

GAO

Report to the Chairman, Oversight and
Investigations Subcommittee, Committee
on Energy and Commerce, House of
Representatives

March 1989

CPA AUDIT QUALITY

Status of Actions Taken to Improve Auditing and Financial Reporting of Public Companies





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

Comptroller General
of the United States

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March 6, 1989

The Honorable John D. Dingell
Chairman, Subcommittee on Oversight
and Investigations
Committee on Energy and Commerce
House of Representatives

Dear Mr. Chairman:

In response to your letters of September 8 and October 28, 1987, this report presents the results of our review of the implementation of changes to improve auditing and financial reporting of public companies. It also identifies related recommendations which would require legislative or regulatory actions in order to be implemented.

We conclude that the public accounting profession and others have taken positive actions to address concerns about audit quality and the accuracy and reliability of financial disclosures of public companies. However, several proposals for action, most notably those relating to the Securities and Exchange Commission, have been released for public comment but not yet adopted and other actions remain to be taken.

We are sending copies of this report to the Director, Office of Management and Budget; the Chairman, Securities and Exchange Commission; the Chairman, American Institute of Certified Public Accountants; and other interested persons. Copies will be made available to others upon request.

The report was prepared under the direction of Frederick D. Wolf, Assistant Comptroller General for Accounting and Financial Management, and John J. Adair, Director, Audit Oversight and Policy. Other major contributors are listed in appendix I.

Sincerely yours,

A handwritten signature in cursive script that reads 'Charles A. Bowsher'.

Charles A. Bowsher
Comptroller General
of the United States

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Results in Brief

The public accounting profession and others have taken positive actions which demonstrate a commitment to addressing concerns about audit quality and the accuracy and reliability of financial disclosures. GAO believes these actions, when fully implemented, will improve auditing and financial reporting. However, several of the proposals for action, most notably those relating to the SEC, have been released for public comment but not yet adopted, while other actions remain to be taken. Also, continued monitoring of implementation efforts is important to their success.

Principal Findings

The Public Accounting Profession

GAO found that the accounting profession has made substantial progress in addressing problems by expanding the auditor's responsibilities to (1) evaluate internal controls, (2) provide early warning of a company's financial difficulties, (3) design the audit to provide reasonable assurance of detecting material fraud, and (4) improve communication to the financial statement user and to the management of public companies. The accounting profession has also amended professional standards to require continuing professional education and quality reviews and adopted a revised code of ethics to help ensure auditor independence and objectivity.

Although the profession has made substantial progress, some audit guides for specialized accounting and auditing practices of particular industries have not been kept up-to-date with changes in industry or

Specifically, GAO recommends that the SEC

- resolve the remaining issues and adopt a requirement that all firms practicing before the SEC be subject to periodic peer reviews,
- adopt its proposal to require management to publicly report on its responsibility for the financial statements and internal controls in an annual management report,
- adopt rules requiring auditors to review and publicly report on management's internal control report, and
- reverse its decision and require public companies to establish audit committees.

Further, GAO recommends that the AICPA expedite the long delayed revisions of several industry audit guides and undertake an effective program to update other guides which have not been kept current.

Chapters 2 through 5 contain additional GAO recommendations.

Agency Comments

GAO provided a draft of this report to the AICPA and other officials of the public accounting profession, the SEC, Financial Accounting Standards Board, and members of the Committee of Sponsoring Organizations of the Treadway Commission for comment. Each organization generally agreed with the facts GAO presented and most of the organizations provided technical comments. The comments generally did not indicate agreement or disagreement with the report's recommendations. GAO has incorporated the organizations' comments where appropriate.

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Abbreviations

AICPA	American Institute of Certified Public Accountants
ASB	Auditing Standards Board
CPA	certified public accountant
FASB	Financial Accounting Standards Board
GAAP	generally accepted accounting principles
GAAS	generally accepted auditing standards
GAO	General Accounting Office
IG	inspector general
MD&A	management's discussion and analysis
NASBA	National Association of State Boards of Accountancy
SAS	statement on auditing standards
SEC	Securities and Exchange Commission

Company management must set the appropriate tone and establish the overall control environment in which it prepares financial reports. In addition, public companies registered with the SEC must maintain an adequate system of internal accounting control. The Securities Exchange Act of 1934, as amended by the Foreign Corrupt Practices Act of 1977, requires these controls to ensure that, among other things, transactions are recorded as necessary to permit preparation of statements that are in accordance with applicable standards.

The public accountant's audit is an important element in the financial reporting process because the audit subjects financial statements, which are management's responsibility, to scrutiny on behalf of shareholders and creditors to whom management is accountable. The auditor is the independent link between management and those who rely on the financial statements. In that role, the auditor evaluates the judgments made by management in applying standards for the presentation of financial information.

The SEC, with primary responsibility for administering and enforcing the federal securities laws, is the most important federal agency involved in setting accounting and auditing requirements affecting publicly traded companies. As such, the SEC establishes rules and regulations for public disclosure and independent audits. Rules promulgated by the Financial Accounting Standards Board—generally accepted accounting principles (GAAP)—have been accepted by the SEC as the primary standard for preparation of financial statements. The SEC has accepted rules promulgated by the AICPA—generally accepted auditing standards (GAAS)—as the standard for audits conducted to meet its requirements. The SEC also reviews and comments on registrant filings and issues interpretive guidance and Staff Accounting Bulletins on accounting and auditing matters.

The SEC exercises oversight in the standard setting processes of both the FASB and AICPA. The SEC's staff participates in meetings and on task forces with FASB and AICPA staff, monitors the development of new standards, and carries on a continuing discussion with the FASB and the AICPA on the implementation and interpretation of the standards.

The stock exchanges, which are self-regulatory organizations under SEC authority, establish accounting and auditing regulations for listed companies. The major exchanges require listed companies to prepare and publish annual reports containing financial statements which have been prepared in accordance with GAAP and audited by independent public accountants.

SEC registrants to maintain a system of internal accounting controls sufficient to provide reasonable assurance that transactions are executed consistent with management's authorization and are recorded to permit preparation of financial statements in conformity with generally accepted accounting principles.

In its 1978 report, the Commission on Auditors' Responsibilities (Cohen Commission), presented its conclusions and recommendations on the roles of the independent auditor and company management.² Among them were that: (1) the auditor has a duty to search for fraud, (2) management should prepare a report acknowledging its responsibilities for the financial statements, (3) the profession and company management should recognize the important role played by the board of directors and audit committees in maintaining the independence of the outside auditor, and (4) accounting firms should have an independent peer review and the detailed reports of that review should be made available to concerned parties.

Major Current Issues

Many recommendations of the Cohen Commission were not implemented. Once again congressional hearings, studies, and recent business failures—some of which have required government intervention—have focused attention on the adequacy of accounting, auditing, and financial reporting under the federal securities laws. The Subcommittee on Oversight and Investigations, House Committee on Energy and Commerce, began hearings in February 1985 on the role of the SEC and on problems in the accounting profession. Since 1985, those hearings, professional forums, several independent studies, and the literature have explored a number of issues relating to financial reporting.

For purposes of this review, we have summarized the debate, recommendations, and actions taken on 10 issues we have identified and believe are the major issues resulting from the hearings, studies, and reviews. There are interrelationships among several of the issues—early warning of financial difficulty, fraud detection, and communicating audit results; internal controls and compliance with laws and regulations; and auditor changes/opinion shopping, auditor independence, and audit committees. As a result, we have grouped and discussed them according to these interrelationships. The issues and some of the questions which have been debated are:

²The Commission on Auditor's Responsibilities: *Report, Conclusions, and Recommendations*, American Institute of Certified Public Accountants, 1978.

Several Groups Have Addressed the Issues

The accounting profession and other groups, in response to the Subcommittee's investigation and their own initiatives, established a number of special study groups and task forces to address issues relating to financial reporting and auditing.

The AICPA appointed the Special Committee on Standards of Professional Conduct for Certified Public Accountants in October 1983. The Committee was charged with studying the relevance and effectiveness of professional standards in light of the changing economic, social, legal, and regulatory climates and to recommend a course of action. In its July 1986 report, the Committee recommended that the AICPA revise its professional standards.³

In October 1985, the National Commission on Fraudulent Financial Reporting, commonly called the Treadway Commission, (a private-sector initiative sponsored by the AICPA, the American Accounting Association, the National Association of Accountants, the Financial Executives Institute, and the Institute of Internal Auditors), was created to identify causal factors that can lead to fraudulent financial reporting and to propose steps to reduce its incidence. After a 2-year study, the Commission issued its final report in October 1987.⁴ The Commission made 49 recommendations to deter fraudulent financial reporting which were addressed to the management of public companies, independent public accountants, the SEC and other regulatory agencies, and to educators.

In 1985, the AICPA established the Task Force on Risks and Uncertainties to consider ways to meet the need for improved disclosure about the risks and uncertainties facing business enterprises. The task force's July 1987 report recommended that business entities provide more information on risks and uncertainties.⁵

Price Waterhouse, a major accounting firm, prepared a paper in 1985 addressing what it termed the "twin crises of liability and credibility."⁶ The paper addressed and offered recommendations on three main

³Restructuring Professional Standards To Achieve Professional Excellence in a Changing Environment, Report of the Special Committee on Standards for Professional Conduct for Certified Public Accountants, AICPA, July 1986

⁴Report of the National Commission on Fraudulent Financial Reporting, October 1987.

⁵Report of the Task Force on Risks and Uncertainties, American Institute of Certified Public Accountants, July 1987.

⁶Challenge and Opportunity for the Accounting Profession: Strengthening the Public's Confidence, The Price Waterhouse Proposals, 1985.

Objectives, Scope, and Methodology

We were asked by Congressman John D. Dingell, Chairman of the Oversight and Investigations Subcommittee to (1) monitor the implementation of changes in the accounting profession, (2) report on actions taken to address issues which have been raised, and (3) identify recommendations which require regulatory or legislative action to be implemented.

To accomplish our objectives, we first reviewed the many reports, studies, and articles on auditing and financial reporting to identify major issues. Second, we identified 10 major issues from the numerous issues that were raised at the hearings and at other forums. Third, we identified the major proposals developed to address these issues, their source, and actions taken to implement the recommendations. Finally, we identified those proposals and recommendations that would require regulatory, legislative, or additional actions to be implemented.

Financial reporting by companies listed with the SEC was a major focus of this review. Several of the recommendations, mainly from the Treadway Commission, are addressed to the management of public companies. Many public companies already have some of the recommended controls in place, such as an internal audit function and audit committees. We did not attempt to assess the degree to which recommendations directed to the management of public companies were implemented. However, the Treadway Commission sponsoring organizations conducted a survey of public companies to gather baseline data on their operations in areas related to the recommendations.

A number of recommendations may also influence the operating and reporting practices of unlisted companies and entities receiving government funds. Because of the significance of changes proposed for audits of government funds, particularly in the area of audit quality, we included government audits as a separate issue and address these audits in chapter 6 of this report. Except for the discussion in chapter 7 of the recommendation to require deposit-taking institutions to report to the SEC, we do not address the implications of the recommendations for unlisted companies.

