2001

Final annual report 2001

American Institute of Certified Public Accountants. SEC Practice Section. Public Oversight Board

PUBLIC OVERSIGHT BOARD

FINAL Annual Report 2001

Members of the Public Oversight Board

January 1, 2001 through May 1, 2002

CHARLES A. BOWSHER
Chairman, 1999 - present; joined Board in 1997; Comptroller General of the United States and head of the General Accounting Office, 1981-1996; Partner of Arthur Andersen & Co., 1971-1981; Assistant Secretary of the Navy-Financial Management, 1967-1971; presently a director of several public companies.

DONALD J. KIRK
Vice Chairman, 1999 - January 18, 2002; joined Board in 1995; Financial Accounting Standards Board, member 1973-1977, Chairman 1978-1986; Partner of Price Waterhouse & Co., 1967-1973; Columbia Business School, Professor 1987-1994, Executive-in-Residence, 1995-2000; presently a director of several public companies; received the AICPA's Gold Medal Award for Distinguished Service.

NORMAN R. AUGUSTINE
Joined Board in 2000; Chairman of the Executive Committee, Lockheed Martin Corp. since 1997; Chairman and CEO, 1996-1997; President, 1995-1996; Chairman and CEO, Martin Marietta Corp., 1987-1995; Lecturer, Princeton University, 1997-1999; Assistant Secretary of the Army, 1973-1975, and Under Secretary, 1975-1977; presently a director of several public companies.

JOHN H. BIGGS
Joined Board in 2001; Chairman and CEO of TIAA-CREF since 1993, President and COO, 1989-1993; President and CEO of Centerre Trust Company, 1985-1989; presently a director of several public companies.

AULANA L. PETERS
Joined Board in 2001; Retired Partner in law firm of Gibson, Dunn & Crutcher LLP; Member of the POB's Panel on Audit Effectiveness, 1998-2000; SEC Commissioner, 1984-1988; presently a director of several public companies.

STAFF

JERRY D. SULLIVAN
Executive Director

CHARLES J. EVERS
Technical Director

JOHN F. CULLEN
Assistant Technical Director

ALAN H. FELDMAN
Assistant Technical Director

JOHN C. WEBER
Assistant Technical Director

LEGAL COUNSEL

ALAN B. LEVENSON
Fulbright & Jaworski LLP

A. A. Sommer, Jr.
The POB acknowledges with regret and sadness the passing of A. A. Sommer, Jr., former Chairman of the POB, on January 14, 2002.

Melvin R. Laird, former POB member, once observed that "during Al's tenure on the Board, which coincided with a difficult period in the accounting profession, he inspired his fellow Board members and the whole profession with his leadership. He approached each challenge logically, calmly, cheerfully and with full knowledge of the issues, and he always articulated reasonable solutions to difficult issues." Mr. Sommer will be missed by all who knew him.

About the Public Oversight Board and the SEC Practice Section

The Public Oversight Board (POB)

An independent private sector body, the Public Oversight Board was created in 1977 for the purpose of overseeing and reporting on the self-regulatory programs of the SEC Practice Section (SECPS) of the American Institute of Certified Public Accountants (AICPA). In February 2001 the Board's oversight jurisdiction was expanded to include the activities of the Auditing Standards Board (ASB) of the AICPA. The POB is responsible for monitoring and commenting on matters that affect public confidence in the integrity of the audit process. Funded by dues paid by SECPS members, the Board's independence is assured by its power to set its own budget, establish its own operating procedures, and appoint its own members, chairperson, and staff. The Board consists of five members with a broad spectrum of business, professional, and regulatory experience. Pursuant to the new Charter, the ceiling for the POB's funding was initially set at $5.2 million to cover its expanded oversight responsibilities. Additional funds may be authorized should the need arise. The Charter further provides that the POB will select its members from a slate proposed by a nominating committee. As indicated elsewhere in this report, on January 20, 2002 the Board voted its intent to terminate its existence and did so as of May 1, 2002.

SEC Practice Section

The SECPS was founded in 1977 as part of the Division for CPA Firms of the AICPA and is overseen by the Public Oversight Board. The Section imposes membership requirements and administers two major programs to help assure that SEC registrants are audited by member firms with effective quality control systems. The first is peer review, a process by which other accountants assess and test compliance with the quality control systems for the accounting and auditing practices of Section members. The other is quality control inquiry, which reviews allegations of audit failure contained in litigation filed against member firms involving SEC clients.

Membership in the SECPS

About 1,200 firms belong to the SECPS, including virtually all of the accounting firms that audit publicly held companies. They audit some 17,000 public companies that file reports with the SEC. The requirements of the SECPS affect more than 128,000 professionals at member firms.

