership requirements of the SECPS. The peer reviews should include interviewing the "filing reviewers." (Paragraph 6.40)	According to the AICPA, this recommendation cannot be implemented because it is directed at foreign registrants who are not clients of the SECPS member firms (i.e., U.S. firms). However, the PRC has approved changes to the peer review standards and the related peer review guidance materials to test a firm's compliance with the SECPS membership requirement pertaining to an SECPS member firm with foreign associated firms that audit SEC clients.	SECPS
10) Measures to enhance peer reviewer independence and objectivity should be implemented. (Exhibit 4, page 7)	10.1) The PRC should limit the peer review team captains for the reviews of Tier B firms to two consecutive reviews of the same firm and a total of three consecutive reviews as an engagement team member. (Task Force Recommendation 4a.i.)	The PRC will revise the peer review standards to limit the team captains of Tier B firms to two consecutive triennial peer reviews.	PRC
11) The current protocols among the PRC, POB, SEC, and peer reviewers should be enhanced. (Exhibit 4, page 7)	11.1) The PRC should require the peer review captains for the reviews of Tier B firms to participate in a meeting (exit conference) with the SEC staff and POB staff when the SEC staff reviews the firm's peer review working papers to discuss significant matters considered by the SEC staff during their oversight. (Task Force Recommendation 4a.ii.)	The PRC will revise the peer review standards to require the team captains of Tier B firms to participate in a meeting with SEC and POB staff to discuss significant matters considered by the SEC staff during its oversight of the peer review process.	PRC
	11.2) The PRC should prepare an annual report for the profession, standard-setters, regulators, and others that describes significant matters noted during peer reviews conducted during the year to facilitate timely identification of matters that require the attention of these groups. (Task Force Recommendation 4b.)	See actions described in recommendation 6.3 above that are being pilot tested during 2001.	PRC
	11.3) The PRC should determine a more formal means of identifying emerging issues and higher-risk areas in a timely manner, and providing frequent updates or supplements to the review materials and questionnaires used to perform peer reviews. (Task Force Recommendation 4c.)	The PRC has established a standing task force to, among other things, identify on a yearly basis the emerging/high-risk issues to be addressed by peer reviewers in the upcoming peer review cycle. The task force will also be responsible for updating the peer review guidance materials accordingly. In addition, the Chair of the PRC will be a member of the POB's newly formed Coordinating Task Force.	PRC

Issue: Peer Review			
Findings From Panel Report	**Recommendations Contained in Panel Report**	**Actions Taken as of September 2001 (as Reported by the POB, AICPA, SEC, and NASBA)**	**Recommendations Directed to**
	11.4) The PRC should study the cost vs. benefit of more frequent peer reviewer involvement for Tier A firms in order to improve the effectiveness of the peer review process for these firms. (Task Force Recommendation 4d.)	This recommendation will be considered by the PRC after completion of the pilot test and standards revisions described above that will be applicable mostly to Tier B firms.	PRC
	11.5) The PRC should establish a more formal means for continuously pursuing better approaches to performing peer reviews. (Task Force Recommendation 4e.)	The PRC has established a standing task force to, among other things, be responsible for continuously reviewing the current peer review process and identifying better approaches for performing and reporting on peer reviews.	PRC
	11.6) The SECPS should make clear to peer review team captains and reviewers that the POB, not the firm being reviewed, is the primary client. (Paragraph 6.40)	According to the AICPA, this recommendation cannot be implemented since the PRC, not the POB, is responsible for maintaining and administering the SECPS peer review program. The POB charter gives the POB responsibility for overseeing the activities of the PRC. The POB does not serve in a management capacity.	SECPS
12) Greater depth is needed by the POB in overseeing the performance of peer reviews. (Exhibit 4, page 7)	12.1) The POB should perform an in-depth review of its current approaches to overseeing the performance of peer reviews (including reviewing the scope of the reviews, evaluation, and resolution of issues identified during the review, and communications of the results of the review) with the goal of identifying ways of gaining more timely (i.e., oversight of the work of the peer reviewers as it is being performed) and deeper involvement (i.e., participation with a peer reviewer in some interviews of audit engagement team members) by the staff and Board. (Task Force Recommendation 5a.)	The POB expanded its oversight of the peer review program to include visiting more offices of the largest firms that are being reviewed (5 offices vs. 3 or 4 offices) and will be spending more time at those offices (5 days – 2 at the beginning of the review and 3 days at the end –vs. 3 days at the end of the review). Under the pilot program being tested in the 2001-2002 peer review year, each of the 13 largest firms will undergo continuous review which will involve some level of peer review procedures every year (versus the previous triennial review requirement). The POB will conduct on-site oversight on all 13 firms' reviews on a real-time basis. See action taken to recommendation 12.3 below for what the POB's oversight will cover.	POB

Issue: Peer Review			
Findings From Panel Report	**Recommendations Contained in Panel Report**	**Actions Taken as of September 2001 (as Reported by the POB, AICPA, SEC, and NASBA)**	**Recommendations Directed to**
	12.2) The POB should consider establishing a process for obtaining additional expertise to assist the POB staff, when necessary, in formulating the staff's views on significant matters that occasionally arise during the performance of peer reviews (i.e., to assist in evaluating matters where significant differences of professional judgment exist between the peer reviewers, reviewed firm, and/or POB staff). (Task Force Recommendation 5b.)	The POB hired five recently retired partners who held important quality control functions in their former firms to assist the POB in conducting oversight of the SECPS, including oversight of the peer reviews of the largest firms on a real-time basis.	POB
	12.3) The POB should expand its oversight throughout the peer reviews of the largest firms on a "real-time" basis. The expanded oversight should cover, at a minimum, reviewing the qualifications of the peer review firm and the review team captain; attending all important meetings, focus groups, and interviews with firm personnel; reviewing the draft peer review reports before they are provided to others; and overseeing the planning of the review, and 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; and resolution of issues that arise during the reviews. (Paragraph 6.41)	The fiscal 2002 budget contemplates expending 4000 hours for peer review oversight compared with 3000 hours spent overseeing the 2000-2001 peer review program. The POB has developed a document "SEC Practice Section Oversight" that specifies its oversight objectives and procedures with respect to the SECPS. The POB will continue to oversee the planning of peer reviews, the reviews of functional areas at both the national and practice offices, the reviews of the firms' internal inspection programs, and the wrap-up of the reviews. However, the POB staff now will have more timely involvement on a real time basis in the resolution of issues arising during the reviews. The POB will continue to review the qualifications of the peer review firms and the review team captains, and when it believes appropriate, make suggestions for changes.	POB

Issue: Peer Review			
Findings From Panel Report	**Recommendations Contained in Panel Report**	**Actions Taken as of September 2001 (as Reported by the POB, AICPA, SEC, and NASBA)**	**Recommendations Directed to**
13) The Statements on Quality Control Standards (that provide that firms have a system of quality control) lack specificity. (Exhibit 4, page 8)	13.1) The ASB, in collaboration with the PRC and QCIC, should review the quality control standards and make them more specific and definitive for firms with public clients, especially for the largest firms. (Task Force Recommendation 6; and paragraph 6.42)	The ASB has established a standing Quality Control Standards Task Force with representatives from the ASB, QCIC, PRC, and the AICPA Peer Review Board. The task force has preliminarily concluded that: Statements on Auditing Standards (SASs), Statements on Standards for Attestation Engagements (SSAEs), and Statements on Standards for Accounting and Review Services (SSARSs) should be amended to clarify the relationship between these standards and the Statements on Quality Control Standards (SQCS). *Guide for Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (Guide) should be revised to reflect (1) recently issued SQCSs and (2) the POB Panel's recommendation that the SQCSs be more specific and definitive. (Because the SQCSs cover the entire spectrum of attest services that are applicable to firms of all sizes, the task force believes the POB recommendation can best be addressed and implemented through more specificity to the Guide rather than the standards themselves.) Through the process of updating the Guide, the task force will also consider whether any guidance should be elevated from the Guide to a standard.	SECPS and ASB
	13.2) The ASB, PRC, and QCIC should establish a mechanism for on-going monitoring of the standards to keep them current. (Paragraph 6.42)	A standing Quality Control Standards Task Force has been established to monitor quality control standards and keep them current.	SECPS and ASB
14) The training courses and approach to training peer review captains and teams should be improved. (Exhibit 4, page 10)	14.1) The PRC should establish a standing task force that will oversee the peer review training programs to ensure that the training programs and methods of delivering them meet the needs of the peer review program. (Task Force Recommendation 7a.)	Members of the PRC and SECPS staff are now participating in the activities of the Education and Communications Task Force of the AICPA Peer Review Program. That Task Force is responsible for developing and overseeing appropriate peer review training programs.	PRC