Through a review of the hearing record, literature searches, and interviews, we identified many issues in accounting, auditing, and financial reporting and over 90 recommendations addressing those issues. The recommendations were addressed to various parties—public companies, the SEC and other federal agencies, independent accountants and auditors, the AICPA and other accounting organizations, and educators. In this

Initiatives to Narrow the Expectation Gap

Some users of financial statements may inappropriately equate an unqualified audit report with a guarantee of the accuracy and reliability of the financial statements and of the continued viability of the business. Therefore, when a business fails shortly after receiving an unqualified audit report, the public often perceives the failure as an audit failure. Investors and others question why they were not warned about the company's financial difficulties. Likewise, when charges of fraud are leveled against management or others in a company, the inevitable question is: Where were the auditors? These questions and perceptions suggest that a gap exists between what the public expects of the accounting profession, especially as it relates to the audit function, and what the profession understands or believes is its proper role. This gap has been termed the expectation gap; the Auditing Standards Board has adopted a number of changes in auditing standards as a means of narrowing the gap.

Early warning disclosures, fraud detection, and communicating audit results are the three major areas where an expectation gap was perceived to exist. Several proposals have been advanced to address concerns expressed in these three areas.

Early Warning Disclosure

In today's fast-paced business climate, the need for accurate and credible information on the risks and uncertainties facing a business is great. The public expects the auditor to report on the company's financial condition and to disclose conditions indicating that the company may be unable to continue as a going concern for a reasonable period of time. Proposals of the "Big 7," the Task Force on Risks and Uncertainties, and Price Waterhouse have suggested improvements in both the quality and quantity of information in three closely related areas: (1) continued existence of an entity, (2) risks and uncertainties facing the business, and (3) the "Management's Discussion and Analysis" (MD&A) section of the annual report. These are discussed in greater detail in the following sections.

Evaluating an Entity's Continued Existence

Numerous factors such as sudden and dramatic changes in commodity prices, inflation, and deregulation can impact whether a company continues as a going concern. In his June 1986 testimony, the Comptroller General suggested that the accounting profession provide better disclosure and early warning regarding the condition of companies that are in precarious situations. Price Waterhouse, noting that the public wants

The task force recommended that business enterprises consider disclosing the nature of their operations, the basis of financial statement preparation, certain significant estimates, and current vulnerability due to concentrations (for example, significant loans receivable concentrated in a high-risk area).

At a January 1988 meeting, the Financial Accounting Standards Board (FASB) discussed the task force's report but decided to defer consideration of the recommendations until after it had analyzed comments on a narrower subject, its exposure draft on "Disclosures About Financial Instruments." After reviewing the comments, the Board tentatively proposed to issue a final statement on disclosures about off balance sheet instruments in the first half of 1989 to be followed by a review of other disclosure items.

In January 1989, the Board's Research and Technical Activities Director informed us that the statement on off balance sheet instruments addresses substantial parts of the task force's most significant recommendations and has particular import for the financial services industry where the need for additional disclosures has been most acute. A project has been approved to deal with accounting for the impairment of long-lived assets, another major area in which risks and uncertainties may not be disclosed adequately. This project was weighed by the Board against a number of other potential projects including a separate project on risks and uncertainties.

Given the emphasis on risks and uncertainties in the financial instruments and impairment projects, as well as some concern on the part of the Board about the operability of some aspects of the task force recommendations, the Board's Research and Technical Activities Director informed us that it is unlikely that the Board will choose to address the subject of risks and uncertainties in a separate project, but will continue to address it as an integral part of other projects.

Enhancing Management's Discussion and Analysis

The SEC requires the management of public companies to provide information on known material events and uncertainties which would be relevant to an assessment of the financial condition, changes in financial condition, and results of operations. This information is contained in a section of the annual report often entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations." The SEC has allowed management, within certain broad guidelines, to determine what information should be included in the MD&A, and has not made the

The Auditor's Responsibility for Detecting and Reporting Fraud

The consequences of fraudulent financial reporting can be widespread and devastating. Those affected may include the company's stockholders, creditors, and others whose confidence in the stock market is shaken. Even though the public company has the ultimate responsibility for ensuring accurate financial reporting, the auditor also plays an important role. A major question in the recent debate involved the auditor's responsibility to search for and detect fraud and whether that role should be expanded. A second question was whether the auditor should be required to report fraud to regulators and other outside parties.

As evidenced by recommendations from the Treadway Commission and Price Waterhouse, and testimony presented at the hearings before the Subcommittee on Oversight and Investigations, there is consensus that the auditor has a responsibility to plan the audit to detect material fraud and that auditing standards should clearly describe the auditor's responsibility. Auditing standards have always acknowledged that the auditor has some responsibility to consider the existence of fraud in an audit. However, interpretations of these standards seemed to emphasize the limitations of the auditor's role and, in applying the standards, searching for and detecting fraud was often viewed as a by-product of the audit process.

The Treadway Commission and Price Waterhouse both recommended that auditing standards be revised to restate the independent public accountant's responsibility to detect material financial fraud. Price Waterhouse also recommended that the revised guidance require the auditor to design and perform certain tests to provide reasonable assurance of detecting fraud.

The Treadway Commission made two additional recommendations to improve the auditor's ability to detect fraud: greater use of analytical review procedures and review of quarterly financial data before release to the public. The Commission recommended that the ASB require auditors to perform analytical review procedures in all audits. Application of analytical procedures, which consist of evaluating plausible relationships among both financial and nonfinancial information, can reveal variations in expected patterns and trends that may have been caused by fraud. The Commission reasoned that greater use of analytical procedures would enhance the independent public accountant's ability to identify areas of high risk of fraudulent financial reporting.

auditor, and reporting to a funding agency or others in audits of entities that receive financial assistance from a government agency.

According to the April 1988 statement on illegal acts, the auditor also has a responsibility to design the audit to provide reasonable assurance of detecting misstatements resulting from illegal acts that have a direct and material effect on the financial statements and to be aware of the possibility that illegal acts with an indirect effect may have occurred. Guidance on detecting illegal acts also requires the auditor to confirm that the audit committee or others with equivalent authority are informed of illegal acts, unless the acts are clearly inconsequential. The same requirements which apply for reporting irregularities, as noted above, also apply for reporting illegal acts outside of the client's organization.

New guidance on analytical procedures emphasizes that these procedures are an important part of the audit process and should be used in the planning and the overall review stages of all audit engagements. The statement further states that analytical procedures may be effective in detecting potential misstatements which would not be apparent using other tools.

Auditor Review of Quarterly Financial Data

The SEC rules currently require larger, widely traded public companies to include summarized quarterly data in the annual report to stockholders. The independent public accountant is required to review such data, but not prior to public release. Under the rules, the accountant may review the data on a retrospective basis in connection with year-end audit work. The Treadway Commission did not recommend that the scope of the review for the larger companies be changed, but that the review of the data be performed on a quarterly basis prior to release to the public. Also, the Treadway report recommended that those public companies not subject to the SEC requirement engage their accountant to perform a limited review of the data prior to public release.

In October 1988, the SEC voted to solicit comments on whether it should require that interim financial data of registrants be reviewed by independent accountants before such information is filed with the SEC. The concept release will also invite comments on whether a report issued by the independent accountant on his/her review should be included in interim filings and any registration statements that include interim information.

Other changes include emphasizing the auditor's independence from the client by adding the word "independent" to the title, and adding a statement at the end of the scope paragraph that the auditor believes that the audit provides a reasonable basis for his opinion. These changes are effective for reports issued on or after January 1, 1989, although early application is permissible.

Conclusions

We believe that implementation of auditing standards requiring the auditor to provide early warnings about possible business failures, emphasizing detection of material fraud, and improving communication to users of audit reports should help to narrow the expectation gap.

Information on significant risks and uncertainties is important to financial statement users. The SEC currently requires companies to provide information of this type in the MD&A section of the annual report. However, a criticism of these disclosures is that they frequently consist of obvious facts and do not focus enough on warning signs. We are aware of the SEC's position that management should be allowed flexibility in determining what information is to be included in the MD&A; however, we feel that disclosures in the MD&A section of annual reports could and should be improved.

The Task Force on Risks and Uncertainties made recommendations for improving the information in financial statements on significant uncertainties facing a business. These recommendations would have little effect without action by the FASB. The FASB does not plan to address disclosures about risks and uncertainties in a separate project but has indicated that it will continue to address it as an integral part of other projects. We believe this approach is acceptable.

The major issue that has not been resolved is the extent to which accountants should be required to report information, particularly on fraud, outside of the audited company. There is no consensus on this issue; however, we believe that under certain circumstances, such reporting is necessary and appropriate.

Recommendations

We recommend that the SEC expedite its review of MD&A disclosures and issue guidance, such as the planned interpretative release, to improve information on risks and disclosures in annual reports.

The Treadway Commission noted the well recognized and pervasive impact of internal controls in preventing and detecting fraudulent financial reporting. Therefore, the Commission recommended that public companies should maintain internal controls that provide reasonable assurance that fraudulent financial reporting will be prevented or detected quickly. The Commission recognized that controls broader than internal accounting controls are necessary and included the internal audit function and the audit committee of the board of directors as part of internal controls. The report also emphasizes the importance of management philosophy and operating style, the appropriate tone at the top, and written codes of conduct.

The Treadway Commission recommended that management of public companies and audit committees be required by SEC rule to communicate their roles in the financial reporting process. The Commission recommended that the management report acknowledge management's responsibilities for the financial statements and internal controls, discuss how these responsibilities were fulfilled, and provide management's assessment of the effectiveness of the company's internal controls. Under the guidelines set forth in the Treadway report, the management report should also include a statement about management's response to the recommendations of the auditor concerning the company's internal controls.

The SEC's Proposed Management Report on Internal Controls

In July 1988, the SEC requested comments on a proposed rule which would implement the Treadway Commission's recommendation by requiring a report on management's responsibilities for the financial statements and internal controls. The proposed report would become a part of the annual SEC filings and the annual report to stockholders. In the report, management would describe its responsibility for preparing the financial statements and for establishing and maintaining the internal control system. Management would make an assessment of the effectiveness of internal controls and would also state how it responded to any significant recommendations made by both the internal auditor and the independent accountant. Comments were due to the SEC in October 1988. About 200 letters were received and are currently being analyzed by the staff.

We support the requirement for a management report. In addition, we suggested in our comments to the SEC that the auditor be required to review the management report and to report on that review. Our experience with the reporting required of heads of federal agencies by the

which the independent public accountant has reviewed and evaluated the system of internal accounting control. With respect to evaluating management's assessment of the internal control system, the Treadway Commission recommended that the ASB provide guidance to address situations where the auditor's knowledge of the company's internal accounting controls causes him to disagree with management's assessment in the proposed management report. As discussed below, the ASB has issued two new standards on internal controls.

New Standards on Internal Controls

The ASB standard on internal controls requires the auditor to obtain an understanding of the entity's control structure—control environment, accounting system, and control procedures—in all audits, regardless of whether the auditor plans to rely on the system in determining the appropriate audit tests.³ The new guidance requires the auditor to document his/her understanding of the three elements of the control structure and whether the elements have been placed in operation.

Along with the above requirements, the guidance also states that the auditor should assess control risk, document the basis for conclusions about the assessed level of control risk for financial statement assertions, and design substantive tests, based on his/her knowledge of control structure and assessed risk. This statement is effective for audits of financial statements for periods beginning on or after January 1, 1990, to allow sufficient time for audit firms to incorporate new procedures in their audit approach.