Member firms of the SECPS must adhere to quality control standards established by the AICPA; have a peer review every three years, the results of which are maintained in a public file that also is available on the AICPA's web site; and report to the SECPS Quality Control Inquiry Committee (QCIC) litigation against the firm that alleges deficiencies in the audit of a SEC client. Among other membership requirements, firms must periodically rotate the partner in charge of each SEC audit engagement and conduct a concurring or second partner preissuance review of each SEC audit engagement.

Letter from the Board

The past 15 months have been a busy and tumultuous time for the Public Oversight Board. As detailed elsewhere in this annual report, the Board and its staff carried out their responsibilities to oversee the peer review and quality control inquiry processes, to begin the process of monitoring implementation of the recommendations of the Panel on Audit Effectiveness, to oversee the setting of independence and auditing standards, and to attempt to carry out independence reviews of the largest accounting firms. In addition, and in accordance with its new Charter, the POB formed and convened a Coordinating Task Force consisting of the chairs of each body within the POB's oversight jurisdiction to exchange information relating to each committee's activities.

These activities, however, were overshadowed by the decision of the POB on January 20, 2002, to terminate its existence. That decision was made reluctantly and as a matter of principle. The Board has represented the public interest in overseeing the self-regulatory programs of the accounting profession for 25 years and has always sought to work closely with the profession and the SEC toward enhancing the effectiveness of the programs under its purview.

SEC Chairman Harvey Pitt announced on January 17, 2002 his proposal for a new private sector regulatory structure - a structure the AICPA said was "unprecedented in the more than 100 year history of the accounting profession" - without any input or consultation with respect to the proposed changes with the POB.

The proposal announced by Chairman Pitt had been the subject of discussions between the accounting profession and the SEC for some time. The POB asked to be included in these discussions, but was not. Being excluded from the process, effectively undercut the POB's legitimacy as an "overseer." Under the circumstances, the POB concluded that to appear to continue to conduct oversight activities could mislead the public. Furthermore, the POB was concerned that if it were to continue during an interim period before a new governance structure were in place, it would leave the impression that the POB approved of the SEC proposal, which it did not. Therefore, it felt that in the public interest it had no choice but to disband.

While this proposal was the immediate event that triggered the decision to disband, three other events contributed to the POB's decision:

- On May 3, 2000, the SEC Practice Section (SECPS) - an organization within the American Institute of Certified Public Accountants (AICPA) - took the unprecedented action of notifying the POB that it would refuse to pay, as part of the POB budget, for the POB's special reviews of public accounting firms. The special reviews in question had been sought by the SEC to determine whether the firms had complied with SEC and professional independence standards.
- Following the decision to withhold funding of these special reviews, the Big 5 accounting firms agreed with the SEC that the POB should instead conduct more limited independence reviews of the large firms. Despite this agreement, the next 21 months were marked by a singular lack of progress. The POB, in the end, was unable to conduct the reviews.
- The POB, which for years had carried out its oversight responsibilities under a set of bylaws adopted after it was created in 1977, believed that a formal charter would improve the independence of the Board. The creation of a charter was one of the primary recommendations in 2000 of the Panel on Audit Effectiveness. Objections from the AICPA and the firms caused negotiations to drag out for more than a year. Ultimately, a new charter took effect in February 2001.

Given these and other circumstances, the POB concluded that it was not possible for it to adequately oversee the accounting profession. The five members of the POB thus unanimously voted to disband after an appropriate period for a transition of its responsibilities. This step was considered by the POB to be akin to what an auditor does when it believes it must resign from a client engagement because it can no longer carry out its responsibilities. This decision was taken only after careful deliberation in view of the Board's high regard for the work of the overwhelming number of professionals in the accounting and auditing fields and the Board's commitment to self-regulation as one element of an oversight regime. In the end, as the "conscience and critic" of the profession's self-regulatory system (as the Securities and Exchange Commission labeled the mission of the POB in 1980), the POB felt it had no choice but to disband.

In deciding to disband, the POB felt that it had an obligation to provide its views on how regulation of the accounting profession could be improved. It has done this in the form of a White Paper - *The Road to Reform: A White Paper From The Public Oversight Board On Legislation to Create a New Private Sector Regulatory Structure for the Accounting Profession*. This White Paper was released at a hearing before the Senate Banking Committee on March 19, 2002, at which POB Chairman Bowsher and POB Member Peters gave testimony. The White Paper is printed in full and included in this annual report.

In summary, the Public Oversight Board strongly believes that a new regulatory structure for the accounting profession is both essential and feasible. However, the POB believes that to be effective and to restore trust in the accounting profession, such a structure must be totally independent of the accounting profession, although with input from the profession. Further, the structure should remain in the private sector and be statutorily based.