Issue: Peer Review			
Findings From Panel Report	**Recommendations Contained in Panel Report**	**Actions Taken as of September 2001 (as Reported by the POB, AICPA, SEC, and NASBA)**	**Recommendations Directed to**
	14.2) The PRC should develop a system for evaluating the performance of team captains. The results of such evaluations should be summarized on a periodic basis to identify team captains who are not performing at an acceptable level so that appropriate actions can be considered by the PRC. (Task Force Recommendation 7b.)	The PRC implemented a more formal process for evaluating and monitoring the performance of peer review team captains that includes the completion of a written evaluation for each team captain whose performance on a peer review was deemed to be ineffective or unsatisfactory. POB staff provides input to these evaluations. The results are periodically summarized for consideration by the PRC so that appropriate actions can be taken.	PRC
15) A market-driven fee arrangement between a Committee Appointed Review Team (CART) and a firm would result in more qualified reviewers. (Exhibit 4, page 10)	15.1) The PRC should discontinue setting rates for peer reviews conducted by CARTs. Fees for participating in a CART review should be established by the firm being reviewed and the members of the review team. (Task Force Recommendation 7c.)	Effective April 1, 2001, the PRC discontinued allowing CARTs to be formed.	PRC
16) Peer review is only required for SECPS member firms. (Exhibit 4, page 2)	16.1) The SEC should mandate that all firms that audit SEC registrants be enrolled in a peer review program that includes public oversight. With respect to foreign-based CPA firms, the requirement should extend to the peer review programs/processes in their foreign locations. (Paragraph 6.43)	The costs versus the benefits of mandating that all firms that audit SEC registrants join a peer review program would have to be considered in deciding whether to implement this recommendation. A previous SEC proposal to mandate such involvement was never adopted due, in part, to such concerns.	SEC

Issue: Disciplinary Process			
Findings From Panel Report	**Recommendations Contained in Panel Report**	**Actions Taken as of September 2001 (as Reported by the POB, AICPA, SEC, and NASBA)**	**Recommendations Directed to**
17) The disciplinary system is perceived to be slow and ineffective. (Paragraphs 6.15 and 6.52)	17.1) The following procedures should be followed when civil litigation or a criminal or public regulatory investigation contains allegations of an audit failure: (1) Devote more resources to the QCIC to speed up the process. (2) A firm should conduct an internal review of the subject engagement to evaluate performance of the senior engagement personnel. The firm should respond to a standard question from the QCIC and POB staff, regarding whether the firm had conducted such a review. (3) The Ethics Division should inform the firm that its consideration of the matter was being deferred. (4) Upon notification by the Ethics Division regarding deferral, the firm should select one of the following three options to apply to the engagement partner during the period of 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 complete; (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 the QCIC and the POB, and subject the partner to additional oversight on all public company audit engagements for at least one year and thereafter subject the partner to those additional oversight procedures that are determined necessary. (5) The process 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	The SECPS membership requirement (Procedures in Connection with an Alleged Audit Failure) which became effective January 1, 2001, requires SECPS member firms to have quality control policies and procedures in place, so that, in the event of litigation alleging deficiencies in the conduct of an audit of financial statements of a present or former SEC client, the firms will report that matter to the QCIC and follow other applicable procedures of the QCIC. These procedures call for the member firm to conduct a review of the engagement that is the subject of the litigation in order to evaluate the performance of senior engagement personnel with respect to specific issues contained in the complaint against the firm or individuals. The QCIC will inquire whether the firm reviewed timely other public company audits that such senior audit personnel completed within the preceding 12 months. The QCIC will review the matter, and for each case that is closed by QCIC, the AICPA's Professional Ethics Division is advised of those cases for which it is believed there may be engagement personnel issues of significance. The Ethics Division will assess whether or not the performance-specific issues warrant investigation. If the Ethics Division determines an investigation is appropriate, it will inform the member firm of that and also that the investigation of the matter will be deferred until the litigation is resolved. Once the member firm and the audit engagement partner involved have been notified by the Ethics Division that the matter is being deferred, then the firm must select one of the following options to apply to the engagement partner during the period of deferral, if that individual is still associated with the firm: (A) terminate or retire the individual from the member firm, (B) remove the individual from performing or supervising audits of public companies until the Ethics Division's ethics enforcement process is completed, or (C)	SECPS, AICPA, the POB, and audit firms

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Issue: Disciplinary Process			
Findings From Panel Report	**Recommendations Contained in Panel Report**	**Actions Taken as of September 2001 (as Reported by the POB, AICPA, SEC, and NASBA)**	**Recommendations Directed to**
	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. (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) The Ethics Division should refer matters to the QCIC that involve financial reporting of an SEC registrant in which the SECPS member firm has not been made a party, and the Ethics Division would otherwise open an investigation. (9) If the matter ends without the firm having been made a party, the QCIC would keep the case 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 the Ethics Division referral 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. (Paragraph 6.56)	subject the individual to additional, prescribed oversight on all public company audit engagements in which she/he is involved for at least 1 year. Additional oversight, for the purpose of this membership requirement, is defined to mean for at least 1 year, the individual will perform such audits subject to oversight by a senior technical partner appointed by the member firm's Managing Partner/CEO. The senior technical partner oversight of such engagements, at a minimum, will meet the SECPS's concurring partner review membership requirement, which in these circumstances, will include timely involvement in significant planning activities, the determination of risk assessments, and the designs of tests of controls and substantive audit procedures. Thereafter, the individual must remain under the additional oversight that the firm's Managing Partner/CEO determines, in light of that person's evaluation of the individual's performance, is necessary to protect the public interest. Implementation of the option chosen is subject to review through the peer review process and by the POB. If the individual leaves the firm and joins another SECPS firm, the successor firm must select one of the three options. The Ethics Division and the QCIC staff recognize that it is in the public interest to cooperate with each other to minimize duplication of efforts, and are in constant communication regarding matters that may or may not involve litigation against an auditor of an SEC registrant. The Ethics Division and QCIC handle those matters that do not involve litigation on a case-by-case basis. Once the Ethics Division deferral is lifted, the Ethics Division expedites its investigation of the matter. The AICPA has allocated additional resources to both QCIC and the Ethics Division to enable both bodies to perform its responsibilities promptly and effectively. The POB will work with the PRC to develop peer review procedures to assure that (a) the firm has procedures in place to reasonably assure its compliance with the options chosen, and	

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Issue: Disciplinary Process			
Findings From Panel Report	**Recommendations Contained in Panel Report**	**Actions Taken as of September 2001 (as Reported by the POB, AICPA, SEC, and NASBA)**	**Recommendations Directed to**
		(b) the peer review and inspection programs include the review of at least one engagement to which Option C was applied. POB is in the process of establishing a system to accumulate PEEC's deferrals and the options chosen by the firms to apply to the engagement partner during the PEEC's deferral period. The POB intends to report options chosen by the firms for those deferrals by the PEEC on an aggregate "no-name" basis. The POB also oversees each QCIC case.	
	17.2) The POB and SECPS should review the results of implementing the Panel's recommendations concerning the disciplinary process over a 2- to 3-year period to determine their effectiveness. If the POB determines that these recommendations have not satisfactory protected the public, the POB, in cooperation with the SEC, should seek legislation to achieve the protections necessary to the make the disciplinary process more effective. (Paragraph 6.57)	New membership requirement concerning disciplinary procedures became effective for cases reported to the QCIC in 2001. The QCIC, SECPS Executive Committee, and POB will continually monitor the effectiveness of the requirement.	POB, SECPS, and SEC
	17.3) The POB should leverage the knowledge it gains in its oversight of the disciplinary process recommended by the Panel, to determine whether changes in professional standards or further guidance is needed and communicate these findings to the appropriate standard-setters or authoritative bodies. (Paragraph 6.58)	The POB leverages knowledge it gains from its oversight of PRC, QCIC, as well as its liaison with PEEC, through its Coordinating Task Force. This task force will determine whether a need for changes in professional standards has been or should be communicated to standard-setters or other authoritative bodies, or the PITF if appropriate.	POB
18) Some state boards have not been effective in disciplining substandard conduct because of limited budgets and the lack of effective means to investigate allegations and impose discipline. (Paragraph 6.50)	No recommendation made.		

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Issue: Disciplinary Process			
Findings From Panel Report	**Recommendations Contained in Panel Report**	**Actions Taken as of September 2001 (as Reported by the POB, AICPA, SEC, and NASBA)**	**Recommendations Directed to**
19) The AICPA's Ethics Division cannot issue subpoenas (has to rely on the cooperation of the individual being investigated) or compel testimony (cannot talk to the plaintiff or client company involved). (Paragraphs 6.11 and 6.51)	No recommendation made.		
20) The AICPA's Ethics Division investigations and QCIC files are not privileged and are subject to subpoena. (Paragraphs 6.48 and 6.54)	No recommendation made.		
21) The AICPA's Ethics Division can impose only limited sanctions. Their disciplinary authority extends only to a CPAs membership rights in the AICPA or a state society of CPA's (state boards are the only agencies that can revoke a CPA license). (Paragraphs 6.6, 6.49, and 6.51)	No recommendation made.		