The ASB also issued guidance to assist the auditor in identifying and reporting certain internal control conditions observed during an audit.⁴ These matters, termed "reportable conditions," are matters that the auditor feels should be reported to the audit committee or its equivalent because they represent deficiencies that could adversely affect the organization's ability to produce reliable financial disclosures.

In the spring of 1988, the ASB established a task force to study alternative models for reporting on internal controls. The task force will determine if the minimum study of controls required by the statement on consideration of internal control structures provides the auditor with a

³Statement on Auditing Standards No. 55, Consideration of the Internal Control Structure in a Financial Statement Audit, AICPA, April 1988.

⁴Statement on Auditing Standards No. 60, Communication of Internal Control Structure Related Matters Noted in an Audit, AICPA, April 1988.

assists management in its effort to avoid noncompliance with laws and regulations which could result in such significant liabilities or losses.

We believe that companies are best served when management seeks the advice of lawyers in developing a compliance program. For example, a lawyer's training and skills are critical in addressing specific legal issues, and also enable the lawyer to bring a different approach to setting objectives, identifying issues, and making decisions concerning the business's operations. Therefore, the lawyers, both in-house and outside counsel, should not only make determinations on legal matters but, where instances of noncompliance are found or the risk of noncompliance is great, should also help in developing alternative methods for achieving management's objectives consistent with maintaining compliance with laws and regulations. Such involvement in the compliance program provides additional assurance that management's actions will be in compliance with laws and regulations.

Early and comprehensive involvement of lawyers is desirable because it should help in avoiding problems and assist in assuring compliance with laws and regulations. When lawyers are used only to analyze actions already taken by management, the lawyer's role often is limited to being an advocate for management. Even if management actions have not been taken, using lawyers only to review specific legal issues identified by management after it has determined its objectives and business plan, may unwisely limit the lawyer's ability to identify issues and contribute to management's consideration of actions that will be in compliance with laws and regulations.

The Treadway Commission emphasized the critical importance of the tone set by top management, noted that management of public companies is responsible for establishing and enforcing codes of conduct,⁵ and recommended that all public companies develop and enforce a written code of corporate conduct. The Treadway report also recommended that the code include a corporate policy of compliance with domestic and foreign laws affecting the business, including those laws relating to financial disclosure.

⁵In June 1988, the Committee of Sponsoring Organizations of the Treadway Commission sent a survey to 8,654 public companies to gather baseline information on aspects of their operations related to the Treadway recommendations. The Committee received only 1,014 responses. Overall, fewer than half of the 1,014 responding companies have a written code of conduct. A large percentage (72 percent) of those that do not have a code indicated that they have no plans for developing one. However, of the larger companies which responded (10 percent of the larger companies responded), 87 percent have a written code. The percentage of companies with written codes decreases as the size of the companies decreases.

developed by management with the professional assistance of its lawyers, both in-house and outside counsel; and maintained with the participation of the internal auditors.

Recommendations

We recommend that the SEC adopt its proposal to require management of public companies to publicly report on its responsibility for the financial statements and internal controls. We also recommend that the SEC require the auditor to review and publicly report on the management report.

We suggest that boards of directors of public companies encourage management—which should seek the advice of its in-house lawyers and outside counsel—to develop and maintain a compliance program. The program should include the establishment of internal controls to prevent and detect noncompliance with laws and regulations which, if violated, could materially affect a company's operations and financial statements.

Enhancing Auditor Independence

The auditor has an obligation to be fair not only to management and owners of a business, but also to investors, creditors, and others who may rely upon the auditor's report. Also, the auditor must be independent in both fact and appearance, so that the results of his examination are perceived to be fair and impartial. The "Big 7" proposals included a recommendation to enhance the public's perception of the independence and objectivity of auditors by requiring them to communicate regularly with the audit committee or, absent an audit committee, with the entire board of directors. Matters to be communicated included consultation with other auditors, business and other risks facing the company, large and unusual transactions, and situations where alternative GAAP could materially affect the financial statements.

The Treadway Commission proposed that (1) management should advise the audit committee when it seeks a second opinion, (2) the audit committee should review management's evaluation of factors relating to the independence of the public accountant, and (3) both management and the audit committee should assist the accountant in maintaining his independence.

With respect to communication with the audit committee, the ASB issued a statement which requires the auditor to determine that the audit committee, or others formally designated as having oversight for the financial reporting process, is adequately informed of matters such as disagreements with management, consultations with other accountants, and difficulties encountered in performing the audit such as unreasonable delays by management or unavailability of client personnel.² The communication required by this statement applies to audits of all SEC engagements. The auditor is required to report "reportable conditions" to the audit committee. (See chapter 3)

Management Advisory Services and Auditor Independence

The Code of Professional Conduct adopted by AICPA members in January 1988 includes a section on "Scope and Nature of Services," which requires members to use sound judgement in making decisions about offering non-attest services and about activities that may be perceived as creating conflicts of interest. The CPA is also to assess whether an activity is consistent with his role as a professional and his commitment to the public interest.

²Statement on Auditing Standards No. 61, Communication With Audit Committees, AICPA, April 1988.

The AICPA objected to this recommendation. They stated that the appropriate role of the audit committee is one of oversight, not management, and it is not appropriate to require advance approval from an oversight body of each management advisory service. The AICPA also cited the possibility that managements or audit committees might arbitrarily bar all management advisory services to avoid possible criticism. Finally, the AICPA was concerned that the recommendation could have a counter-productive, negative effect on the quality of independent audits by depriving the auditor of the broader base of knowledge that can be derived from performing non-audit services.³

Impact of Auditor Changes and Opinion Shopping on Auditor Independence

Companies change auditors at their discretion. Companies also seek a second opinion in an attempt to clarify treatment under GAAP, or when they have a legitimate difference of opinion with the auditor. Surveys have shown that audit fees and services are the major reasons cited for changing auditors. However, if a company actively seeks an accountant who will support a proposed accounting treatment to accomplish the company's reporting objective, regardless of whether that treatment is acceptable under GAAP, the company is said to be "opinion shopping." Questions raised in this area include: Is opinion shopping a major problem? What affect, if any, does opinion shopping have on auditor independence? Should requirements for reporting auditor changes be strengthened?

Strengthening Auditor Change Disclosures

The SEC has discussed instances of "opinion shopping" in only three enforcement actions between 1983 and 1987. However, because of the potential abuse of changing auditors to gain approval of questionable accounting practices, the "Big 7," the Treadway Commission, and the AICPA all made recommendations to improve disclosure when a company changes independent public accountants. In general, the recommended disclosures would require the registrant to provide more information in form 8-K¹ on the nature of any disagreements with the former accountant and whether the audit committee was aware of the disagreements. In addition, the "Big 7" proposals would require peer reviewers to scrutinize all engagements assumed since the last peer review where there

³Letter from AICPA to the National Commission on Fraudulent Financial Reporting, AICPA, July 20, 1987.

¹Rules promulgated pursuant to the Securities Exchange Act of 1934 require registrants to file a report (form 8-K) if any of several events occur. Among those events is a change in the registrant's certifying accountant.

were or should have been subject to SAS 50⁷ or (2) were the subject of a disagreement or reportable event with the former accountant. The new rules also require expanded disclosure concerning:

- whether the audit committee (or board of directors) and the former auditor discussed the subject matter of reportable disagreements and events;
- whether the registrant granted the former auditor authorization to respond fully to inquiries of the successor auditor concerning those disagreements and reportable events, if any; and
- whether the former auditor resigned, declined to stand for reelection, or was dismissed.

Under present 8-K requirements, when there is a change in accountants, the registrant has 15 days to notify the SEC of the change. The registrant must also obtain a letter from the accountant stating whether the accountant agrees with the registrant's reasons for the change. That letter must be filed with the SEC within 30 days of filing the 8-K. The total time that could elapse between the change in accountants and the filing of the accountant's letter is 45 days. At hearings held by the Subcommittee on Oversight and Investigations, questions were raised about the timeliness of the filings, especially since a change in accountants can serve as an early warning of problems to the SEC and to investors. The AICPA suggested that the SEC reduce the period allowed for the registrant to file the former accountant's letter from 30 to 21 days and later supported the SEC proposal, discussed below, to reduce the time period to 10 days.

In April 1988, the SEC published for comment a proposal to reduce from 15 to 5 calendar days the time allowed for a registrant to file a form 8-K announcing a change in certifying accountant. The time allowed for the registrant to file the former accountant's letter would be reduced from 30 to 10 calendar days. The former accountant would be permitted to provide an interim letter to the registrant. Any letter from the former accountant must be filed within 2 calendar days of receipt. As proposed, the total time that could elapse between the change in accountant and the registrant's filing of the accountant's letter is 15 days as opposed to the present 45 days. The comment period ended in May 1988, and the

⁷The ASB issued SAS 50, *Reports on the Application of Accounting Principles*, in July 1986. This SAS establishes performance and reporting standards to be used when an accountant provides reports, and in some cases oral advice, to non-audit clients on the application of GAAP. This SAS is intended to discourage the potential abuse of opinion shopping.

would not provide investors with significant additional information and is unnecessary. The Treadway report acknowledged that certain features of the audit committee letter would duplicate existing proxy disclosure but felt that a letter from the audit committee might lead to better disclosures than now provided in proxy statements.

Conclusions

Auditor independence cannot be objectively measured and no conclusive evidence is available to demonstrate that providing management advisory services compromises auditor independence. There is also little, if any, evidence that “opinion shopping” takes place to a significant extent. However, there is general agreement that auditor independence is of paramount importance and must be protected. Changes in 8-K disclosures which require the registrant to provide more information to the SEC on the nature of any disagreement with the former accountant should strengthen auditor independence. We believe that direct notification by the terminated auditor to the SEC can serve as another early warning device to alert the SEC to possible problems which caused the company to change auditors. The recommendation from the heads of the eight major accounting firms that the SEC require that a copy of the accountant’s letter to the client be sent directly to the SEC would—if implemented—somewhat negate the need for other actions on this issue but direct notification would be best.

We support the idea of audit committees for public companies and believe that all members of the audit committee should be independent in fact and appearance. Audit committees have been suggested as a means to enhance several aspects of the financial reporting process. Several new auditing standards require that the auditor communicate matters of importance to the audit committee. Emphasizing the role of the audit committee as an overseer of the company’s financial reporting process and as a buffer between management and the auditor should help to ensure that financial reporting is accurate and that auditor independence is maintained.

Recommendations

We recommend that the SEC reverse its decision on audit committees and adopt a requirement for public companies to establish such committees.

We recommend that the AICPA, or the SEC, if it concludes it has the authority, require accountants to report directly to the SEC when they resign or are terminated. However, if the AICPA or the SEC does not adopt

Initiatives to Improve Audit Quality

The audit is an important element in financial accountability because it subjects financial statements to some scrutiny on behalf of those who rely on these statements. Because of its importance, the audit needs to be of high quality. While other issues discussed in this report, such as auditor independence, relate to the quality of the audit, the self-regulation program directly addresses audit quality. Peer review and the establishment of professional and auditing standards are two important aspects of the self-regulation program. Problems with audits of government funds and of public companies have focused attention on the need to improve regulatory mechanisms and standards, both auditing and professional, to ensure quality audits.