In the White Paper, the Board recommends that Congress create a new Independent Institute of Accountancy - the IIA - and center all regulation under its auspices. A seven-member board would run the Institute totally independent of the AICPA, the Big 5, and other firms. The chair and vice chair would be full time employees of the Institute; five other members would serve on a part time basis. All would be appointed by a panel composed of the chair of the SEC, the chair of the Federal Reserve Board and the Secretary of the Treasury. Once named, the chair of the IIA would join these three in naming other members of the board. Members of the IIA board could be removed only by two-thirds vote of the board itself.

The SEC would have oversight of the IIA, and the SEC's Office of the Chief Accountant would be the liaison to the IIA. Funding of the IIA would be independent of the firms and the accounting profession. The important functions of the Institute would include oversight of all standard setting bodies, yearly and special reviews, investigatory powers, international liaison, and professional education and training.

Beyond these core functions, the POB White Paper also contains a number of recommendations it believes should be incorporated in any legislative reform package. These include certain limitations on non-audit services to audit clients, rotation of auditors every seven years, a two year "cooling off" period in which engagement and other partners associated with an audit would be prohibited from accepting employment with an audit client, expanded action to encourage audit committees to take full responsibility for hiring, evaluating, and (if necessary) firing auditors, requiring more timely and meaningful disclosure of related party transactions, and requiring management of public corporations to prepare annual statements of compliance with internal controls to be filed with the SEC, signed by the Chief Executive Officer and Chief Financial Officer, and reviewed by the external auditor.

The POB feels these reforms are necessary if trust is to be restored in the accounting profession and the damage done to the capital markets by recent events is to be repaired. The Board has presented what it believes is a sensible, workable plan for reform. It is premised on the firmly held belief that the fundamental purpose of regulation is to serve the public interest and that of investors. If this is to be accomplished, regulation must be totally independent of the profession, it must pull together all aspects of regulation from standards to discipline, it must be transparent, and it must provide for adequate funding and staff.

In this last annual report, the Board wishes to thank the POB's loyal staff. The Board has been fortunate to have the dedicated support of the men and women who served the public interest so well under the leadership of POB Executive Director Jerry Sullivan. We are pleased that they will continue to provide interim service under an agreement with the SEC Practice Section until a new and permanent regulatory structure is in place.

Respectfully submitted,

Charles A. Bowsher
Chairman

Norman R. Augustine

Aulana L. Peters

John H. Biggs

Functions of the Independent Institute of Accountancy

Important functions of the Independent Institute of Accountancy—the IIA—would include:

Oversight:

The IIA would exercise oversight for all standard setting bodies, which would remain in the private sector, for accounting, auditing, and independence, as well as interpretations. Accounting standards are just as important as auditing and independence standards. For this reason, the POB believes the Financial Accounting Standards Board should be brought under the umbrella of the IIA, which would take responsibility for its oversight and funding.

Reviews:

IIA employees would conduct thorough and comprehensive yearly reviews of the annual internal inspections of firms that audit more than 100 public corporations each year. Firm-on-firm peer review would be discontinued for such firms. Unlike peer review, no activities of a firm would be off limits to Institute reviewers and the process would produce detailed public reports. For firms that audit less than 100 public corporations yearly, reviews would be performed by other firms selected and paid by the IIA. Their reports would be addressed to the IIA as the client of the reviewer. In addition to the reviews, IIA employees would conduct special reviews, when warranted. Similar to those the SEC originally asked the POB to undertake, these reviews, for example, could take a systematic, in-depth look at a firm's systems, policies, procedures, and operations. If necessary, such special reviews would delve into questions affecting the firm's compliance with applicable professional standards. As with the yearly reviews, reports of these special reviews would be public.

Investigations:

An Office of Enforcement and Discipline within the IIA would have full authority to investigate allegations of wrongdoing by public accounting firms and their personnel. The POB recommends giving the IIA the privilege of confidentiality as well as the power of subpoena to compel testimony and produce documents. Cases of alleged misconduct would be brought before IIA hearing examiners. When warranted, these examiners would recommend to the IIA board the imposition of sanctions, ranging from fines to expulsion from the profession. Cases could be referred to the Justice Department for possible prosecution, or to the SEC, state boards of accountancy, or other agencies, as appropriate.