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Issue: Disciplinary Process			
Findings From Panel Report	**Recommendations Contained in Panel Report**	**Actions Taken as of September 2001 (as Reported by the POB, AICPA, SEC, and NASBA)**	**Recommendations Directed to**
22) The AICPA's Ethics Division's disciplinary proceedings are not timely (they are deferred while litigation or regulatory proceedings are in process). (Paragraphs 6.11, 6.51, and 6.52)	22.1) The Ethics Division takes 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. (Paragraph 6.31)	The Ethics Division has received additional resources in order to process investigations involving audits of SEC registrants in a timely manner and has developed aggressive timelines to process the cases once litigation or regulatory investigations have been concluded. The PEEC has appointed a Statistical Reporting Task Force and a Disciplinary Task Force with the objectives of improving statistical reporting and making the information reported more descriptive and informative. A representative of the POB attends the meetings of the Statistical Reporting Task Force.	AICPA
23) The AICPA's Ethics Division's 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. Similarly, the QCIC's corrective actions it imposes on firms are not made public. (Paragraph 6.51)	No recommendation made.	The PEEC has appointed a Statistical Reporting Task Force and a Disciplinary Task Force with the objectives of improving statistical reporting and making the information reported more descriptive and informative. A representative of the POB attends the Statistical Reporting Task Force meetings.	
24) The SEC has limited resources to pursue cases against auditors. (Paragraphs 6.5 and 6.50)	24.1) The SEC should allocate additional resources to its enforcement activities directed at allegations of failed audits. (Paragraph 6.59)	SEC officials stated that encouraging companies to engage in cooperative measures such as self-policing prior to the discovery of misconduct, self-reporting of misconduct when discovered, remediation, and cooperating with law enforcement authorities will allow the SEC to maximize the use of its enforcement staff and to concentrate on bringing prompt corrective action in the most egregious cases.	SEC

(Continued From Previous Page)

Issue: Disciplinary Process			
Findings From Panel Report	**Recommendations Contained in Panel Report**	**Actions Taken as of September 2001 (as Reported by the POB, AICPA, SEC, and NASBA)**	**Recommendations Directed to**
	24.2) The SEC should periodically undertake similar studies (such as the study of AAERs in Appendix F to the Panel's report) and disseminate the results. (Paragraph 6.60)	The SEC does not plan to taken any additional actions to implement this recommendation. While SEC officials stated that they believe a continuing analysis of AAERs is important, they believe that significant AAERs are currently being analyzed and digested on a real-time basis by a number of organizations, including the press, the accounting profession, accounting and auditing standard-setters, academia, and others. The incremental benefits of an additional annual or biennial study by SEC staff, therefore, may not be sufficient to justify the resources it would take to complete such a study.	SEC
	24.3) The SEC should 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 the AAER. (Paragraph 6.60)	The SEC does not plan to taken any additional actions to implement this recommendation. The SEC stated that its Division of Enforcement has for many years reviewed the conduct of auditors in essentially every investigation related to materially misstated financial statements. When appropriate, the division recommends enforcement or disciplinary action against an auditor. In circumstances where the SEC concludes that a disciplinary action is not appropriate, SEC officials stated that it is unclear to them what benefit accrues from a public airing of the SEC's determination.	SEC

Comments From the Public Oversight Board

Attachments A and B to this letter are not included in this report. However, they are available on the Public Oversight Board's web site (http://www.publicoversightboard.org).

PUBLIC OVERSIGHT BOARD
One Station Place (203) 353-5300
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March 20, 2002

Jeffrey C. Steinhoff
Managing Director
Financial Management and Assurance
United States General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Steinhoff:

I. Introduction

Thank you for your letter dated March 1, 2002 requesting comments on the draft report of the United States General Accounting Office ("GAO") on the status of the Panel on Audit Effectiveness ("Panel") recommendations to enhance the self-regulatory system of the accounting profession ("Draft Report"). The Public Oversight Board ("POB") appreciates the professionalism with which the members of the GAO staff conducted their review in this matter, and believes that the Draft Report provides useful information concerning the status of the Panel recommendations.

In response to your March 1st letter, we set forth below a discussion of the background here, a brief description of the POB's White Paper on proposed legislation for a new private sector regulatory structure for the accounting profession dated March 19, 2002 ("White Paper") (Attachment A), and our general comments on the Draft Report. Specific comments on the Draft Report from the POB staff are being prepared, and will be forwarded to you before the close of this month.

II. Background

To put the Panel recommendations in context, we note, as you do in the Draft Report, that these recommendations were made by the Panel within the framework of the existing regulatory system of the accounting profession. The Panel's Report and Recommendations dated August 31, 2000 ("Panel Report") were directed at enhancing, not replacing, the present regulatory system. The Panel Report did not propose or discuss alternative models for regulation of the accounting profession (e.g., by legislation), or their relationship to the current financial reporting model.

Mr. Jeffrey C. Steinhoff
March 20, 2002
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Recent events, including those surrounding the Enron collapse, have very much changed the context in which the Panel issued its Report. There is now a significant focus on replacing the present regulatory system of the accounting profession with a different one. This has been, and continues to be, the subject of Congressional hearings and widespread media attention. In addition, several Congressmen and Senators have introduced legislation to establish a new regulatory system. In view of these events, as well as the obstacles the POB has encountered in carrying out its oversight responsibilities under the existing system, the POB has come to the conclusion that there is a need for legislation to effectively deal with regulation of the accounting profession. The POB's proposal for this legislation is discussed in its White Paper. While we attach a copy of our White Paper for your information, we believe that the summary of that Paper set forth below will be helpful to you in connection with your Report on the status of the Panel's recommendations.

III. POB White Paper

The POB's White Paper, among other things, sets forth the POB's observations about recent problems affecting the present regulatory structure of the accounting profession, the POB's proposals for reform, and a discussion of the POB's decision in January 2002 to terminate its existence by March 31, 2002. This White Paper, and my prepared statement (Attachment B), were submitted for the record of my testimony before the Senate Committee on Banking, Housing, and Urban Affairs on March 19, 2002.

As discussed in the attached White Paper, the POB recommends that Congress create a new Independent Institute of Accountancy Board ("IIA") and place the new private sector regulation under its auspices. The IIA would be run by a seven-member board totally independent of the American Institute of Certified Public Accountants ("AICPA"), the Big Five and other public accounting firms. The Chair and Vice Chair of the IIA would serve on a full-time basis, and five other members would be part-time. All would be appointed by a panel composed of the Chair of the SEC, the Chair of the Federal Reserve Board, and the Secretary of the Treasury. Once named, the Chair of the IIA would join these three in selecting other members of the Board.

Important functions of the IIA would include:

- Exercise oversight for standard setting for accounting, auditing and independence, and their interpretation.
- IIA employees would conduct comprehensive yearly reviews of the annual internal inspections done by firms that audit more than 100 public corporations each year. Reviews of smaller audit firms would be performed by other firms selected and paid by the IIA.
- IIA employees would conduct special reviews, when warranted.

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- The Office of Enforcement and Discipline within the IIA would have full authority to investigate allegations of wrongdoing by member CPA firms and their personnel, and would be empowered to issue subpoenas for testimony of persons and production of documents. The Office also would be empowered to take appropriate disciplinary action after notice and opportunity for public hearing.

- Funding for the new regulatory system would be provided through fees imposed on public corporations in amounts sufficient to cover the cost of the IIA.

- The IIA would be charged with coordinating international liaison and oversight of continuing professional education.

IV. General Comments

While you shall be furnished with specific comments by the POB staff on your Draft Report by the close of this month, as I mentioned above, we have two general comments on the Draft Report for your consideration. These are set forth below.

A. First General Comment

First, we believe it would be helpful to readers of the GAO's Report for the Report to include, in addition to the Panel's recommendation and the status of the action taken, an identification of any differences between Panel recommendations and the actions, taken or proposed, to implement those recommendations, with an explanation for the differences and the estimated time to complete implementation.