Self-Regulation

Certain aspects of the profession's current program of self-regulation grew out of concerns expressed in the mid 1970s by the Congress, the SEC, and others. Questions centered around the reliability of financial disclosures and the audit of those disclosures, especially in light of the reliance the public places on the audit opinion and report. In 1977, the AICPA established the Division for CPA Firms, with an SEC Practice Section and a Private Companies Practice Section to administer the profession's self regulatory program. That same year, the AICPA also created the Public Oversight Board, independent of the Division, to oversee the activities of the SEC Practice Section.

The peer review program is the cornerstone of the quality assurance mechanism. We use various terms—quality control, quality assurance, practice monitoring, and peer review—to describe the practice of reviewing a firm's quality control operations and procedures and their adherence to standards. However, peer review is but one quality control mechanism; others include state board oversight, firm's internal inspection programs, SEC enforcement actions, and private litigation. The questions which have been raised in this area are: Is the profession's present system of self-regulation adequate to ensure quality audits? What steps must the profession take to ensure that all audits are conducted in accordance with applicable standards?

Price Waterhouse recommended establishing a self-regulatory organization to administer the profession's self-regulatory program. The proposed organization would combine much of the profession's present program under the SEC Practice Section with a formal structure for government oversight. Participation would be required for all firms or sole practitioners that audit SEC clients.

accountant's response to any identified weaknesses would be available for public inspection.

The SEC's staff reviewed the comments but has delayed action on the proposed rule while it addresses a number of issues including the structure of an SEC sponsored peer review program, the cost and benefit of mandatory peer review, and questions about the SEC's authority to require mandatory peer review.

In January 1988, AICPA members voted to restructure professional standards. The new standards require members/firms in public practice to participate in a practice-monitoring program as a condition of membership. The program, a cooperative effort between the state societies and the AICPA, is educational, rehabilitative, and corrective in nature—not punitive. According to the AICPA, there should be few disciplinary proceedings and they would occur only if a firm refuses to cooperate or has deficiencies so serious that corrective action could not solve them. There will be no public file.

The AICPA is developing standards for the program and anticipates that reviews of firms with 10 or more professionals will begin in early 1989. The AICPA contemplates that between 300 and 500 firms will be reviewed in these first reviews. State societies can decide the extent of their involvement in the practice monitoring program, but the AICPA expects significant state participation once the program is fully implemented.

Reporting Alleged Audit Failures

Another aspect of the accounting profession's program to ensure audit quality involves reporting alleged audit failures to the AICPA's Special Investigations Committee (the Committee's name was recently changed to the Quality Control Inquiry Committee). Members of the AICPA's SEC Practice Section are required to report to the Committee within 30 days each allegation of audit failure in litigation or other regulatory proceedings against the firm or any of its personnel. However, the Public Oversight Board's Annual Report for 1987-1988 notes that some firms are not complying with the 30-day requirement. The Committee investigates and determines whether these allegations indicate the need for corrective measures by members or reconsideration of professional standards.

All activities of the Committee are performed in strict confidence; there is no public file. The Special Investigations Committee maintains that confidentiality is necessary so that the case against the firm is not

New Professional Conduct Standards

In October 1983, with the appointment of the Special Committee on Standards of Professional Conduct for Certified Public Accountants (the Anderson Committee), the profession undertook a major effort to improve the relevance and enhance the quality of its work through a restructuring of professional standards. In its 1986 report, the Committee recommended that the profession take steps to improve the quality of its work by revising professional standards.

Subsequent to the Committee's report, the AICPA formed an implementation committee to consider members' views on the plan to revise professional standards. This Committee, after considering comments from various sources, refined and modified the Anderson Committee report as the Plan to Restructure Professional Standards and initiated a vote of AICPA members on six proposals designed to enhance the quality of the profession's work through education and self-improvement.

In January 1988, AICPA members approved proposals to

- revise the ethics code,
- consolidate the regional trial boards,
- mandate quality reviews for all firms in public practice as a condition of membership,
- require members in public practice to take continuing professional education,
- require members not in public practice to take continuing professional education, and
- increase education requirements for future candidates for AICPA membership.

The new rules were effective with their adoption; however, implementation procedures may be necessary in a few cases.

Audit Standards and Guides

Audit standards are necessary to help ensure that audits are conducted in a quality manner. Both the AICPA and the GAO (for audits of government funds) issue audit standards. As we have discussed, in April 1988, the ASB issued nine new standards which relate to audit quality, reporting, and related subjects. AICPA standards are applicable to and generally accepted for audits conducted to express opinions on the fairness with which an organization's financial statements present the financial position, results of operations and cash flows, or changes in financial position.

action has been taken on one ("Audits of Stock Life Insurance Companies" issued in 1972).

Conclusions

The peer review program is the cornerstone of the quality assurance mechanism. In order to ensure that the accounting profession performs quality audits, peer review should be mandatory for all auditors of public companies. The AICPA's mandatory peer review requirement for members in public practice represents significant progress; however, not all firms that audit public companies belong to the AICPA. The SEC has delayed action on mandatory peer review for all auditors of public companies while it addresses a number of issues including the structure of an SEC sponsored peer review program, the cost and benefit of mandatory peer review, and questions about its authority to require such reviews. These issues need to be resolved as quickly as possible to expedite action on the mandatory peer review requirement.

Although the SEC has been granted limited access to information about operations of the Special Investigations Committee, the secrecy surrounding activities of the Committee and the ability of the SEC to monitor the investigative process continue to be of concern.

Accountants rely on professional and auditing standards in performing their audits; therefore, quality standards must be established and maintained. The AICPA has made significant progress in improving both professional and auditing standards. However, there are many complex and specialized areas which impact audits in such industries as government contracting, savings and loan, health care, and many others. It is important that the industry audit guides be kept current with changes in industry and with new auditing standards.

Recommendations

We recommend that the SEC resolve the remaining issues and adopt a requirement that all firms practicing before the Commission be subject to periodic peer reviews. However, if SEC determines that it does not have sufficient authority to do this, legislation would be necessary.

In order for the SEC to monitor the effectiveness of the Special Investigations Committee's activities, we recommend that the Committee provide the SEC with access to all required information about the cases it investigates.

CPA Audits of Government Funds

Over the past several years, the quality of audits of government funds by nonfederal auditors, mostly CPAs, has been the subject of review by GAO. As of January 1989, GAO had issued five reports on these reviews.

In our first review of the system employed by seven agency inspectors general (IGs) for monitoring audit quality, we reported in December 1985¹ that the IGs identified significant numbers of problem reports and audits. We made eight recommendations to the IGs to improve the audit quality review process so that greater reliance can be placed on CPA audits of government funds. In a separate report,² we independently reviewed a sample of CPA audits to determine if these audits complied with professional standards. We reported that CPAs frequently did not comply with professional standards, and suggested that the public accounting profession improve its educational effort with respect to governmental audits and strengthen its enforcement efforts in the area of governmental auditing to ensure that CPAs perform those audits in a quality manner. The AICPA has taken action on our recommendation to improve the quality of CPA audits of government funds.

Action Taken to Respond to GAO's Reviews

To develop a comprehensive action plan to address concerns raised by the two GAO reviews mentioned above, the AICPA appointed a Task Force on the Quality of Audits of Governmental Units in 1985. The Task Force report includes 25 recommendations in five areas that are directed at the three major participants in the governmental audit process: the auditors, the auditee, and the organization that oversees the auditor and the auditee. The Task Force also recommended that a steering committee composed of representatives of the three groups monitor implementation of the recommendations. A committee has been established and has reported on implementation of the recommendations. A summary of the five areas along with some actions taken follows.

Education: (1) Training in governmental accounting and auditing should be mandatory for persons who perform governmental audits. (2) A statement on auditing standards should be issued to provide guidance on reporting on compliance with laws and regulations.

¹CPA Audit Quality: Inspectors General Find Significant Problems (GAO/AFMD-86-20, December 5, 1985).

²CPA Audit Quality: Many Governmental Audits Do Not Comply With Professional Standards (GAO/AFMD-86-33, March 19, 1986).

Actions Taken: The National Association of State Boards of Accountancy (NASBA) has begun work on the project to institute positive enforcement programs in each state. GAO's report on actions taken by the accounting profession on referrals made by both GAO and IGS of poor quality audits found that a number of state boards have adopted positive enforcement programs.¹⁵ These programs emphasize active monitoring of the CPA's work products.

Effective January 1989, generally accepted government auditing standards require audit organizations conducting government audits to have an appropriate internal quality control system in place and to participate in an external quality control review program. AICPA rules now require all firms/individuals in public practice to participate in a peer review program as a condition of membership. Also, the AICPA's peer review procedures were recently modified to include at least one audit pursuant to the Single Audit Act in the test sample for those firms that perform such audits.

Enforcement: The disciplinary process for substandard CPA audits should be strengthened.

Action Taken: In our report on actions taken on referrals of CPAs who perform poor quality governmental audits, we found that the accounting profession is demonstrating a commitment to strengthening its enforcement efforts. Also, in most cases, we found that the disciplinary actions taken by the state boards and the AICPA were commensurate with the cited problems and the enforcement processes were not unjustifiably delayed.

Exchange: There should be greater dialogue between the government and the public accounting profession on issues affecting governmental audit quality.

Actions Taken: The AICPA worked with the National Intergovernmental Audit Forum at its national conference held in May 1988. The AICPA has encouraged the state societies to include federal and state auditors as co-instructors for governmental accounting and auditing continuing professional education courses.

¹⁵CPA Audit Quality: A Status Report on the Accounting Profession's Enforcement Efforts (GAO/AFMD-88-28, April 25, 1988).

Recommendations From the Treadway Commission and Others Requiring Legislative or Regulatory Actions

In this chapter we respond to the Subcommittee's request to summarize recommendations from the Treadway Commission and others which require legislative or regulatory actions in order to be implemented. We also discuss the need for responsible parties to follow through on initiatives to insure that the proposed improvements in auditing and financial reporting are carried out.

Several recommendations from the Treadway Commission and one from the "Big 7" could only be implemented if the Congress enacts new legislation or amends existing laws. For these recommendations, we provide information on implementation actions following the recommendation. Other initiatives would require a regulatory agency, mainly the SEC, to adopt rules to implement the recommendations. We have discussed many of the recommendations requiring regulatory actions, particularly those directed to the SEC, in chapters 2 through 5. For those recommendations, we provide a page reference where information on that recommendation is discussed.

Legislative Actions Required

Several recommendations from the Treadway Commission and one from the "Big 7" would require legislation to be implemented. The Treadway Commission recommended that the SEC be provided with additional enforcement remedies and that it be given adequate resources to perform existing and additional functions. The "Big 7" recommended that all companies with a public interest in the reliability of their financial statements be subject to SEC jurisdiction. In addition, the Treadway Commission recommendations to the federal financial institutions regulatory agencies are patterned after recommendations to the SEC and may also require legislation to be implemented.

The Treadway Commission recommended that the SEC (1) have the authority to impose civil money penalties in administrative proceedings and to seek civil money penalties from a court directly in an injunctive proceeding, (2) have the authority to issue cease-and-desist orders for securities law violations, and (3) seek the authority to bar or suspend corporate officers and directors involved in fraudulent financial reporting from future service in that capacity.