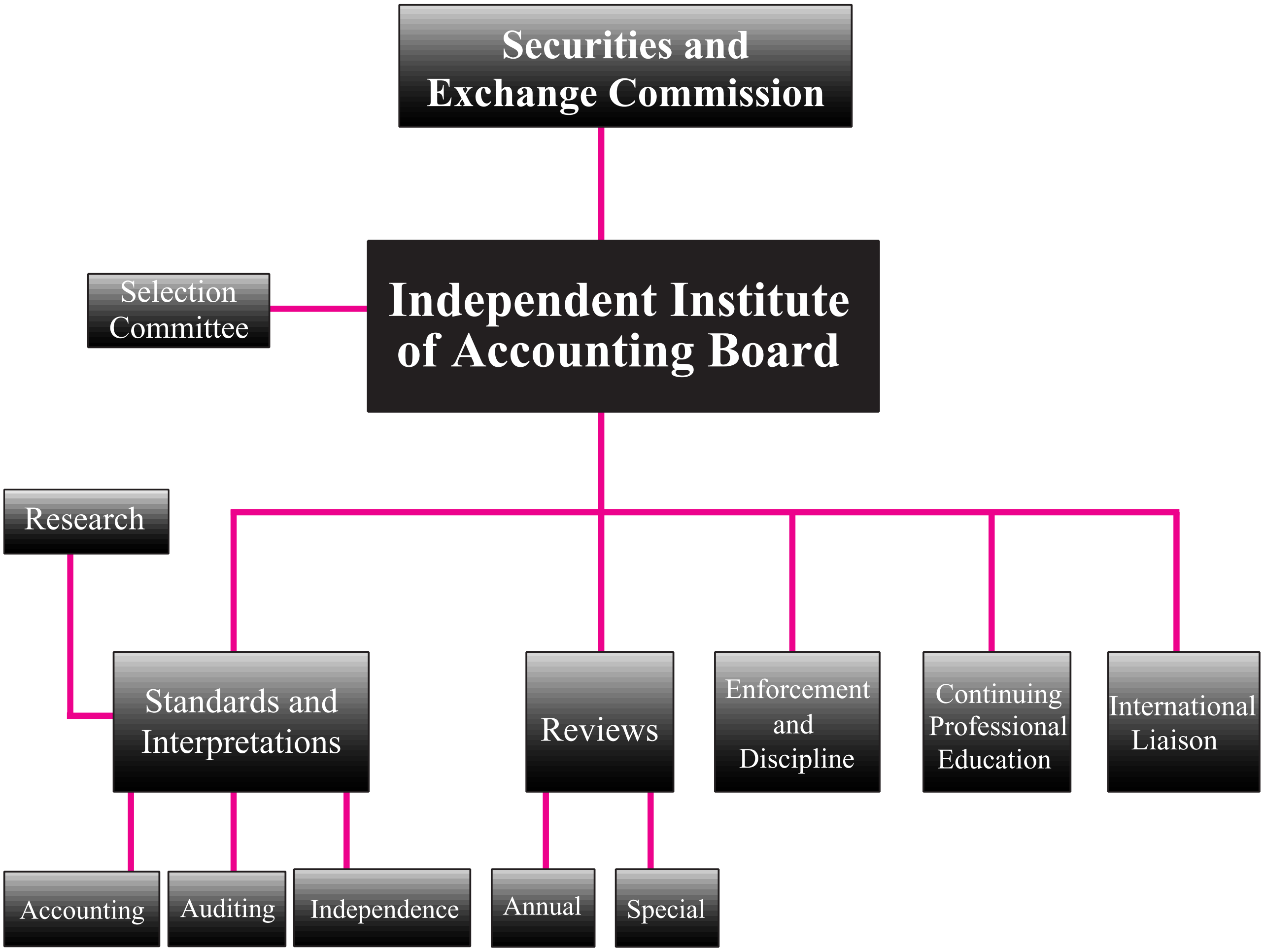
Funding:

Funding would be provided through fees imposed on public corporations in amounts sufficient to cover the costs of the Institute. The POB strongly believes that the funding mechanism must be beyond the reach of the profession to prevent it from withholding necessary funds, as it did in May of 2000.

International Liaison and Professional Education:

The IIA would be charged with coordinating international liaison and overseeing continuing professional education.

Proposed Private Sector Regulatory Structure



POB Activities

During the year ended December 31, 2001 the Board held six regularly scheduled meetings and two special meetings. A significant portion of the Board's time at meetings up to December 31, 2001 was devoted to the initiation of activities to discharge the Board's expanded responsibilities under its new Charter. During those meetings, the Board followed the profession's progress in implementing the recommendations of the Panel on Audit Effectiveness and the status of the planning for the special reviews of the independence quality controls of the eight largest firms that are discussed elsewhere in this report.

As more fully described in later sections of this report, the POB embraced its new and broadened responsibilities under its new Charter, which was adopted February 9, 2001, with enthusiasm and took major steps to discharge them in the public interest. Those steps included recruiting and training additional highly experienced staff to assist in conducting enhanced oversight of traditional SECPS activities, particularly earlier and more extensive oversight of the peer reviews of the largest firms and pilot-testing of peer review enhancements. In addition, our oversight of QCIC cases was expanded to evaluate the implementation of the new disciplinary requirement. The Board and staff conducted oversight of the ASB standards-setting process for the first time. While a POB staff representative was assigned oversight over the Independence Standards Board's (ISB) independence standards-setting, that assignment proved to be short-lived when, in July 2001, the ISB voted to terminate its existence.