For example, the Draft Report states in relevant part at pages 34 to 35:

> In accordance with the Panel's recommendation, the SECPS [SEC Practice Section] membership requirements were revised as follows when civil litigation or a criminal or public regulatory investigation contains allegations of an audit failure:
>
> - The firm is required to conduct an internal review of the subject engagement to evaluate the performance of the senior engagement personnel.
> - The QCIC [Quality Control Inquiry Committee] should conduct its usual inquiry and the QCIC and the POB would jointly discuss the engagement. If the QCIC believes that standards may have been violated and, accordingly, refers the case to the Ethics Division of the AICPA, the firm would be notified that the Ethics Division is deferring its investigation pending the completion of the litigation.
> - The firm is then required to take one of the following actions: (1) terminate or retire the partner involved in the alleged audit failure, (2) remove the partner from all public company audit engagements until the Ethics Division's

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Mr. Jeffrey C. Steinhoff
March 20, 2002
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> investigation is completed, or (3) perform an additional second partner review of all public company audit engagements completed by the partner in the 12 months prior to the deferral, subject the partner to additional oversight on all public company audit engagements for at least one year, and thereafter subject the partner to those additional oversight procedures that the firm's managing partner determines are necessary to protect the public based on the firm's evaluation of the partner's performance.
>
> The process implemented by the firms when they choose the third option would be subject to peer review and POB oversight.

Appendix II to the Draft Report captioned, "Actions Responding to Panel on Audit Effectiveness' Recommendations" at pages 84 to 87 of the Draft Report sets forth, in a side-by-side columnar format, the relevant Panel recommendation[1] here and the SECPS membership requirements intended to implement that recommendation.[2] When one reviews these two columns, it is apparent there are certain differences between this Panel recommendation and SECPS membership requirements that could be material to the public interest.

For example, with respect to a firm's selection of one of the three specified options, the Panel recommendation states:

> 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.[3]

In contrast, the SECPS membership requirements, which provide for a more limited POB review, state, "The implementation of the option selected [by the member firm] is subject to review in the member firm's peer review and by the Public Oversight Board."[4]

Accordingly, under the Panel's recommendation, it is expressly stated that the POB could disagree with a member firm's selection of Option C. In this event, the POB could take the position that, instead of being allowed to participate in public company audit engagements under additional oversight, the subject partner should be terminated, retired or otherwise be removed from those engagements. The SECPS Executive Committee, by not adopting this Panel recommendation as part of the SECPS membership requirements, detracts from the weight to be

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1 Section 6.56 of the Panel Report at 153-156.

2 Section 1000.08(p) and Section 1000.47 (Appendix M) of the SEC Practice Section Reference Manual ("SECPS Manual").

3 Section 6.56 of the Panel Report at 155.

4 Section 1000.47(.05) of the SECPS Manual.

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Mr. Jeffrey C. Steinhoff
March 20, 2002
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given to a POB disagreement with a firm's selection of Option C. This difference could be material to the public interest.

B. Second General Comment

Our second general comment is that we believe it would also be helpful to readers of the GAO's Report for the Report to set forth the GAO's evaluation of the reasonableness of any differences between the Panel recommendations and the actions, taken or proposed, to implement those recommendations.

For example, the Draft Report at page 30 states in relevant part:

> Peer reviews are performed to enhance the public's confidence in independent auditors. The Panel felt that the POB, as the public's representative, should be viewed as the principal stakeholder in the peer review process and accordingly recommended that it should be made clear to peer reviewers that the POB, not the firm being reviewed, is the primary client. The Panel wanted the peer reviewers to have the "mind-set" that peer reviews are performed in the best interest of the public, and not solely for the benefit of the reviewed firm. By considering the POB as the primary client, the Panel hoped the peer reviewers would likely bring the POB more into the process up front and continue to keep them apprised of issues throughout the review. The POB could then be in a better position to monitor and oversee the reporting of peer review results.
>
> The AICPA rejected the Panel's recommendation because the PRC, not the POB, is responsible for maintaining and administering the peer review program. The AICPA did adopt a related Peer Review Process Task Force recommendation to address the peer review reports to both the PRC and the reviewed firm. The Peer Review Process Task Force made this recommendation because it felt that the PRC serves as an "audit committee" and that by including the PRC as an addressee on the peer review report would emphasize to peer reviewers and reviewed firms that they should consider the PRC as the "audit committee." However, the Panel told us that including the PRC as an addressee on the peer review report does not satisfy the intent of its recommendation to have the POB be the primary client of peer review.

The POB agrees with the Panel recommendation,[5] as well as with the Panel's position that the alternative approach of having the Peer Review Committee as an addressee on the peer review report does not satisfy this recommendation. Further, the POB believes that, because the POB under its Charter has oversight responsibility for both the Peer Review Committee and peer review program, it (or its successor) is more like an "audit committee", and in a better position to

[5] Section 6.40 of the Panel Report at 148.

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be the primary client of the peer review process, than the Peer Review Committee. The Peer Review Committee, since it has responsibility for maintaining and administering the peer review program, and is subject to POB oversight, is more like "management" than an "audit committee," and therefore should not be the primary client of the peer review process.

V. Conclusion

Again, the review conducted by your staff was professional and we appreciate this opportunity to provide comments on the GAO Draft Report.

Sincerely,

Charles A. Bowsher

Charles A. Bowsher
Chair

cc: Mr. Robert W. Gramling
Consultant
United States General Accounting Office

Mr. Michael C. Hrapsky
Senior Project Manager
United States General Accounting Office

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Comments From the American Institute of Certified Public Accountants

AICPA

April 1, 2002

Mr. Jeffrey C. Steinhoff
Managing Director
Financial Management and Assurance
U.S. General Accounting Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Steinhoff:

The American Institute of Certified Public Accountants (AICPA) appreciates the opportunity to review and comment on the U.S. General Accounting Office's (GAO) draft report, *The Accounting Profession: Status of Panel on Audit Effectiveness Recommendations to Enhance the Self-Regulatory System,* dated March 2002.

We agree with the GAO findings and conclusions that most, if not substantively all, of the Public Oversight Board (POB) Panel on Audit Effectiveness' (the "Panel") recommendations addressed to the AICPA have been adopted. The report accurately summarizes, in Appendix II, the many actions the AICPA has taken with respect to the Panel's recommendations as of September 2001. We understand the GAO has not been requested to update the status of implementation of the recommendations since September 2001 given more recent events (for example, the announcement on January 17, 2002 by SEC Chairman Harvey Pitt of a proposed new public regulatory system to oversee the accounting profession, and the POB's decision to disband on or about March 31, 2002). While we agree with the SEC's proposal, we disagree with the POB's decision to disband, because we believe it is in the public interest to continue our self-regulatory programs, with public oversight, during the transition period to a new public regulatory model. As a result, the AICPA and the SEC have agreed that the POB staff will continue to oversee the profession's self-regulatory activities for auditors of public companies; and the SEC will continue its oversight as well.

We wish to emphasize the importance of the accuracy and clarity of the information in the report. The following areas are very important as Congress and regulators consider ideas while they deliberate on a new public regulatory model that enhances the current model to provide for the full protection of the investing public.

Coordination within the system of regulation of auditors of public companies. We agree that the current system of federal, state and self- regulation of auditors of public companies could and should be better coordinated. Within the current *self*-regulatory element of this overall system, the AICPA's efforts are well coordinated and appropriate communications occur. However, we believe that a critical goal for a new public regulatory body should be enhanced coordination among the activities of the new regulatory body, the profession, and state and federal regulators.

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POB oversight over the independence standard setting and disciplinary processes of the AICPA's ethics committee. The Panel's report recommended POB oversight authority over the independence standard setting process for auditors of public companies. Accordingly, the POB charter provided the POB with oversight authority over the activities of the Independence Standards Board (ISB), the primary independence standard-setter, at the time, for auditors of public companies. With the SEC's independence rulemaking effort in 2000, the SEC essentially exercised its regulatory authority in the independence standard-setting process and again became the primary independence standard-setter for public company auditors. POB oversight over the ethics committee's independence standard setting activities was unnecessary in these circumstances, particularly in light of the significant participation (versus oversight) on the ethics committee by five prominent public sector individuals. We do not believe that the POB Panel ever suggested POB oversight over the ethics committee's disciplinary function. Rather, the Panel's recommendations focused on the disciplinary activities of the Quality Control Inquiry Committee (QCIC). In fact, as the recently approved POB charter was being drafted there were several discussions about this very subject. As these discussions took place, the profession and the POB both agreed that the POB Panel's recommendations were meant to cover the ISB and QCIC.

POB budget cap. We do not disagree that a budget cap, adjusted annually for inflation and including a provision to increase that cap if needed, could be *perceived* as a lack of support for public oversight. However, the AICPA has always supported independent public oversight with fiscally accountable "no strings funding." The POB charter is perfectly clear that the "POB shall have adequate no strings funding" and that "…once the POB submits and consults on its annual budget…the EC (SECPS Executive Committee) and the AICPA Board shall not withhold funding for any reason." We also agree with the statement made on page 22 of the draft report that the existence of the cap would not impede the POB's ability to operate in any way. We believe that any new public regulatory body should be granted appropriate funding, subject to reasonable and appropriate fiscal accountability.