In September 1988, the SEC sent a legislative proposal to Congress to implement the Treadway Commission's recommendations to provide the SEC with the authority to impose civil money penalties and the explicit authority to bar directors and officers. The SEC did not include a request

Regulatory Actions Required

The Treadway Commission and others made several recommendations for administrative action by a federal regulatory agency. These recommendations are addressed primarily to the SEC and involve both the public company and the auditor. The recommendations are that the SEC require:

- all public companies to establish audit committees (p. 40),
- all accounting firms that audit SEC-registered companies to undergo peer review (p. 44),
- independent public accountants to review quarterly financial data of all public companies before its release to the public (p. 23),
- additional information on risks and uncertainties in the management's discussion and analysis section of the annual report and that the information be subject to audit coverage (p. 19),
- direct and quicker notification to the SEC when public companies change independent public accountants (p. 37),
- all public companies to include a management report in their annual report (p. 27),
- independent auditors to review and publicly report on management's report (p. 27), and
- all public companies to include a letter signed by the chairman of the audit committee describing the committee's responsibilities and activities (p. 40).

The SEC is reviewing its authority to administratively implement two of these recommendations: peer review and direct notification when public companies change accountants.

The Treadway Commission also recommended that the SEC (1) take enforcement action when a public accountant fails to remedy deficiencies cited in the quality assurance reviews, and (2) reconsider its long-standing position that corporate indemnification is against public policy and is unenforceable.

Finally, the Treadway Commission recommended that the financial institutions regulatory agencies take actions similar to the financial reporting actions recommended to the SEC. The "Big 7" recommendation that entities which are justified by the public interest be subject to SEC jurisdiction would have a similar effect. The major thrust of both recommendations is to help ensure that entities which are of public interest adhere to the same regulations. The Treadway Commission also recommended that the financial regulatory agencies join the SEC and the

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We note that organizations sponsoring two groups—the Treadway Commission and the Task Force on the Quality of Audits of Governmental Units—have established committees to oversee and periodically report on implementation of the recommendations made by the groups. We support the establishment of these committees and believe that they should continue to be diligent in assuring that necessary changes are implemented in a timely manner.

The Treadway Commission's Sponsoring Organizations Committee issued its first report on implementation of the Commission's recommendations in August 1988. The report noted that a number of educational efforts aimed at encouraging corporate management to implement recommendations have been undertaken by the sponsoring organizations. It is important that the sponsoring organizations continue, through conferences and other means, to encourage and assist top management of companies to implement the Commission's recommendations.

The Steering Committee of the Task Force on the Quality of Audits of Governmental Units has held several meetings and has reported that progress is being made in implementing a number of the task force's recommendations. Until all of the recommendations have been implemented, the steering committee should continue to monitor and report on implementation efforts.

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Department of Justice in their program to increase criminal prosecution for fraudulent financial reporting.

Follow-through on Initiatives Is Important

Legislative action on granting additional enforcement authority to the SEC and extending SEC jurisdiction to financial institutions, and a number of regulatory actions remain to be taken. However, as discussed in chapters 2 through 6, the accounting profession and others have taken positive actions to implement many of the recommendations addressing problems in auditing and financial reporting. For example, the ASB has adopted nine new standards to respond to the public's expectation about the auditor's responsibilities to provide quality audits. These new standards expand the auditor's role in several areas and create new responsibilities in others. We believe the statements, when fully implemented, will help to narrow the gap between what the public expects of the auditor and how the auditor views his responsibilities.

The AICPA has amended professional standards to require mandatory peer review for members in public practice, continuing professional education for all members, and additional education requirements for new members after the year 2000. The code of ethics containing standards of conduct and rules of performance and behavior has also been revised.

These initiatives demonstrate a commitment to quality audits and reliable and accurate financial disclosures. However, implementation and continued vigilance are needed to ensure improvements in auditing and financial reporting.

As to actions which have been taken, several initiatives are in the early stages of implementation. Other initiatives have been embraced as beneficial but have not been adopted. It is too soon to fully assess what effect these initiatives will have on auditing and financial reporting; however, we believe that actions taken to date, if fully implemented by the profession and others, should improve the accuracy and reliability of financial disclosures. We also make recommendations, at the end of chapters 2 through 5, on additional actions the SEC, the profession, and others should take.

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for the recommended cease-and-desist authority in its legislative proposal. The SEC's rationale is that it already has statutory authority to issue administrative orders aimed at financial fraud which have the same effect as cease-and-desist orders. However, the SEC did request that its authority to issue administrative orders be increased. The proposed legislation was resubmitted to Congress in January 1989, but has not yet been acted upon.

The Treadway report also recommended that the SEC be given adequate resources to perform existing and additional functions that help prevent, detect, and deter fraudulent financial reporting. We agree that the SEC should be provided additional resources. There has been enormous growth in recent years in the securities industry as well as mounting concern over the efficiency and fairness of the financial markets. The appropriate level of resources for the SEC to accomplish its regulatory objectives is a matter that needs further attention.

Another recommendation that would require legislation to be implemented is the recommendation from the "Big 7" to extend SEC jurisdiction to all classes of entities with a sufficient public interest in the reliability of their financial statements. One example of such companies is financial institutions whose securities are exempt from the registration requirements of the Securities Act of 1933. The Securities Exchange Act of 1934 grants the powers, functions, and duties vested in the SEC to administer and enforce certain sections of the securities laws to the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board. Although securities of financial institutions are exempt from the registration requirements of the Securities Act of 1933, if these institutions form holding companies, they may report to the SEC in an exchange offer context under the 1933 Act, and if they have more than 500 shareholders, they must report to the SEC on a continuing basis under the 1934 Act.

We believe that a requirement for financial institutions of a certain size to report financial information to the SEC is in the public interest and would support legislation to accomplish this goal. In a related matter, we note that current banking regulations do not require independent audits of all banks. We support a requirement for all banks and their holding companies with a securities affiliate to have an independent audit of both entities' financial statements. We believe such audits would provide an additional safeguard to ensure the safety and soundness of the nation's banking system.

Conclusions

In the past, there have been serious problems with the quality of CPA audits of government funds. Responding to our recommendations and recommendations of the Task Force on the Quality of Audits of Governmental Units, the AICPA, state boards, and others have taken a number of substantive actions to improve these audits. Some of the recommended actions are still awaiting adoption. It is too soon to assess their effectiveness; however, if properly implemented, these actions collectively should significantly strengthen the quality of CPA audits of government funds.

Actions Taken: GAO's revised standards include a requirement that auditors involved in government audits complete, every 2 years, at least 80 hours of continuing education and training, with at least 24 hours in subjects directly related to the government environment and government auditing. Revised professional standards recently approved by AICPA members also include a continuing professional education requirement as a condition for membership.

In May 1988, the ASB issued a draft statement on compliance auditing which provides guidance for testing compliance with laws, regulations, and contractual terms governing the financial assistance an entity receives from a governmental agency.³ The statement would apply to audits conducted in accordance with GAAS of financial statements of state and local government units and not-for-profit organizations. It would also apply when an audit is performed in accordance with "yellow book" standards, or in accordance with the Single Audit Act of 1984. The comment period ended in August 1988.

Engagement: The process by which CPAs are engaged to perform government audits should be reviewed.

Actions Taken: In August 1987, GAO developed a framework for procuring audit services and recommended that entities carefully assess their procurement practices and take actions to include the four critical attributes of that framework in the procurement process to better ensure themselves of obtaining qualified auditors at a reasonable cost.⁴ Also, in May 1988, the National Intergovernmental Audit Forum issued a handbook to assist entities in ensuring that they engage a qualified auditor and receive a quality audit.⁵

Evaluation: Among the recommendations were that (1) each state should institute a positive enforcement program that includes reviews of audits of governmental units, and (2) auditors and audit organizations should be required to participate in a peer review program that includes reviews of governmental audits.

³Proposed Statement on Auditing Standards, *Compliance Auditing: The Auditor's Responsibility for Testing Compliance With Laws, Regulations and Contractual Terms Governing Financial Assistance Certain Entities Receive From Government*, AICPA, May 6, 1988.

⁴CPA Audit Quality: A Framework for Procuring Audit Services (GAO/AFMD-87-34, August 18, 1987).

⁵How to Avoid a Substandard Audit: Suggestions for Procuring an Audit, National Intergovernmental Audit Forum, May 1988.

We recommend that the AICPA issue the industry audit guides currently under revision as quickly as possible and undertake an effective program to keep all guides current.

Standards issued by GAO, Government Auditing Standards, commonly known as the “yellow book,” are to be followed by auditors and audit organizations when required by law, regulation, agreement, contract, or policy. Government auditing standards incorporate AICPA’s standards for field work and reporting on financial statement audits. In July 1988, GAO revised these standards. The revised standards expand and clarify the responsibilities of the auditor relative to certain standards—for example, the role of the auditor in detecting errors, irregularities, abuse, and illegal acts—and add requirements for continuing professional education and quality control, both external and internal. The new standards became effective for audits starting January 1, 1989, although early application is permissible.

In addition to standards, the AICPA also issues interpretations and audit guides on the application of standards. There are about 25 guides currently in use. These interpretations and guides do not have the authority of standards issued by the AICPA; however, auditors and others rely heavily on these guides for the specialized accounting and auditing practices of a particular industry. Also, auditors may have to justify departures from the guides and interpretations if the quality of their work is questioned.

As of January 1989, the AICPA had one proposed new audit guide and three revisions to existing guides outstanding:

- “Common Interest Realty Associations,” was issued in draft in August 1988. The comment period ended in December 1988.
- “Audit of Property and Liability Insurance Companies,” a revision of “Audits of Fire and Casualty Insurance Companies,” was issued in draft in July 1987. The comment period ended October 1987. The guide committee is reviewing the comments.
- “Audits of Providers of Health Care Services,” a revision of the “Hospital Audit Guide,” was issued in draft in March 1988. The comment period ended June 1988. The committee is reviewing the comments.
- “Audits of Government Contractors” was last updated in 1975. A draft revision was issued in November 1987 and the comment period ended in April 1988. The guide committee is reviewing the comments.

The AICPA has a committee that monitors changes in the industries in order to keep the guides current. However, in addition to the guides listed above, six other guides have not been revised since the 1970s. Two of these are being replaced by other documents, revision has begun on three, including the 1979 Savings and Loan Association Guide, and no

prejudiced; working papers are destroyed after the Committee completes its investigation. As a result of concerns raised about the lack of information about the Committee's investigations and whether the SEC had adequate information to oversee the operations of the Committee, the SEC was granted limited access to certain information about the Committee's process. Committee representatives meet periodically with SEC staff to discuss matters of mutual interest, including changes that the SEC believes would make the process more effective.

Other Initiatives to Improve Audit Quality

The Treadway Commission made two recommendations to the public accounting profession which are designed to improve audit quality within the profession's existing regulatory framework. Both recommendations required changes to the AICPA's SEC Practice Section rules. The first recommendation was that the SEC Practice Section strengthen its peer review program by increasing the number of reviews of audit engagements involving public company clients who are new to a firm. In addition, the Treadway Commission recommended that for each office selected for review, the first audit of all such new clients be reviewed. The second recommendation was that the SEC Practice Section revise its concurring partner review requirements.

In line with the Treadway recommendation, SEC Practice Section peer review standards were revised to place more emphasis on the audits of new public company clients by member firms. The new standards were effective for peer review years beginning after January 1, 1988. The SEC Practice Section also initiated a program to monitor the performance of peer reviewers more effectively.

With respect to second or concurring partner reviews, the Treadway Commission recommended that the requirement be revised to, among other things, (1) require concurring review partner involvement in the planning stages of the audit in addition to the final review stages, (2) specify qualifications of the concurring review partner to require prior experience with audits of SEC registrants and familiarity with the client industry, and (3) require the concurring review partner to consider himself a peer of the engagement partner for purposes of the review.