In accordance with the Board's Charter, the Board conducted a three-day outreach meeting - the first day in Washington, DC and the second and third days in New York City - to solicit views and recommendations about the accounting profession's self-regulatory program and the POB's oversight process. Participating in this meeting were the Chief Accountant of the SEC, the Comptroller of the Currency, representatives from the GAO, the chief executive officers of the eight largest firms, AICPA and SECPS leadership, and representatives from the ASB, the Financial Accounting Standards Board (FASB), the Transnational Auditors Committee, and academia. Guests were invited to other Board meetings to enhance the Board's understanding of issues facing the accounting profession. We believe the concept of an outreach meeting should be given consideration by the IIA proposed in our White Paper - *The Road to Reform: A White Paper From The Public Oversight Board On Legislation to Create a New Private Sector Regulatory Structure for the Accounting Profession.*

Also in accordance with the Charter, the POB formed and convened a Coordinating Task Force consisting of the chairs of each body within the POB's oversight jurisdiction to exchange information relating to each committee's activities. The Board's Vice Chairman served as the chair of this task force. The first meeting was also attended by the chairs of several bodies not within the jurisdiction of the POB-the Professional Ethics Executive Committee (PEEC), the FASB, the Accounting Standards Executive Committee, and the Peer Review Board.

Sessions were held for the Board to discuss developments in the Section's peer review program and the innovations being pilot-tested; the QCIC process, particularly the implementation of the new disciplinary requirements and coordination with the PEEC; and the process of setting auditing standards. Liaison roles were assigned to Board members relating to oversight of the peer review, QCIC, and auditing standards-setting processes. Board members also played active roles in the oversight of the large firm full-scope peer reviews.

The Board's staff actively participated in deliberations of the various SECPS task forces, particularly those relating to establishing guidelines for conducting the pilot-tests of the peer review innovations and evaluating results.

During 2002 the Board held five meetings during which it decided to dissolve and conducted business related to transition matters and the issuance of this final annual report.

POB Actions Relating to Enron Collapse

The Board has taken a number of actions to protect investors and maintain confidence in our capital markets in light of the Enron collapse.

On January 17, 2002, the Board sent individual letters to the Chairman of the QCIC and to the Chairman of the ASB requesting that they take action on a number of issues raised by Enron's collapse. (These letters can be found on the POB's web site.)

The letter to the QCIC Chairman, copies of which were sent to other interested parties, including members of Congress, the SEC, the General Accounting Office (GAO), the SECPS, the AICPA, representatives from the Big Five accounting firms, the ASB and the FASB, urged the QCIC to review "Andersen's audits of Enron for the year 2000 and relevant prior years to determine whether the alleged audit deficiencies indicate[d] a need for corrective measures by Andersen in its system of quality controls and whether restrictions should be placed on Enron engagement personnel pursuant to the QCIC's recently adopted disciplinary process (beyond those recently taken by Andersen)." (See "Quality Control Inquiry Process" for a status report of QCIC's inquiries into the case later in this report.) The POB also requested that the QCIC look into discussions between Andersen and Enron's audit committee concerning Andersen's evaluation of the critical accounting policies used in Enron's financial statements, Andersen's independence as well as other matters. In addition, the POB urged the QCIC Chairman to "determine if there [were] profession-wide issues that needed to be addressed" and, if there were, to identify them and refer them to the standard-setting bodies for consideration and appropriate action.

The January 17, 2002 letter to the ASB Chairman, copies of which were sent to the same group of interested parties as the letter of the same date to the QCIC Chairman, requested that the ASB review and take appropriate action on the auditing issues related to the Enron matter, including the adequacy of auditing guidance related to off-balance sheet financing, special purpose entities, and energy and other commodity contracts for which there is no readily determinable market.

In addition, the POB was actively involved in overseeing the peer review of Arthur Andersen LLP, Enron's outside auditors, which was completed at the end of last year. In connection with this peer review of Andersen, the peer reviewers extended their procedures in view of Enron's November 2001 announcement that it would restate its financial statements for 1997 through 2000 and also the first two quarters of 2001. The POB staff provided substantial oversight for this extended peer review, including discussing the extended procedures with the peer reviewers and visiting four additional offices, one being the Houston office that conducted the Enron audit. The extended peer review of Andersen included additional procedures that involved reviewing Andersen's policies, guidance materials, training programs and practice aids with respect to those areas that had been identified in the restatements, namely, special purpose entities, issuance of equity instruments for receivables, energy trading contracts, related party transactions, and waived adjustments. (See "Oversight of Large Firms' Peer Reviews" elsewhere in this report for further discussion of the Andersen extended peer review.)

In addition, the POB staff will exercise oversight of the QCIC, which will be considering allegations in the Enron matter to determine whether the facts indicated deficiencies in Andersen's system of quality controls and whether the auditing engagement team complied with professional standards.