Peer review report addressed to POB. The Panel recommended that peer review reports be addressed to the POB rather than to the firm subject to peer review. The AICPA's Peer Review Committee fully considered this recommendation and concluded it would have no affect on the quality of the peer review nor the content of peer review reports. It further concluded that peer review reports would be more appropriately addressed to the Peer Review Committee as the body responsible for maintaining and administering the peer review program. The decision in no way impacts the level of oversight necessary to adequately protect the public interest.

Meeting Today's Challenges

This is a time of exceptional challenges for all participants in the financial reporting system. The AICPA is committed to meeting these challenges and continues to serve the public interest by promoting efforts to ensure that CPAs maintain integrity, objectivity, competence and independence, and possess the skills needed in a complex business and economic environment.

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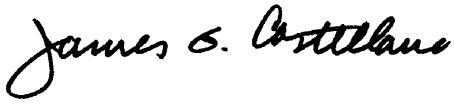
We commend the GAO staff's efforts in studying the actions taken to improve the regulation of the profession, and believe the report will be very helpful towards establishing a new regulatory model. Thank you for the opportunity to review the report and provide our views.

Sincerely,



James G. Castellano, CPA
AICPA Chairman

cc: The Honorable David M. Walker, Comptroller General

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Comments From the National Association of State Boards of Accountancy

NASBA

National Association of State Boards of Accountancy

150 Fourth Avenue North Suite 700 Nashville, TN 37219-2417

Tel 615/880-4200 Fax 615/880-4290 Web www.nasba.org

March 14, 2002

Mr. Jeffrey C. Steinhoff
Managing Director - Financial Management and Assurance
United States General Accounting Office
441 G Street, NW – Suite 5050
Washington, DC 20548

Dear Mr. Steinhoff:

Thank you for offering the National Association of State Boards of Accountancy (NASBA) the opportunity to comment on the GAO's report to Congressman John Dingell on the status of the recommendations made by the Panel on Audit Effectiveness (the Panel). As pointed out in the report's introduction, the resignation of the Public Oversight Board (POB) as of March 31 and the many new proposals being offered by the Securities and Exchange Commission (SEC) and Congress for the regulation of the accounting profession, have left the Panel's recommendations being only instructive for what may exist in the future. The following remarks are directed to that future regulatory scheme, rather than commenting on a system that may soon be abandoned or greatly altered.

Unfortunately, while the Panel's report called for "improved communications" with the state boards of accountancy, it made few concrete suggestions on how this was to be achieved. During the Panel's hearings, state board representatives had specifically called for (1) the boards' involvement in rulemaking bodies for independence and other ethical standards, and (2) direct prompt referrals to the boards of individuals and firms associated with audit failures. Neither of these suggestions was recommended by the Panel in its final report.

As correctly noted in the GAO's report, "...with regard to the public regulatory systems, no substantial actions were taken to improve communications." GAO was told by the POB that they "planned to begin a dialog with NASBA and several state boards of accountancy to explore ways to improve communication." NASBA and the boards would have welcomed such dialog if it had ever been offered by the POB. It was NASBA that initiated the development of a joint NASBA/AICPA Ethics Task Force -- and it was the AICPA that withdrew from that task force.

It is frustrating to read that the GAO was advised by the Panel that "they viewed disciplinary actions against SECPS members as primarily a function of the SEC and the courts. The PEEC Chairman, who is part of the AICPA's Ethics Division and responsible for investigating and disciplining members of the AICPA concerning violations of standards, stated that its cases involving SECPS members are a relatively small percentage of its total cases and that having public members on the PEEC adequately protects the public interest without POB oversight." State boards operate on a complaint-driven system and, for protecting the public interest, PEEC should directly make referrals to the boards.

Mr. Jeffrey C. Steinhoff
March 14, 2002
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The entire discussion of improving peer review as related in the GAO's report fails to take into consideration a basic problem with the system. Firms have voluntarily undergone peer review because they have been told by the professional associations that its primary goal is education. For peer review to be effective, it has to be more clearly linked to the regulatory process. This would include forwarding to all state boards modified or adverse peer review reports so that licenses could be limited when appropriate, suspended or revoked. Firm registration renewal in many states depends on having completed a peer review; however, the results of those reviews, in most cases, are not provided to the state boards.

The GAO's report notes: "The Panel found that some state boards of accountancy have not been effective in disciplining substandard conduct due to limited budgets and the lack of effective means to investigate allegations and impose disciplinary measures." Many state boards are very effective in disciplining substandard conduct. For example, the Texas State Board of Public Accountancy estimates it handles over 300 discipline cases per year and the North Carolina State Board of CPA Examiners over 150. State accountancy boards are responsible for approximately 577,000 licensees, while the American Institute of CPAs estimates its membership at 350,000. Even the Panel identified more than 50 firms that were auditing SEC registrants and were not members of the AICPA -- but they were under the authority of the state boards.

Another flaw in the Panel's report is pointed out when the GAO correctly notes: "...the Panel made various recommendations to improve the disciplinary process to provide greater protection to the public without recommending legislative changes necessary to provide protective powers.... The Panel's recommendations were largely made to components of the self-regulatory system, although some recommendations were made to the SEC regarding resources and leveraging information from its investigations. No recommendations were made to the state boards of accountancy." Why not?

The GAO report picks up the Panel's conclusion that the AICPA's Ethics Division's lack of protective power contributes to the length of time the Division takes to complete its cases. The report states: "The lack of protective power may also affect the Ethics Division's ability to work cooperatively with the state boards of accountancy on investigations. The Ethics Division has entered into cooperative investigative agreements with four states that, with the member's consent, allow it to conduct investigations and share the results with the four state boards of accountancy [CT, IL, WV, RI]. The Ethics Division stated it will attempt to expand this type of cooperative agreement to other states but states previously have expressed little interest in such an agreement." This cooperative program has been available for more than ten years and has not been found acceptable to most states' attorneys general. It should be noted the Connecticut State Board of Accountancy has only used this cooperative service once and has taken action against numerous licensees independent of it.

According to the GAO's report, the POB had formed a coordinating task force "to leverage the knowledge it gains through oversight to determine whether changes in professional standards or further guidance is needed and communicate these findings to the appropriate standards setter or authoritative bodies." While the SEC was invited to attend the meetings, the state boards, that oversee all licensees and firms, were not.

Mr. Jeffrey C. Steinhoff
March 14, 2002
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The GAO report repeats the Panel's recommendation: "...the self-regulatory system must also have the necessary powers to timely and effectively address alleged noncompliance with professional standards. Ethics Division's investigations without protective powers will continue to take years to complete after an allegation of an audit failure is initially made through litigation and will perpetuate the Panel's findings that the public's perception is that the self-regulatory system is not timely or effective." Once a complaint is filed with a state board and an investigation is started, the boards in most states are bound to have a prompt resolution to the case. The power to protect the public is in the hands of the state boards of accountancy and can easily be set into motion with appropriate communication from the professional self-regulatory system.

As correctly concluded by the GAO: "The POB, or its successor, the Ethics Division, and the SEC also need to build effective working relationships with the state boards of accountancy. The Panel reported that although these parties have a common interest, they generally work separately and information is not freely shared, which contributes to the public perception that the discipline function of the accounting profession is not timely or effective." The state boards' attorneys have for several years been encouraging the SEC to allow them to share case information before a settlement agreement is reached and the materials become unavailable. For the boards, the protection of the public is the primary goal, but they do afford due process to all licensees and they do have strict rules about confidentiality of materials.

Certainly there is a place for self-regulation, but for the public to have confidence in the profession, the SEC's and state boards' essential positions in the regulatory scheme need to be properly recognized and supported.

Sincerely,

Barton W. Baldwin, CPA
Chair, NASBA

David A. Costello, CPA
President and CEO, NASBA

Thomas J. Sadler, CPA
Chair, NASBA Litigation Response and Assistance Committee

Accounting Profession: Oversight, Auditor Independence, and Financial Reporting Issues

Comptroller General of the United States

United States General Accounting Office
Washington, DC 20548

May 3, 2002

The Honorable Paul S. Sarbanes
Chairman, Committee on Banking,
Housing, and Urban Affairs
United States Senate

Subject: *Accounting Profession: Oversight, Auditor Independence, and Financial Reporting Issues*

Dear Mr. Chairman:

This letter responds to your recent request that we provide our views regarding what steps the Congress should consider taking to strengthen oversight of the accounting profession, auditor independence, and selected financial reporting matters. The sudden and largely unexpected bankruptcy of the Enron Corporation (Enron) and other large corporations' financial reporting restatements have raised questions about the soundness of the current self-regulatory and financial reporting systems and resulted in substantial losses to employees, shareholders, and other investors. These events have also raised a range of questions regarding how such dramatic and unexpected events can happen and the role and capacities of various key players under the existing systems.