In June 1988, amendments to the SEC Practice Section rules which address the Treadway Commission's recommendation regarding concurring partner review were approved.

The AICPA rejected the call for a self-regulatory organization, maintaining instead that improvements in the quality and effectiveness of the independent audits should be accomplished by acting within the existing self-regulatory and supervisory system. The Treadway Commission concluded that in many areas such an organization would only duplicate functions that the present system, namely the AICPA's Division for CPA Firms, is performing quite well and as intended.

Mandatory Peer Review

Until recently, the profession's peer review program was voluntary. An initiative approved by AICPA members in January 1988 makes peer review mandatory for those members in public practice as a condition of membership. Not all firms which audit companies registered with the SEC are AICPA members. The issue of whether peer review should be mandatory for all accountants/firms that audit companies registered with the SEC has been debated. Another issue is whether more information about the results of the peer review process should be made available to the public. Critics of the profession's program have raised questions about the apparent reluctance to impose sanctions and disciplinary actions, the confidentiality of the proceedings, and the objectivity of one large accounting firm evaluating another.

In June 1986, the Comptroller General testified that the profession should make peer review mandatory for all firms that audit public companies. The "Big 7" proposed that all auditors of SEC registrants be members of the AICPA's SEC Practice Section. The Treadway Commission made a similar recommendation that the SEC require all CPA firms auditing public companies to be members of a professional organization that has peer review and independent oversight functions and is approved by the SEC.

In April 1987, the SEC proposed rules on mandatory peer review for comment. The proposed rules would require financial statements included in filings with the Commission to be certified by an independent accountant or firm which has undergone a peer review of its accounting and auditing practice within the last 3 years. Accountants would have the option of satisfying the requirement by undergoing a peer review under the auspices of an acceptable peer review organization or by having their peer review performed by another firm under the supervision of the SEC. The peer review organization would be required to grant the SEC access to the organization's policies and procedures and the working papers documenting the review. The report on the peer review and the

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such a requirement, legislation would be necessary to require direct notification to the SEC.

SEC staff is reviewing the comments. According to an SEC official, commentators generally acknowledged the benefits of reducing the overall filing period but raised objections to the specific periods proposed. The objections primarily were based on the use of calendar rather than business days and the resultant effect of weekends and holidays on the registrant's ability to comply with the proposed rules.

Audit Committee

The Treadway Commission noted that the audit committee can play an important role in preventing and detecting fraudulent financial reporting and in enhancing auditor independence. The Commission also noted the importance of an informed, vigilant, and effective audit committee as overseers of the company's financial reporting process and internal controls. The "Big 7" endorsed the idea of the audit committee as a means to enhance the auditor's appearance of independence, but observed that the profession does not have the authority to mandate audit committees.

The Treadway Commission recommended that the board of directors of all public companies be required by SEC rule to establish audit committees composed solely of independent directors. The Commission also recommended that the SEC require all public companies to include in their annual reports to stockholders a letter signed by the chairman of the audit committee describing the committee's responsibilities and activities during the year.

The SEC endorses the audit committee as an effective force for ensuring auditor independence. However, the SEC decided in April 1988 not to impose a rule requiring all public companies to establish an audit committee. Instead, the Commission decided to encourage the exchanges (the self-regulatory organizations) to reexamine their listing requirements relating to audit committees. The SEC reasoned that the regulatory organizations would be in a better position to consider cases involving smaller companies that may warrant an exemption because of difficulties in establishing independent audit committees.

Regarding the recommendation for public companies to include a letter in the annual reports signed by the chairman of the audit committee, present SEC regulations require certain companies that solicit proxies to disclose information concerning the existence of and the functions performed by audit committees. The SEC reasoned that certain information in the proposed audit committee letter would duplicate existing proxy statement disclosure. Therefore, the SEC felt that the proposed letter

were disclosures of a significant disagreement with the former accountant or where the former accountant resigned. The Treadway Commission recommended that management advise the audit committee when it seeks a second opinion on a significant accounting issue.

As recommended by the "Big 7," the Executive Committee of the AICPA's SEC Practice Section amended the Section's rules. The amended rules require that peer reviews beginning on or after January 1, 1988, identify SEC engagements accepted since the end of the last peer review where, as reported in a form 8-K or similar public filing, the former accountant resigned or there was a reported disagreement over any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure. The review procedures performed include a review of (1) the client-acceptance documentation that relates to the matters or procedures that were the subject of the resignation or disagreement and (2) working papers from either the current or prior engagement, financial statements, or auditor's reports to the extent considered necessary to be able to evaluate whether the matters or procedures were handled appropriately.

The SEC and the AICPA have discussed the feasibility and the benefit of having the accountant notify the SEC directly when he/she is no longer the auditor of a registered company. This notification currently takes place indirectly through the 8-K reporting process, which requires the audit client to report the change and provide a letter from the former accountant. One option proposed by the heads of eight major accounting firms would have the SEC require, as part of the 8-K notification process, that a copy of the letter be sent directly to the SEC by the accountant. The SEC has questions about whether it has the authority to mandate direct disclosure. The AICPA could make such disclosure a part of its SEC Practice Section rules, but, partly because of liability concerns, some professionals would prefer that the disclosure requirement be mandated by the SEC. If neither the SEC nor the AICPA mandates direct notification, it could be required by legislation.

In April 1988, the SEC adopted new disclosure requirements for reporting a change in accountants. The new rules are effective for changes in accountants after May 20, 1988. Disclosures concerning consultations with the newly-engaged accountant that occurred within approximately 2 years prior to engagement must be reported if those consultations (1)

There has been no conclusive evidence of an auditor's independence being impaired by the performance of management advisory services. However, public confidence in the integrity of financial reporting can be eroded if there is a perception that performing management advisory services compromises the auditor's independence. The issue has been raised at hearings before the Subcommittee on Oversight and Investigations and by the media, the "Big 7," and the Treadway Commission.

The "Big 7" suggested that the Public Oversight Board of the AICPA complete a survey of the promotion of management advisory services and of its effect, if any, on the perception of auditor independence and objectivity. The Board commissioned a study in 1986 which measured the perceptions of key members of the public about the accounting profession. The results of the survey suggested that a number of non-audit services performed by CPAs, such as designing a computer system or performing actuarial services for a company's pension plan, are not generally perceived as impairing independence. The survey found that a general perception exists that performing certain services, such as identifying merger or acquisition candidates, carrying out searches for senior management personnel, valuing assets acquired in business combinations, and developing executive compensation plans can impair objectivity and independence.

Also in 1986, the AICPA commissioned a survey to measure attitudes toward the accounting profession. As with the Public Oversight Board survey, many non-audit services offered by CPAs were thought to be proper; however, the respondents viewed other services, such as appraisal, executive search, and packaging and selling tax shelters as inappropriate services for CPAs to offer.

The Treadway Commission, noting the debate about the possible adverse effects of management advisory services on an accountant's independence, recommended that the audit committee annually review management's plans for engaging the company's independent public accountant. In performing this review, the Commission suggested that the audit committee weigh carefully the possible advantages of such use against the possible effect it may have on independence. The review would consider the types of services that may be rendered, helpful knowledge that the accountant may bring to the task because of the audit work, and a comparison of the cost of management advisory services relative to the cost of audit services.

Auditor Independence Must Be Protected

Independence is important to the effective performance of the audit function and is required by both government and AICPA standards. Auditors must always be without bias to ensure that an audit of a client's financial statements is fair and impartial. A company using the threat of changing accountants—opinion shopping—to pressure its existing accounting firm to accept a less than desirable accounting treatment is one way independence is threatened. Audit committees, in their oversight role, can serve as a buffer between the auditor and management and they can enhance the auditor's independence.

Auditor Independence

Discussions about auditor independence raised questions about the importance of independence, how independence can best be maintained, and what actions detract from independence. The importance of auditor independence is recognized in the securities laws, by the Supreme Court, and in auditing and professional standards. For example, federal securities laws recognize the importance of independence by referring specifically to independent public accountants. Also, the SEC, under its authority to issue rules and regulations to implement various statutory requirements, has defined situations where an auditor would not be considered independent for an audit of the financial statements.

The U.S. Supreme Court, in *United States v. Arthur Young & Co.*,¹ emphasized the public responsibility entrusted to the independent public accountant and his need to maintain an independent attitude. The Supreme Court stated that “The independent public accountant...owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This ‘public watchdog’ function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust. ...”

Both government and AICPA auditing standards address independence and require that the audit organization and the auditor be independent 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 impartial by knowledgeable third parties.

¹ *United States v. Arthur Young & Co.*, 465 U.S. 805, 817-818 (1984).

The Treadway report emphasized the importance of internal audit and stated that all public companies should maintain an effective internal audit function. Also, the internal auditor's qualifications, staff, status within the company, reporting lines and relationship with the audit committee of the boards of directors must be adequate to ensure the effectiveness and objectiveness of the internal audit function. The report further states that the internal auditor should consider his findings in the context of the company's financial statements and, to the extent possible, should coordinate his activities with the activities of the independent public accountant.

We agree that the internal audit function is important and we believe that management should have its internal audit department periodically review the system of compliance with laws and regulations. An external auditor's role in a compliance program should be to determine whether management has established and is maintaining (including monitoring) a system of internal controls to prevent and detect noncompliance. The new ASB statement on illegal acts by clients provides guidance to the auditor in detecting violations of laws and government regulations that may have a material effect on the determination of financial statement amounts. The standard advises the auditor to request written representations from management concerning the absence of violations or possible violations of laws and regulations. In chapter 2, we discussed the guidance provided by the statement on illegal acts by clients in regard to the auditor's responsibility to detect and report fraud and illegal acts.

Conclusions

Internal controls and related accounting and financial systems are important to ensure accurate financial reporting and compliance with laws and regulations. The SEC's proposal, which would require management to publicly report on the effectiveness of internal controls, should help to provide the investor with some assurance that companies registered with the SEC are maintaining effective control systems. The proposed report should also make management more accountable for accurate financial reporting. In addition, a management report would provide the auditor with a basis against which to compare his/her assessment of the internal control structure.

We believe that auditor review and public reporting on management's report on internal controls would significantly enhance the reliability and credibility of the report and result in improved internal controls. Emphasis on compliance with laws and regulations is important and a compliance program should be encouraged by the board of directors;

sufficient basis for reporting on internal controls. The task force will also address the Treadway Commission recommendation that the ASB provide guidance to address the situation where an accountant disagrees with disclosures in the proposed management report on internal controls.

Compliance With Laws and Regulations

We believe that achieving compliance with laws and regulations should be a major concern for both corporate management and its lawyers and an important matter that the auditor must be aware of in examining financial statements. Noncompliance with federal and state laws can result in serious consequences such as fraudulent financial reporting, business failures, and litigation. What role should management, its lawyers, and the auditors play in ensuring compliance with laws and regulations?

Establishing a Compliance Program

Federal laws and regulations impact most industries and may materially affect an entity's financial statements and its business operations or mission. Given the direct financial impact of many of these laws and regulations, their legal complexity, and the serious impact that noncompliance can have on operations and on the financial statements of companies, it is important that management and its lawyers establish and implement a sound compliance program for the company.