Oversight of the Self-Regulatory Structure of the Auditing Profession

In last year's Annual Report, the POB noted that an important milestone in the history of the self-regulatory system of the auditing profession was reached on February 9, 2001, when the POB announced agreement on a Charter aimed at strengthening and broadening its oversight of the profession. In connection with the POB's responsibilities under its Charter, set forth below is a status report on developments relating to the Panel on Audit Effectiveness Report and Recommendations, auditing standards setting, auditor independence, and the look-back and special reviews of the large firms' independence quality controls.

Status Report: The Recommendations of the Panel on Audit Effectiveness

The August 31, 2000 Report of the Panel on Audit Effectiveness contained recommendations directed at 15 groups of stakeholders in the financial reporting process. The POB strongly believes that the public interest demands that all the recommendations made by the Panel should be carefully considered by each stakeholder group and an explanation given for non-implementation or a deviation from implementation of the recommendation. Therefore, the Board urges the successor regulatory organization to continue to monitor implementation and to take action to assure appropriate implementation of the Panel's recommendations.

The Board and its staff followed implementation of the recommendations during 2001. At the direction of the Board, the staff prepared a report, *POB Staff Status Report: The Recommendations of the Panel on Audit Effectiveness as of February 15, 2002*. This report is available on the POB's web site www.publicoversightboard.org. It summarizes the extent to which the various stakeholders have responded to the most significant of the Panel's recommendations. It is intended to be useful to those responsible for regulating or overseeing the accounting profession, particularly the SEC, Congress, and the GAO.

The Panel's overall conclusions included the following:

- The risk-based approach to audits of financial statements is appropriate, but it needs to be enhanced, updated, and implemented more consistently.
- Auditors should perform "forensic-type" procedures on every audit to enhance the prospects of detecting material financial statement fraud.
- The governance of the auditing profession should be enhanced through a strengthened POB that would oversee the setting of auditing standards, the monitoring of auditor performance, and the disciplining of auditors for substandard performance, as well as conduct special reviews as appropriate.

Although a number of the Panel's recommendations have been addressed by the various stakeholders in the financial reporting process, no conclusions can be drawn about the extent to which the actions taken to date have enhanced audit effectiveness. The Panel's report was published less than two years ago and, of the recommendations that were accepted, none of the stakeholders have completed the process of implementating the Panel's recommendations. In many cases, new standards or other forms of guidance or audit policy are at the exposure draft stage; in some cases, new standards, guidance, or policies have been promulgated but are not yet effective; and in most cases audits have not yet been performed under those standards, guidance, or policies. The POB believes that the implementation of those Panel recommendations will enhance audit effectiveness; however, it believes that sufficient time has not yet passed for the benefits of its recommendations to be measured.

Representative John Dingell has indicated his interest in the Panel's recommendations relating to the governance of the auditing profession and has requested that the GAO review and report on their implementation. In that regard, representatives of the POB met with GAO staff and the POB prepared a comprehensive response to GAO's inquiries, *The Public Oversight Board's Response to GAO's June 14, 2001 "Approach Questions"/Meeting with the Public Oversight Board (Congressional Request Related to Chapter 6 of the August 2000 Report of the Panel on Audit Effectiveness)*. The GAO report is expected to be issued in May 2002. In its letter to the SEC Chief Accountant dated April 4, 2002, the POB recommended that, in view of the importance of the Panel's recommendations, the SEC take appropriate steps to assure that the POB's responsibility for monitoring the implementation of those recommendations is taken on, and fulfilled, by an independent entity. (This letter is on the POB web site.) Such action by the SEC would serve the public interest by promoting implementation of the Panel's recommendations, while at the same time assuring the independence and objectivity of the monitoring process. The POB also recommended that the independent entity issue periodic status reports that would be available to the public. In addition, the POB recommended that the SEC consider establishing an independent entity, like The Committee of Sponsoring Organizations of the Treadway Commission (COSO), to take on the responsibility for monitoring the Panel's recommendations.

Auditing Standards-Setting

The POB's February 2001 Charter gave it oversight of the ASB for the first time. The ASB promulgates auditing, attestation, and quality control standards to be observed by members of the AICPA in accordance with its Bylaws and Code of Professional Conduct. The ASB is composed of 15 members, including representatives from international, national, regional, and local firms, as well as representatives from accounting education and state government. The POB's recommendation for a successor private sector regulatory organization includes the ASB under its oversight, as described in the White Paper.