The issues surrounding the accounting profession's current self-regulatory system for auditors involves many players in a fragmented system that is not well coordinated, involves certain conflicts of interest, lacks effective communication, has a funding mechanism that is dependent upon voluntary contributions from the accounting profession, and has a discipline system that is largely perceived as being ineffective. (Enclosure 1 serves to illustrate the complexity of the current system of regulation and oversight and the stakeholders who rely on the system.)

Simply stated, the current self-regulatory system is broken and oversight of the self-regulatory system by the Securities and Exchange Commission (SEC) has not been effective in addressing these issues to adequately protect the public interest. As a result, given the important role that independent auditors play and various inherent problems in the current self-regulatory system, direct government intervention is needed to statutorily create a new body to oversee the accounting profession's responsibilities for auditing public companies. This step is necessary in order to increase the effectiveness of the audit process and to rebuild public confidence. The new body should be independent of the accounting profession, have significant standards-setting, oversight, and disciplinary authority, be adequately resourced to

fulfill its responsibilities, and have sufficient operating flexibility to attract and retain quality leadership and supporting staff.

On the other hand, the concerns relating to the timeliness, relevancy and transparency of the financial reporting model may be best addressed through the SEC working more closely with the Financial Accounting Standards Board (FASB), assuring that the FASB has an adequate and independent source of funding for its operations, and reporting periodically to the Congress in connection with certain FASB matters. If such an approach is not successful in achieving the expected improvements in the financial reporting model in a timely and effective manner, the government can then take further action.

The areas of oversight of the accounting profession, auditor independence, and financial reporting are important on their own, but they also represent interrelated keystones to protecting the public's interest. Failure in any of these areas can place a strain on the entire system. Consequently, potential actions should be guided by the fundamental principles of having the right incentives for the key parties to do the right thing, adequate transparency to provide reasonable assurance that the right thing will be done, and full accountability if the right thing is not done. These three fundamental principles represent a system of controls that should operate in conjunction with a policy of placing special attention on areas of greatest risk.

NEW BODY NEEDED TO REGULATE AND OVERSEE THE ACCOUNTING PROFESSION

Enron's failure and a variety of other recent events have brought a direct focus on the ineffectiveness of the current system of regulation and oversight of the accounting profession. Independent auditors have a key role to play in protecting shareholders and the public's interest in our capital market system. They hold a public trust and their actions or inactions can have significant implications on investors, creditors and other users of financial reports. In this regard, auditors must place additional emphasis on whether financial statements are "fairly presented in all material respects" in addition to their traditional emphasis on whether such financial statements are prepared "in accordance with generally accepted accounting principles." Fair presentation requires providing reasonable assurance that major value and risk elements are appropriately reflected in the financial statements and related notes in an understandable fashion. It also requires employing an "economic substance" versus "transaction form" approach to important accounting and reporting issues.

Many proposals are before the Congress to establish a new body to regulate and/or oversee accounting firms that audit public companies. In our view, the Congress should consider the following key factors or criteria in establishing this new body, each of which is critical to its likely effectiveness.

Functions of the New Body

The new body should have direct responsibility and authority for certain critical functions in connection with public accounting firms and their members who audit public companies. These include:

- establishing professional standards (independence standards; quality control standards, auditing standards, and attestation standards). The new body should be authorized to issue professional standards. In that respect, the new body should also be authorized to affirmatively adopt, at its discretion, professional standards, in whole or in part, promulgated by another standard-setting body. In the area of new standards, the new body may choose to require auditor reporting on the effectiveness of internal control over financial reporting in connection with audits of public companies, which is currently not required under existing auditing standards. It may also decide not to affirmatively adopt a standard developed by another standard-setting body but instead issue a modified version of the standard.

- monitoring public accounting firms for compliance with applicable professional standards. For efficiency, except for quality reviews of the largest firms and those firms in which the nature of the audits they perform pose a higher level of risk as determined by the new body, the new body should be authorized to use contractors or accounting firms to perform quality reviews in accordance with standards and processes set by the new body. However, the new body should have final approval authority in connection with any quality review engagements performed by any contractors or accounting firms.

- investigating and disciplining public accounting firms and/or individual auditors of public accounting firms who do not comply with applicable professional standards. Investigations and disciplinary actions of the new body should be in addition to existing investigatory and disciplinary authority that already exists with the SEC and state boards of accountancy.

- establishing various auditor rotation requirements for key public company audit engagement personnel (i.e., primary and second partners, and engagement managers). Related to this function, we believe the new body should undertake a study and report to the Congress on the pros and cons of any mandatory rotation of accounting firms that audit public companies before taking any action with regard to establishing requirements for any mandatory rotation of accounting firms.

Funding for the New Body

The new body should have independent sources of funding by virtue of mandatory, not voluntary, payments. Public accounting firms and audit partners that audit financial statements, reports, or other documents of public companies that are required to be filed with the SEC should be required to register with the new body. The new body should have the authority to set annual registration fees and fees for

services such as peer reviews of public accounting firms. The fees should be set to recover full costs and sustain the operations of the new body.

Reporting Requirement of the New Body and GAO Access to Records

The new body should report annually to the Congress and the public on the full range of its activities, including coordination with other standard-setting bodies whose standards it so chooses to adopt, setting professional standards, peer reviews of public accounting firms, and related disciplinary activities. Such reporting also provides the opportunity for the Congress to conduct oversight of the performance of the new body. The Congress also may wish to have GAO review and report on the performance of the new body after the first year of its operations and periodically thereafter. Accordingly, we suggest that the Congress provide GAO not only access to the records of the new body, but also access to the records of other entities that the new body has chosen to rely on, such as other standard-setting bodies, and contractors or public accounting firms that conduct quality reviews, to the extent GAO considers necessary to assess the performance of the new body.

Structure of the New Body

The new body should be created by statute and should be independent of the accounting profession. To facilitate operating independently, the new body's board members should be highly qualified and should have authority to set and approve its operating rules. The new body should have independent decision-making authority; however, it should coordinate and communicate its activities with other parties such as the SEC, the various state boards of accountancy, other standard- setters, and GAO, as appropriate. The new body should set its own human resource and other administrative requirements and should be given appropriate flexibility to provide compensation that is competitive to attract highly competent board members and supporting staff. The new body should also have adequate staff to effectively discharge its responsibilities.

Candidates for the new body's board membership could be identified through a nominating committee that could include the Chairman of the Federal Reserve, Chairman of the SEC, the Secretary of the Treasury, and the Comptroller General of the United States. This approach would help to assure the qualifications and independence of all board members.

The number of board members could be 5 or 7 and have stated terms, such as 5 years with a limited renewal option, and the members' initial terms should be staggered to ensure some continuity. Ideally, the members of the board should be presidential appointees who are confirmed by the Senate (PASs). However, if the board members are not PASs, the board should be actively overseen by and accountable to a body that is composed of PASs, such as the SEC, in order to assure adequate accountability to the Congress and the public. At a minimum, the chair and vice-chair should serve on a full-time basis. None of the board members should be active

accounting profession practitioners, and a majority of board members should not have been accounting profession practitioners within the recent past (e.g., 3 years).

There are several alternative structures that the Congress could choose from in establishing the new body, including creating (1) a new unit within the SEC, (2) an independent government entity within the SEC, (3) an independent government agency outside the SEC, or (4) a non-governmental private-sector entity overseen by the SEC. Each of the above alternative structures have various pros and cons that should be considered in order to assure the credibility and effectiveness of the new body in protecting the public interest. We believe that each of the alternative structures provides an organizational foundation for managing and operating the new body that potentially is workable. For the following reasons, we favor alternatives two and three and believe they have a greater likelihood of success.

Under alternatives one and four, the new body's functions (e.g., establishing professional standards, monitoring, and discipline) would be subject to SEC approval in order to assure that all actions are in the public's interest and appropriate accountability to the Congress and the public. This, however, would increase the SEC's responsibility as well as its workload, for the agency and the Commissioners, both of which are already overloaded. Also, under alternatives one and four the new body's board members would not likely be PASs since under alternative one the SEC Chair and other Commissioners are PASs, and since alternative four involves a non-governmental entity. Therefore, under alternatives one and four, the new body would have less direct accountability to the Congress and the public than a body with board members who are PASs. This limitation could be mitigated to some extent by ensuring that regardless of the structure of the new body that board members are selected from candidates provided by an independent and appropriately qualified nominating committee as previously discussed.