We believe such a program should identify those fundamental laws and regulations which, if violated, could materially affect the company's operations and financial statements. Management and its lawyers should also establish and maintain an effective system of internal controls to prevent and detect noncompliance with those laws and regulations. Lawyers should advise their client on the need to establish and maintain such a system and the resultant consequences of noncompliance to management and its board of directors. After a system is established, it is necessary to set up an educational program for management employees operating the system. The system must be monitored by internal audit after it is established. The board of directors on its own initiative should inquire into whether management has established and is maintaining an effective system.

In identifying the legal and regulatory requirements that affect the financial statements and operations, management must be concerned with noncompliance that could result in significant liabilities or loss of income. Early and comprehensive involvement on the part of lawyers

Federal Managers' Financial Integrity Act of 1982 has shown that a management report would be beneficial. We believe that auditor review of and public reporting on management's report will significantly enhance the reliability and credibility of the report, and result in improved internal controls.

Coordinated Guidance on Internal Controls

To help management judge the effectiveness and ultimately improve the operations of its internal control systems, the Treadway Commission suggested that its sponsoring organizations cooperate to provide integrated guidance on internal controls. The Commission's sponsoring organizations have formed a task force that has considered existing internal control guidance issued by the AICPA, Institute of Internal Auditors, and the Financial Executives Institute. The task force plans to develop guidance that would bring together and reconcile the various concepts, definitions, and terms used to describe internal control.

Auditor Association With the Internal Control System

Establishing an effective system of internal controls is management's responsibility. As part of the broader issue of internal controls, questions arose as to what is the auditor's role in (1) evaluating the internal control system, (2) communicating internal control related matters to the audit committee or others, and (3) reviewing management's report on the internal control system?

In June 1986 testimony, the Comptroller General suggested that auditors review an entity's internal control system, and we believe that auditors should also review management's report on that system. Price Waterhouse recommended that the auditor be required to review and evaluate the system of management controls, which are part of the internal control system, regardless of whether the auditor intends to rely on the system in developing audit tests. These management controls include organizational controls, operating controls, and information system controls. Price Waterhouse reasoned that such review and evaluation would require the auditor to gain a more complete understanding of the client's business and thereby reduce the risk of undetected management fraud.

The Treadway Commission recommended that standards be revised to restate the public accountant's responsibility to detect fraud and to require the auditor to assess the company's control environment, including its management, in planning the audit. The Commission also recommended that the revised auditor's standard report describe the extent to

Responsibility for Internal Controls and Compliance With Laws and Regulations

Internal controls are an essential part of good management; establishing and maintaining a system of internal control is management's responsibility. A good system of internal controls is important to properly and effectively manage a company, to ensure corporate accountability and accurate financial reporting, and to prevent fraud. Achieving compliance with laws and regulations is also management's responsibility. The internal control system can help management to ensure compliance with laws and regulations that are fundamental to company operations and that may materially affect the financial statements.

Public companies are not currently required by the SEC to report externally on the operation of their internal control systems. The issues which have been raised in this area are: What is the importance of internal controls? Should management be required to report on the effectiveness of the control system? What are the auditor's responsibilities for reviewing and reporting on the internal control system? What are the responsibilities of management, its attorneys, and the auditor in ensuring compliance with laws and regulations?

Importance of Internal Controls

The Congress recognized the importance of an effective system of internal controls to preparing accurate financial statements and, in 1977, enacted the Foreign Corrupt Practices Act as an amendment to the Securities Exchange Act of 1934. The accounting provisions of the act require each SEC registrant to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurance that "... transactions are recorded as necessary...to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements"

The SEC has also emphasized the importance of internal controls to financial reporting. In 1979, the SEC proposed a rule to require a management report on internal controls.¹ That rule would also have required the auditor to examine and report on the assumptions in management's report. However, in 1980, in the face of substantial opposition and on the basis of a determination that the private sector initiatives for public reporting on internal accounting controls have been significant and should be allowed to continue, the SEC withdrew the proposal.²

¹Securities Exchange Act Release No. 34-15772, April 30, 1979.

²Securities Exchange Act Release No. 34-16877, June 6, 1980.

Reporting Fraud Directly to Regulators

Legislation (House Bill 5439) introduced in 1986 and debated at the hearings, would have required auditors to detect and report material financial fraud directly to the SEC. At a hearing before the Subcommittee on Oversight and Investigations in May 1988, the Chairman of the SEC expressed his support for a requirement to have auditors directly notify the SEC of fraud—a major component of House Bill 5439—if problems in protecting the accountant against possible legal liabilities could be overcome. He stated that the issue had not come before the Commission. No action has been taken on this issue.

Communicating Audit Results

The short-form two paragraph auditor's report has been used for nearly four decades. Questions have arisen about whether the audit report clearly reflects what an audit involves and whether the report may lead to a misconception that the audit and the resulting report provide guarantees regarding the financial statements. One of the issues debated was whether the audit report should be revised to more clearly reflect the results of an audit.

Revised Standard Report

The Treadway Commission noted that since the standard report is the auditor's primary vehicle to communicate with those who rely on his/her work, the report should be revised to better communicate the responsibilities the auditor assumes. The Treadway Commission recommended that the auditor's standard report should state that the audit provides reasonable, but not absolute, assurance that the audited financial statements are free from material misstatements as a result of fraud or error.

In April 1988, the ASB revised the statement relating to audit reports⁶ to more explicitly address the auditor's responsibility, the procedures the auditor performs, and the assurances the audit provides. Among the major changes to the report are (1) the addition of an introductory paragraph that differentiates management's responsibilities for the financial statements from the auditor's role in expressing an opinion on them, (2) a scope paragraph, which describes the nature of an audit including an explicit acknowledgement that the audit is planned and performed to obtain reasonable assurance that the financial statements are free of material misstatements, and (3) a third paragraph expressing the auditor's opinion.

⁶Statement on Auditing Standards No. 58, Reports on Audited Financial Statements, AICPA, April 1988.

As for the review of quarterly financial data, the Treadway Commission recommended that the SEC require independent accountants to review,³ for all public companies, such data before it is released to the public. The Commission did not recommend an audit of this data, but stated that timely review of quarterly financial data can improve the reliability of quarterly reporting and increase the likelihood of early detection of fraudulent financial reporting.

There is no consensus on the second issue relating to reporting fraud outside of the client organization. Traditionally, auditing standards have recognized an auditor-client relationship with the auditor's primary reporting responsibility being to the client. Any outside reporting was generally considered the client's responsibility. However, under recently revised auditing standards, the auditor has a responsibility to inform the audit committee or its equivalent of errors and irregularities and illegal acts which come to his/her attention and may have a duty, under certain limited circumstances, to inform others outside of the client organization.

Changes in Auditing Standards

In April 1988, the ASB issued two standards—one on errors and irregularities and one on illegal acts⁴—which directly address the auditor's responsibility for fraud detection, and a third standard on analytical procedures⁵ which relates indirectly to that responsibility.

The new statement on errors and irregularities requires the auditor to design the audit to provide reasonable assurance of detecting material errors and irregularities. The statement requires that the auditor inform the audit committee or others with equivalent authority about irregularities that have been detected. The statement also acknowledges that circumstances may exist which require the auditor to report outside of the client organization. These include reporting by the entity of an auditor change, responding to a subpoena, communicating with a successor

³The Treadway report states that a review differs from an audit in the degree of evidence the independent accountant must obtain to support the financial information and also in the degree of assurance a user may place on such information. Because a review is not designed to express an opinion on the financial information, it requires significantly less supporting evidence than an audit requires.

⁴Statement on Auditing Standards No. 53, The Auditor's Responsibility to Detect and Report Errors and Irregularities, and Statement on Auditing Standards No. 54, Illegal Acts by Clients, AICPA, April 1988.

⁵Statement on Auditing Standards No. 56, Analytical Procedures, April 1988.

rules more specific for fear that MD&As would result in “boilerplate” disclosures. However, a criticism of the present MD&A disclosure is that it too often consists of obvious facts and does not focus enough on warning signs of potential problems. The “Big 7” recommended that the MD&A be enhanced by providing additional disclosures on risks and uncertainties and that these enhanced disclosures be audited.

In April 1987, the SEC published a “Concept Release on Management’s Discussion and Analysis of Financial Condition and Operations.” In this release, the SEC requested comments on recommendations it had received from members of the accounting profession suggesting that the SEC (1) adopt a more specific approach for requiring disclosure of business risks and uncertainties and (2) require additional board of director scrutiny and independent auditor association with these disclosures. The response from industry was that the present rules were adequate to meet the SEC’s objectives and that no changes were required. However, other commentators suggested that the rules were too vague and provided insufficient guidance as to the SEC’s interpretations regarding MD&A. The SEC’s staff has undertaken an evaluation project to study the adequacy of current MD&A disclosures made by registrants. The first phase of the study, which included the review of the annual reports of 218 registrants, has been completed. A second phase of the project, which involves the review of the disclosures of an additional 141 registrants, is underway. An SEC official informed us that as a result of this project, the staff will issue an interpretative release with suggestions for improving MD&A disclosures.

In February 1987, the ASB released a proposed statement on standards² which would have provided guidance to the auditor when accepting an engagement to examine and report on MD&A. The ASB voted to defer discussion of this statement pending action by the SEC on the MD&A concept release.

²Proposed Statement on Standards for Attestation Engagements, Examination of Management’s Discussion and Analysis, AICPA, February 1987.

“early warnings” in plain English when a company’s continued existence is questionable, recommended that the auditor review and evaluate the company’s system of management controls. Price Waterhouse maintained that this review and evaluation would benefit the auditor as he gathers additional audit evidence with which to assess the financial condition of the entity and to identify those entities which may be facing imminent financial or operating difficulties.

In financial reporting, absent significant information to the contrary, a company is assumed to be a going concern, that is, it is assumed that it will continue in business. However, in 1988, the Auditing Standards Board (ASB) issued a new statement on auditing standards (SAS) on going concerns,¹ which requires the auditor to evaluate whether there is substantial doubt about a company’s ability to continue as a going concern for a reasonable period of time. While no new technical audit procedures are required, the auditor is now explicitly required to evaluate whether the aggregate results of all audit procedures indicate there could be substantial doubt about whether a company is a going concern. The audit report should include an explanatory paragraph if the auditor concludes that there is substantial doubt about the entity’s ability to continue as a going concern for a reasonable period of time. However, the new standard also states that the auditor is not responsible for predicting future events and that the absence of a reference to substantial doubt still does not provide assurance of the entity’s ability to continue as a going concern.

Disclosing Risks and Uncertainties

Disclosures about risks and uncertainties are of concern to investors, accountants, regulators, and others. Accordingly, the “Big 7” suggested that companies provide more relevant information on risk concentration, uncertainties, significant judgments, assumptions, and estimates in the financial statements.

The Task Force on Risks and Uncertainties concluded that a business should make disclosures beyond those now generally made in financial reports about the risks and uncertainties facing the business as of the date of the financial statements. The task force urged the FASB to consider practical ways of establishing requirements for improved disclosures of information on risks and uncertainties in financial statements.

¹Statement on Auditing Standards No. 59, The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern, AICPA, April 1988.

review, we only report on the major recommendations and actions taken on the 10 major issues identified above.