Independence Standards-Setting

The POB's February 2001 Charter gave it oversight of the ISB's independence standards-setting process. Since the ISB voted to terminate its existence in July 2001, the POB staff has observed public meetings of the AICPA's Professional Ethics Executive Committee. The POB Charter provides that the POB would monitor the agenda of PEEC to identify rule-making, regulatory, and standard-setting activities that relate to the audit of public companies for the purpose of communicating information relating to such activities to the Coordinating Task Force, formed by the POB, for appropriate consideration. The PEEC sets independence standards that all AICPA members are obliged to follow in the conduct of audits. (If the SEC has established a more stringent independence requirement in a specified area, auditors are required to follow the SEC requirement with respect to their public clients.)

Look-Back and Special Reviews of Large Firms' Independence Quality Controls

In a letter to the POB dated December 9, 1999, then SEC Chief Accountant Lynn Turner expressed concern that public accounting firms possibly lacked adequate quality controls for independence. As a step to "safeguard the public interest," he "strongly recommend[ed]" that the POB undertake "a special review of SECPS member firms' current compliance" with independence requirements. On December 21, 1999, the POB agreed to do so. Two weeks later, on January 6, 2000, the SEC announced that an internal investigation at PricewaterhouseCoopers LLP (PwC) had disclosed more than 8,000 independence violations of varying degrees of significance. At this time, there were publicly expressed concerns that the widespread independence violations at PwC might also be found at other large accounting firms if they were subject to a similar compliance review. Against this background, the POB commenced preliminary work on the special reviews in January 2000, and had meetings with the firms to discuss the reviews.

Then, in early May 2000, the POB's work on the special reviews was stopped by a decision of the SECPS to cut off the POB's funding for them. Arthur Levitt, the Chairman of the SEC, stated that this was "a significant setback to self-regulation and independent oversight" and raised "serious questions as to the profession's commitment to self-regulation." Melvin Laird, former Congressman and Secretary of Defense and the longest-serving member of the POB, said that this was "the worst incident in my 17 years" on the POB.

The special reviews did not go forward, but shortly afterward, in June 2000, the SEC and the Big 5 firms entered into a "Term Sheet for Independence Look-Back Testing Program" (term sheet), which called for the POB to conduct more limited independence reviews.

Subsequently, on October 10, 2000, the POB received a letter from Mr. Turner asking that the POB do the independence reviews called for by the term sheet "in lieu of" the special reviews previously requested in his December 1999 letter to the POB. The POB agreed to do so, and commenced preliminary work on these reviews in November 2000. Between then and January 2002, a period of more than a year, the POB did a substantial amount of work preparing to conduct the independence reviews. This work included a request for documents sent to the firms and the SEC staff in July 2001 as well as comprehensive work programs for both phase I (evaluation of design and implementation effectiveness) and phase II (testing and evaluation of operating effectiveness) of the reviews, sent to the firms and SEC staff in October 2001 and January 2002, respectively. In addition, the POB was involved in working with the firms on a confidentiality agreement for the independence reviews. The POB's efforts to enter into a confidentiality agreement with the firms, going back to July 2001, met with no success. In addition, by the middle of January 2002, the POB still had not been able to obtain from the firms documents it had requested for the independence reviews in July 2001. This lack of progress in conducting the independence reviews was one of the factors that led to the POB voting to terminate its existence.

In its letter of January 21, 2002 informing Chairman Pitt of the POB's decision to terminate, the POB stated that arrangements had to be made for a transition of its responsibilities. (This letter is on the POB web site.) In this regard, the POB specifically noted that plans had to be made to transfer from the POB to an independent entity the conduct of, and issuance of public reports on, the special independence reviews of the Big 5 accounting firms, agreed to by the SEC and the firms in June 2000.

In a letter to the SEC and the firms dated March 5, 2002, the POB set forth its position on the transfer of its responsibility for conducting the independence reviews and issuing public reports to an independent person and discussed the background of the independence reviews. This letter can be found on the POB's web site.

On March 19, 2002, the SEC announced plans for completing reviews of the design, implementation, and operating effectiveness of each of the five largest firms' systems for assuring compliance with the independence rules. The POB is hopeful that these reviews and the reports on the reviews will be timely completed in a manner consistent with the POB's March 5, 2002 letter, particularly with regard to the scope of the reviews and form and content of the reports.

Efforts to Enhance Peer Review

In response to a Panel recommendation, during the 2001-2002 peer review year, the SECPS pilot-tested a number of innovations in the peer reviews of the 13 largest firms in recognition of the greater public interest in their audit practices. These innovations were intended to make the peer review process more effective by focusing peer reviewers and the firms' internal inspection programs on some of the higher risk areas of audits. Our oversight of the pilot-tests is discussed later in this report under "POB Oversight of the Peer Review Process."

The risk areas covered in the pilot-tests were those identified by the Panel on Audit Effectiveness as requiring additional attention by auditors, peer reviewers, and standards-setters. Reviewers made qualitative assessments of auditing decisions and communicated those assessments to the reviewed firms. The POB believes that focusing on risk areas and the auditing decisions in those areas enhances the peer review process. In addition, a series of topics, including "tone at the top" and independence, were the subject of focus group meetings. The goals of these meetings were to identify (a) areas where the firm's quality control policies and procedures could be strengthened, (b) auditing or other standards that need reconsideration, and (c) best practices that might be shared across firms.