Although a structure that provides direct accountability to the Congress and the public is important in our view, a more critical question regarding the structure of alternatives one and four is whether the SEC has the capacity to effectively take on such an additional workload. Clearly, the SEC has the culture and potential to perform an active oversight role and this would be in line with its current mission. But, does it realistically have the capacity to do so? From a historical perspective, while the SEC has had authority for over 70 years to regulate the public accounting profession under the federal securities laws and regulations related to public companies, it has largely relied on the public accounting profession to regulate itself. It is now apparent that this model has not adequately protected the public's interest. Therefore, the SEC would need to institute a new function within its organization, as called for in alternative one, or a new oversight structure for a private-sector entity outside the SEC, as called for in alternative four, both of which would require additional resources and a significant increase in priority to more directly regulate the accounting profession at a time when the SEC is already facing a range of challenges in fulfilling its current responsibilities. Further, we believe that the SEC also needs to increase the amount of time and attention that it allocates to interacting with the FASB, the stock exchanges, and the investment banking/analyst community.

As we recently reported,[1] the SEC's ability to fulfill its mission has become increasingly strained due, in part, to significant imbalances between the SEC's workload (such as filings, complaints, inquiries, investigations, examinations, and inspections) and staff resources. Although additional resources could help the SEC do more, additional resources alone would not help the SEC address its high staff turnover, which continues to be a major challenge for the agency. About 40 percent of the SEC's staff left the agency between 1998 and 2001 and, as a result, the average level of experience at the SEC has been declining. For example, in 2000, 76 percent of the SEC's examiners had been with the agency less than 3 years. However, we also reported that the SEC has not made effective use of strategic planning and information technology to leverage its limited resources. In addition to putting more strain on the SEC's capacity, alternatives one and four would also likely be less efficient models for the new body to operate under by requiring additional time and attention from the SEC.

Alternative two, which calls for the creation of an independent government entity within the SEC, and alternative three, which calls for the creation of an independent government agency outside the SEC, do not pose the same capacity challenges for the SEC, especially at the Commissioner level, as alternatives one and four. Also, alternatives two and three both meet each of the critical factors outlined above for the structure of the new body. We recognize there may be concern over adding more political appointments that have to be Senate confirmed, as called for under alternatives two and three, given the recent challenges of filling positions that are PASs. However, having an independent entity overseen by PASs serves to significantly enhance the entity's accountability to the Congress and the public.

Of these two alternatives, we favor alternative two as having a greater likelihood of success because the new body would be housed within the SEC and, therefore, could receive administrative support from the SEC, including human resources, payroll, and other administrative support. More importantly, this alternative should better facilitate communication and provide for maximum coordination with the SEC, while also allowing the new body the independence to design its own policies and procedures and systems as it deemed appropriate. In addition, alternative two would not require the Congress to create a separate federal entity. Alternative two would also facilitate a consolidation of the new entity under the SEC in future years if such a consolidation was deemed to be both desirable and appropriate. Therefore, we believe that alternative two has the greatest likelihood of success in terms of potential effectiveness, efficiency, and accountability of the new body. However, as previously stated, each of the alternative structures has merit and can potentially work if properly designed and implemented.

AUDITOR INDEPENDENCE

For over 70 years, the public accounting profession, through its independent audit function, has played a critical role in enhancing a financial reporting process that has

[1] *SEC Operations: Increased Workload Creates Challenges*, (GAO-02-302, March 5, 2002).

supported the effective functioning of our domestic capital markets, which are widely viewed as the best in the world. The public's confidence in the reliability of issuers' financial statements, which relies in large part on the role of independent auditors, serves to encourage investment in securities issued by public companies. This sense of confidence depends on reasonable investors perceiving auditors as independent expert professionals who have neither mutual, nor conflicts of, interests in connection with the entities they are auditing. Accordingly, investors and other users expect auditors to bring to the financial reporting process integrity, independence, objectivity, and technical competence, and to prevent the issuance of misleading financial statements.

Enron's failure and certain other recent events have raised questions concerning whether auditors are living up to the expectations of the investing public; however, similar questions have been raised over a number of years due to significant restatements of financial statements and certain unexpected and costly business failures, such as the savings and loan crisis. Issues debated over the years continue to focus on auditor independence concerns and the auditor's role and responsibilities. Public accounting firms providing nonaudit services to their audit client is one of the issues that has again surfaced by Enron's failure and the large amount of annual fees collected by Enron's independent auditor for nonaudit services.

Auditors have the capability of performing a range of valuable services for their clients, and providing certain nonaudit services can ultimately be beneficial to investors and other interested parties. However, in some circumstances, it is not appropriate for auditors to perform both audit and certain nonaudit services for the same client. In these circumstances, the auditor, the client, or both will have to make a choice as to which of these services the auditor will provide. These concepts, which we strongly believe are in the public's interest, are reflected in the revisions to auditor independence requirements for government audits,[2] which GAO recently issued as part of *Government Auditing Standards*.[3] The new independence standard has gone through an extensive deliberative process over several years, including extensive public comments and input from my Advisory Council on Government Auditing Standards.[4] The standard, among other things, toughens the rules associated with providing nonaudit services and includes a principle-based approach to addressing this issue, supplemented with certain safeguards. The two overarching principles in the standard for nonaudit services are that:

[2] *Government Auditing Standards: Amendment No. 3, Independence* (GAO-02-388G, January 2002).

[3] *Government Auditing Standards* was first published in 1972 and is commonly referred to as the "Yellow Book," and covers federal entities and those organizations receiving federal funds. Various laws require compliance with the standards in connection with audits of federal entities and funds. Furthermore, many states and local governments and other entities, both domestically and internationally, have voluntarily adopted these standards.

[4] The Advisory Council includes 20 experts in financial and performance auditing and reporting drawn from all levels of government, academia, private enterprise, and public accounting, who advise the Comptroller General on *Government Auditing Standards*.

- auditors should not perform management functions or make management decisions, and
- auditors should not audit their own work or provide nonaudit services in situations where the amounts or services involved are significant or material to the subject matter of the audit.

Both of the above principles should be applied using a substance over form doctrine. Under the revised standard, auditors are allowed to perform certain nonaudit services provided the services do not violate the above principles; however, in most circumstances certain additional safeguards would have to be met. For example, (1) personnel who perform allowable nonaudit services would be precluded from performing any related audit work, (2) the auditor's work could not be reduced beyond the level that would be appropriate if the nonaudit work were performed by another unrelated party, and (3) certain documentation and quality assurance requirements must be met. The new standard includes an express prohibition regarding auditors providing certain bookkeeping or record keeping services and limits payroll processing and certain other services, all of which are presently permitted under current independence rules of the AICPA. However, our new standard allows the auditor to provide routine advice and technical assistance on an ongoing basis and without being subject to the additional safeguards.

The focus of these changes to the government auditing standards is to better serve the public interest and to maintain a high degree of integrity, objectivity, and independence for audits of government entities and entities that receive federal funding. However, these standards apply only to audits of federal entities and those organizations receiving federal funds, and not to audits of public companies. In the transmittal letter issuing the new independence standard, we expressed our hope that the AICPA would raise its independence standards to those contained in this new standard in order to eliminate any inconsistency between this standard and their current standards. The AICPA's recent statement before another congressional committee that the AICPA will not oppose prohibitions on auditors providing certain nonaudit services seems to be a step in the right direction.[5]

The independence of public accountants is crucial to the credibility of financial reporting and, in turn, the capital formation process. Auditor independence standards require that the audit organization and the auditor be independent both in fact and in appearance. These standards place responsibility on the auditor and the audit organization to maintain independence so that opinions, conclusions, judgments, and recommendations will be impartial and will be viewed as being impartial by knowledgeable third parties. Because independence standards are fundamental to the independent audit function, as part of its mission, the new statutorily created body, which we previously discussed, should be responsible for setting independence standards for audits of public companies, as well as have the

[5] Testimony of AICPA Chairman before the House Energy and Commerce Committee (Subcommittee on Communications, Trade and Consumer Protection), February 14, 2002.

authority to discipline members of the accounting profession that violate such standards.

FINANCIAL REPORTING

Business financial reporting is critical in promoting an effective allocation of capital among companies. Financial statements, which are at the center of present-day business reporting, must be timely, relevant, and reliable to be useful for decision-making. In our 1996 report on the accounting profession,[6] we reported that the current financial reporting model does not fully meet users' needs. More recently, we have noted that the current reporting model is not well suited to identify and report on key value and risk elements inherent in our 21st Century knowledge-based economy. The SEC is the primary federal agency currently involved in accounting and auditing requirements for publicly traded companies but has traditionally relied on the private sector for setting standards for financial reporting and independent audits, retaining a largely oversight role. Accordingly, the SEC has accepted rules set by the FASB—generally accepted accounting principles (GAAP)—as the primary standard for preparation of financial statements in the private sector.