For chapters 2 through 5, we discuss the major issues, recommendations, actions taken, and provide conclusions and recommendations. In chapter 2 we discuss three issues (early warning, fraud detection, and communicating audit results) where a gap seems to exist between what the public expects of the auditor and how the auditor views his responsibility. In chapter 3 we address internal controls and compliance with laws and regulations, the relationship between the two, and the role of management, its attorneys, and the auditor in ensuring compliance. In chapter 4 we address issues relating to auditor independence. In chapter 5 we discuss audit quality issues.

In chapter 6 we discuss issues relating to the quality of audits of government funds. In chapter 7, as requested by the Subcommittee, we identify recommendations from the Treadway Commission and others which would require regulatory or legislative actions to be implemented, and we discuss the need for continued monitoring of the initiatives. We did not assess the effectiveness of initiatives taken to date, because many of the actions that have been taken are in the early stages of implementation.

We conducted our review between December 1987 and November 1988, in accordance with generally accepted government auditing standards. We provided a draft of the report to the Public Oversight Board, the Financial Accounting Standards Board, and the SEC; and to the AICPA and other members of the Committee of Sponsoring Organizations of the Treadway Commission. Each organization generally agreed with the facts we presented and most of the organizations provided technical comments. The comments generally did not indicate agreement or disagreement with the report's recommendations. We have incorporated the organizations' comments where appropriate.

issues: the auditor's responsibility to detect fraud, the profession's self-regulatory program, and the auditor's liability.

In April 1986, the heads of seven major accounting firms, referred to as the "Big 7" throughout this report, submitted eight recommendations to the AICPA Board of Directors to improve the relevance, reliability, and credibility of financial information.⁷ The recommendations addressed the need for more information on risks and uncertainties in financial reporting, auditor independence, peer review, and other issues.

In June 1986, GAO testified that the public expects improvements in the areas of fraud detection, compliance with laws and regulations, internal controls, and peer review.⁸ We encouraged the profession to take action in these areas. We have also completed several reviews and made recommendations to improve the quality of CPA audits of federal funds.

In 1985, during the period of our reviews of government audits,⁹ the AICPA appointed a Task Force on the Quality of Audits of Governmental Units to develop a comprehensive action plan designed to improve the quality of audits of governmental units. The Task Force report¹⁰ includes 25 recommendations in five areas: education, engagement, evaluation, enforcement, and exchange. These recommendations are directed at the three major participants in the governmental audit process: the auditors, the auditee, and the organization that oversees the auditor and the auditee.

In April 1988, the AICPA's Auditing Standards Board issued nine standards which respond to many of the study groups' recommendations. These standards expand the auditor's role in several areas such as providing early warnings, detecting fraud, and communicating to the audit committee and to users of financial statements. In general, the standards are effective for audits of financial statements for periods beginning on or after January 1, 1989.

⁷The Future Relevance, Reliability, and Credibility of Financial Information: Recommendations to the AICPA Board of Directors, April 1986.

⁸Statement of the Honorable Charles A. Bowsher before the Oversight and Investigations Subcommittee, House Committee on Energy and Commerce, June 19, 1986.

⁹CPA Audit Quality: Inspectors General Find Significant Problems (GAO/AFMD-86-20, December 5, 1985) and Many Governmental Audits Do Not Comply With Professional Standards (GAO/AFMD-86-33, March 19, 1986).

¹⁰Report of the Task Force on the Quality of Audits of Governmental Units, AICPA, March 1987.

Early warning—Are users of financial statements provided adequate warning when a company is facing financial difficulties?

Fraud—What is the auditor's role in searching for and identifying fraud and should that role be expanded? Should the auditor be required to report material fraud outside of the client organization?

Communicating audit results—Should the audit report be revised to more accurately reflect the results of an audit?

Internal controls—What is the importance of internal controls and who has responsibility for establishing and maintaining those controls? Should management be required to report on the effectiveness of its control system? What should the auditor's role be with respect to evaluating and reporting on internal controls and reviewing management's report on these controls?

Compliance with laws and regulations—What is management's responsibility for ensuring compliance with laws and regulations? What is the role of the company's legal counsel? What is the auditor's responsibility?

Auditor independence—How important is independence to the audit function? How can independence best be maintained and what actions might detract from independence?

Auditor changes/Opinion shopping—Is opinion shopping a major problem? What effect, if any, does opinion shopping have on auditor independence? Should requirements for reporting auditor changes be strengthened?

Audit committees—Is the audit committee an effective tool for ensuring accurate financial reporting and the independence of the auditor? Should all public companies be required to establish an audit committee?

Self-regulation/Audit quality—Is the profession's present system of self-regulation adequate to ensure quality audits? Should peer review be mandatory for all accountants/firms that audit companies registered with the SEC or other entities? Are auditing standards current?

Audits of government funds—Are certified public accountants (CPAs) performing quality audits of government funds? What factors contribute to effective audits of government funds?

The agencies that regulate financial institutions—the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve System, and the Federal Home Loan Bank Board—adopt rules and regulations regarding financial reporting by the entities they regulate. These agencies administer portions of the federal securities laws applicable to the entities under their jurisdiction.

Problems in Financial Reporting Are Not New

During the 1970s two significant events—illegal payments made to foreign officials, and financial difficulties suffered by large companies such as Lockheed and Penn Central which required federal assistance—led the Congress and others to review the role of the SEC and the auditor in the financial reporting process.

In 1975, the staff of the Subcommittee on Reports, Accounting and Management, Senate Committee on Government Operations, began a study of the federal government's role in establishing accounting practices used by publicly owned corporations in financial reporting.¹ According to Subcommittee Chairman Metcalf, the major purpose of the study was "to provide Congress and the public with an understanding of the various private organizations and federal agencies involved in establishing and administering accounting practices which have substantial impact on federal policies and programs, as well as private economic decisions." The staff made a number of recommendations to the Congress.

In 1977, the same Subcommittee held a series of hearings on the role of the federal government in assuring the accuracy of corporate financial reports of listed companies. Witnesses at the hearings included representatives from the Congress, academia, public accounting firms and public interest groups, and the SEC. Many of the issues discussed in this report—audit committees, auditor's role in detecting fraud, auditor independence, and questions about self-regulation—were discussed at those hearings.

In December 1977, as a result of revelations that falsification of records and improper accounting allowed corporations to make millions of dollars in questionable or illegal payments, the Congress enacted the Foreign Corrupt Practices Act. The accounting provisions of the act require

¹The Accounting Establishment—A staff study prepared by the Subcommittee on Reports, Accounting, and Management of the Committee on Government Operations, United States Senate, (Ordered to be printed on March 31, 1977).

Introduction

Federal securities laws and regulations require publicly owned companies to disclose financial and other information in a manner which accurately depicts the results of company activities. Both the SEC and the independent auditor play a role in ensuring compliance with provisions of these laws. In recent years, charges of audit failure in connection with business failures have raised questions about the effectiveness of both the independent audit function and oversight of the accounting profession.

Since February 1985, the Subcommittee on Oversight and Investigations, House Committee on Energy and Commerce, has held 25 hearings on the adequacy of accounting, auditing, and financial reporting under the federal securities laws. In response to the Subcommittee's investigation as well as other forces, several groups have addressed problems, both identified and perceived, in financial reporting and auditing and made numerous recommendations to improve the processes. These groups include the Special Committee on Standards of Professional Conduct for Certified Public Accountants, the National Commission on Fraudulent Financial Reporting, the Task Force on Risks and Uncertainties, representatives of the major accounting firms, the Task Force on the Quality of Audits of Governmental Units, and the Auditing Standards Board.

In September 1987, Representative John D. Dingell, Chairman of the Subcommittee, asked us to (1) monitor implementation of changes, for a 1-year period, affecting the accounting profession, (2) report, at the end of that year, on the status of the implementation of each of the major proposals that have been set forth, and (3) make any recommendations which we might have as to issues the Subcommittee should pursue. In a second request in October 1987, Chairman Dingell asked us to identify recommendations to correct problems in the accounting profession that require regulatory or legislative action in order to be implemented.

Participants in the Financial Reporting Process

Full, fair, and accurate disclosure of financial results is a cornerstone of our system of public securities markets. Public companies have full responsibility for providing the necessary disclosure. The independent public accountant plays an important, though secondary, role through the audit process. Other entities, most notably the Securities and Exchange Commission (SEC) and the stock exchanges, as well as other regulatory agencies and organizations, also play important roles in the financial reporting process.

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new auditing standards. Many of these guides are currently being revised.

The Securities and Exchange Commission

The SEC has adopted new disclosure requirements for public companies when there is a change in the company's independent accountant which should provide the SEC with more information on potential problems.

However, the SEC has not finalized many of its actions. Although it has released for public comment a rule to require firms auditing companies that are registered with the SEC to undergo mandatory peer review, the SEC has delayed action on the proposal while it addresses a number of issues. These include the structure of an SEC sponsored peer review program, the cost and benefit of mandatory peer review, and questions about its authority to require mandatory peer review. GAO believes that because not all firms auditing public companies are members of the AICPA and covered by its mandatory peer review requirement, action by the SEC is needed to ensure that firms auditing public companies are required to maintain this critical quality assurance mechanism.

The SEC also has proposed for comment a rule requiring management of public companies to report on their responsibilities for the financial statements and their assessment of their company's internal control system but again has not finalized action on this issue. GAO believes public reporting—particularly when combined with an auditor's review and report—significantly enhances the reliability and credibility of information and results in improved internal controls.

The National Commission on Fraudulent Financial Reporting concluded that audit committees can play an important role in preventing and detecting fraudulent financial reporting and enhancing auditor independence. The SEC, while recognizing the importance of audit committees, decided not to impose a rule requiring all public companies to establish independent audit committees. Instead, the Commissioners voted to encourage the stock exchanges to reexamine their listing requirements relating to audit committees.

Recommendations

GAO recommends that the SEC and the AICPA take additional steps to improve the quality of audits and financial disclosures and expedite efforts to complete certain actions currently underway.

Executive Summary

Purpose

The federal securities laws, which seek to protect the public in their securities transactions, require public companies to disclose information which accurately depicts the financial condition and results of company activities. Full, fair, and accurate disclosure of financial information is a cornerstone of our system of public securities markets. Both the independent auditor and the Securities and Exchange Commission (SEC) play major roles in ensuring that public companies meet their financial reporting responsibilities.

During the past 5 years, several well publicized business failures and a series of congressional hearings raised questions about the effectiveness of the independent audit of public companies and the SEC's oversight of the public accounting profession. As a result of those questions, several groups were formed to study these issues and have made numerous recommendations for improving the auditing and financial reporting processes of public companies.

In related requests in September and October 1987, Representative John D. Dingell, Chairman, Subcommittee on Oversight and Investigations, House Committee on Energy and Commerce, asked GAO to (1) monitor implementation, for a 1-year period, of the recommended changes affecting the accounting profession, (2) report on the implementation of each of the major proposals that have been set forth, (3) identify those recommendations which would require legislative or regulatory action in order to be implemented, and (4) make any recommendations as to issues the Subcommittee should pursue.

Background

Since February 1985, the Subcommittee has held 25 hearings on auditing and financial reporting under the federal securities laws. During these hearings, and in related studies and reports, several organizations and groups offered proposals and recommendations to enhance the effectiveness of the independent audit and to strengthen the system of financial reporting.

GAO has identified 10 major topics debated at the hearings and discussed in those studies and reviews. The chart below lists these topics and the chapters where they are discussed.