We found that despite the continuing efforts of FASB and the SEC to enhance financial reporting, changes in the business environment, such as the growth in information technology, new types of relationships between companies, and the increasing use of complex business transactions and financial instruments, constantly threaten the relevance of financial statements and pose a formidable challenge for standard setters. A basic limitation of the model is that financial statements present the business entity's financial position and results of its operations largely on the basis of historical costs, which do not fully meet the broad range of user needs for financial information.[7] Enron's failure and the inquiries that have followed have raised many of the same issues about the adequacy of the current financial reporting model, such as the need for additional transparency, clarity, more timely information, and risk-oriented financial reporting.

Among other actions to address the Enron-specific accounting issues, the SEC has requested that the FASB address the specific accounting rules related to Enron's special purpose entities and related party disclosures. In addition, the SEC Chief Accountant has also raised concerns that the current standard-setting process is too cumbersome and slow and that much of the FASB's guidance is rule-based and too

[6] *The Accounting Profession: Major Issues: Progress and Concerns* (GAO/AIMD-96-98, September 24, 1996).

[7] The accounting and reporting model under generally accepted accounting principles is actually a mixed-attribute model. Although most transactions and balances are measured on the basis of historical cost, which is the amount of cash or its equivalent originally paid to acquire an asset, certain assets and liabilities are reported at current values either in the financial statements or related notes. For example, certain investments in debt and equity securities are currently reported at fair value, receivables are reported at net realizable value, and inventories are reported at the lower of cost or market value. Further, certain industries such as brokerage houses and mutual funds prepare financial statements on a fair value basis.

complex. He believes that (1) a principle-based standards will yield a less complex financial reporting paradigm that is more responsive to emerging issues, (2) the FASB needs to be more responsive to accounting standards problems identified by the SEC, and (3) the SEC needs to give the FASB freedom to address the problems, but the SEC needs to monitor projects on an ongoing basis and, if they are languishing, determine why.

We generally agree with the SEC Chief Accountant's assessment. We also believe that the issues surrounding the financial reporting model can be effectively addressed by the SEC, in conjunction with the FASB, without statutorily changing the standard-setting process. However, we do believe that a more active and ongoing interaction between the SEC and the FASB is needed to facilitate a mutual understanding of priorities for standard-setting, realistic goals for achieving expectations, and timely actions to address issues that arise when expectations are not likely to be met. In that regard, the SEC could be directed to:

- reach agreement with the FASB on its standard-setting agenda, approach to resolving accounting issues, and timing for completion of projects;
- monitor the FASB's progress on projects, including taking appropriate actions to resolve issues when projects are not meeting expectations; and
- report annually to the Congress on the FASB's progress in setting standards, along with any recommendations, and the FASB's response to the SEC's recommendations.

The Congress may wish to have GAO evaluate and report to it one year after enactment of legislation and periodically thereafter on the SEC's performance in working with the FASB to improve the timeliness and effectiveness of the accounting standard-setting process. Accordingly, we suggest that the Congress provide GAO access to the records of the FASB that GAO considers necessary for it to evaluate the SEC's performance in working with the FASB.

The FASB receives about two-thirds of its funding from the sale of publications with the remainder of its funding coming voluntarily from the accounting profession, industry sources, and others. One of the responsibilities of the FASB's parent organization, the Financial Accounting Foundation, is to raise funds for the FASB and its standard-setting process to supplement the funding that comes from the FASB's sale of publications. Some have questioned whether this is the best arrangement to ensure the independence of the standard-setting process. This issue has been raised by the appropriateness of certain accounting standards related to consolidations, that the FASB has been working on for some time, applicable to Enron's restatement of its financial statements as reported to the SEC by Enron in its November 8, 2001, Form 8-K filing. However, the issue has previously been raised when the FASB has addressed other controversial accounting issues, such as accounting for stock options. We believe that the FASB should have mandatory sources of funding to remove the appearance of any independence issues related to funding FASB. Therefore, the Congress may wish to task the SEC with studying this issue and

identifying alternative sources of mandatory funding to supplement the FASB's sale of publications, including the possibility of imposing fees on registrants and/or firms, and to report to the Congress on its findings and actions taken to address the funding issue.

CLOSING COMMENTS

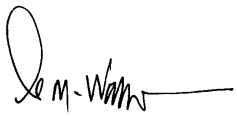
The United States has the largest and most respected capital markets in the world. Our capital markets have long enjoyed a reputation of integrity that promotes investor confidence. This is critical to our economy and the economies of other nations given the globalization of commerce. However, this long-standing reputation is now being challenged by some parties. The effectiveness of systems relating to independent audits and financial reporting which represent key underpinnings of capital markets and are critical to protecting the public's interest, has been called into question by the failure of Enron and certain other events and practices. Although the human elements can override any system of controls, it is clear that there are a range of actions that are critical to the effective functioning of the system underlying capital markets that require attention. In addition, a strong enforcement function with appropriate civil and criminal sanctions is also needed to ensure effective accountability when key players fail to properly perform their duties and responsibilities.

The accounting profession's self-regulatory system has not effectively fulfilled its responsibilities. In addition, the current model whereby the SEC oversees various self-regulatory organizations in connection with financial reporting and auditing has not worked well, especially in connection with audits of public companies. Further, the SEC is not staffed to take on a more direct role in regulating the accounting profession nor has the SEC strategically managed its limited resources well. Therefore, we strongly believe that a new independent body, created by statute to regulate audits of public companies, is needed in order to better protect the public's interest. However, currently we do not believe that it is necessary or appropriate for the government to assume direct responsibility for financial reporting. We do, however, believe that the Congress should provide the SEC with direction to address the issues concerning financial reporting as we have previously discussed.

In summary, Enron's recent sudden collapse, coupled with other recent business failures and certain other activities, pose a range of serious issues concerning the accounting profession and financial reporting that should be addressed. The fundamental principles of having the right incentives, adequate transparency, and full accountability provide a good sounding board to evaluate proposals that are advanced. In the end, no matter what improvements are made to strengthen the oversight and independence of the accounting profession and enhance the relevancy and transparency of financial reporting, bad actors will do bad things with bad results. We must, however, strive to take steps to minimize the number of such situations and to hold any violators of the system fully accountable for their actions.

We would be pleased to meet with you or other members of the committee to answer any questions that you may have or to provide further assistance.

Sincerely yours,



David M. Walker
Comptroller General
of the United States

Enclosure

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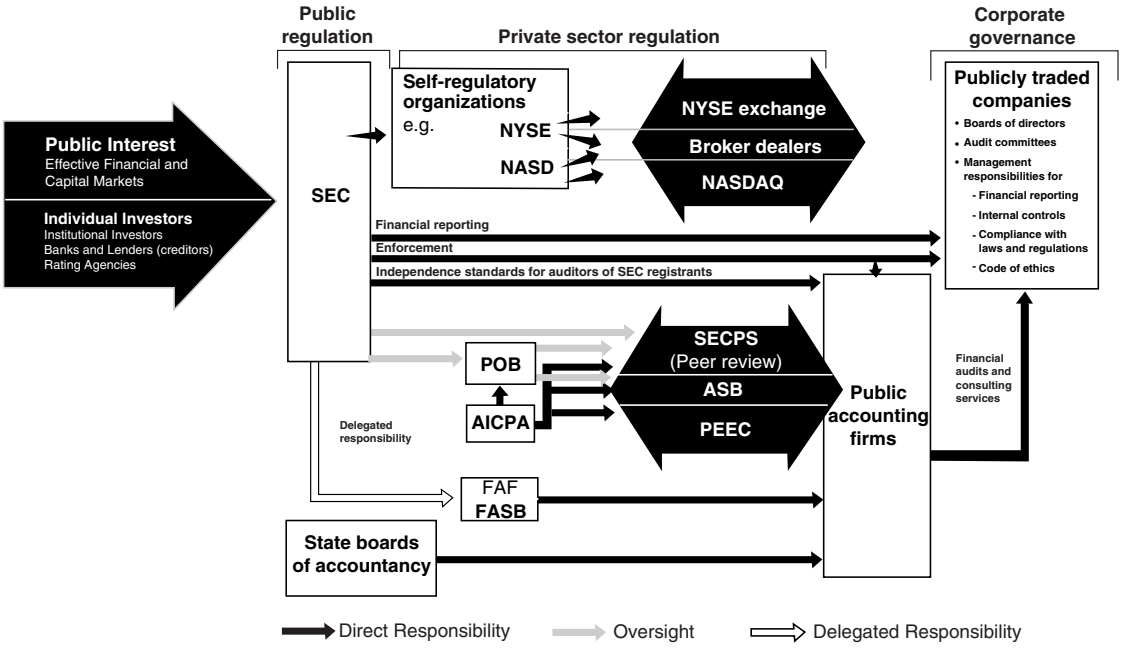

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