In addition, those large firms that were not scheduled for a triennial peer review were subjected to "specified annual procedures." Those procedures focused on the firms' internal inspection and monitoring procedures to determine whether they were sufficiently comprehensive to identify the need to (a) revise policies and procedures, (b) update guidance materials and practice aids, (c) improve professional development activities, and (d) achieve increased compliance with firm policies and procedures.

The "specified annual procedures" reviews were substantially completed as pilot-tests. However, the contemplated non-public reports were not issued. The pilot-tests did not contemplate public reporting; they were performed to develop additional guidance for developing specified annual procedures and for developing reports on the results. That guidance has now been developed, with input from the POB's staff, and the Peer Review Committee (PRC) has approved it for implementation in the 2002-2003 peer review year.

While the reviewers collected some information on best practices and matters for the attention of standards-setters, the information was not considered by the PRC to be important enough to be reported to others. The reviewers' experiences with the pilot program, however, were discussed at two debriefing sessions held by the PRC. The POB encourages the PRC to collect such information in a more formal manner during the 2002 peer reviews.

During the year, peer review reports reflected the revisions the PRC made to the peer review reporting standards to provide more information about the reviews. For example, the new reports better describe the objectives of a peer review and how they are conducted. In addition, the peer review reports were streamlined to make them more understandable in situations where the reports are modified or adverse.

The innovations implemented in the 2001-2002 year have the capability of enhancing the conduct and transparency of peer reviews. The Board believes, however, that the size and complexity of the large auditing firms require annual reviews. Our further recommendations for enhancing the reviews of firms and other aspects of the governance of the profession are included in *The Road to Reform: A White Paper From The Public Oversight Board On Legislation to Create a New Private Sector Regulatory Structure for the Accounting Profession* (the White Paper), which is included in this report.

The Board believes that it is in the public interest to continue the peer review program during the transition period before the establishment of a successor regulatory structure. In that regard, the SECPS Executive Committee chair stated in a letter to the SEC Chief Accountant dated February 15, 2002 that the SECPS intends to continue the self-regulatory programs, including peer review, during the transition.

The PRC has recently approved enhanced guidance for conducting reviews for 2002-2003. The PRC has identified eleven risk areas, including auditing derivatives and special purpose entities, that will be focused on in both full-scope peer reviews and in the specified annual procedures. We understand that the specified annual procedures will be performed for the "Big 5 firms" not subject to full reviews in 2002 and for other firms opting to subject their firms to such reviews, and that the reviewers will issue reports that will be available to the PRC and the POB and SEC staffs, who will continue to oversee the peer review process.

SECPS Executive Committee

The Executive Committee is responsible for the self-regulatory activities of the SEC Practice Section, which include setting membership requirements for member firms. Membership requirements are intended to enhance the quality of practice by CPA firms before the SEC.

A Board member and staff participate in each meeting of the SECPS Executive Committee and its Planning Committee. As discussed below, since our last Annual Report:

- The Executive Committee updated the independence membership requirement and amended the concurring partner review membership requirement to cover quarterly reviews.
- The Professional Issues Task Force (PITF) issued three Practice Alerts.
- The public files of SECPS member firms became accessible on the SECPS's web site.

As provided in the Board's Charter, the POB was consulted on nominations by the SECPS for membership on the Executive Committee and concurred in the nominations for the chair of that committee, which were approved by the committee and the AICPA board.

Requirements for Specified Annual Procedures

In January 2002 the SECPS Executive Committee approved a requirement that firms meeting certain criteria, to be established by the PRC, undergo "specified annual procedures" in years between triennial peer reviews. The PRC voted to require firms with 500 or more SEC clients to undergo such reviews; they are optional for other firms.

Revised Independence Quality Control Requirements

In November 2000 the SEC issued its final rules on auditor independence, which extensively revised the previous rules. The Executive Committee considered these new rules and on October 10, 2001 adopted an amendment to the independence quality control membership requirement that became effective January 1, 2002. The amendment is intended to enhance compliance with the SEC's new rules, particularly with respect to a member firm's foreign-associated firms.

The letter transmitting the amended membership requirement to SECPS firms noted that the final SEC rules provide a safe harbor for accounting firms for inadvertent impairments of independence by covered persons. The impairment must be eliminated as soon as possible after discovery, and the accounting firm must maintain a quality control system that provides reasonable assurance that the firm and its personnel do not lack independence.

To qualify for the safe harbor, firms with more than 500 SEC attest clients are expected to include eight specified features in their independence quality control systems. Other firms also should have a system, but it does not have to include all eight features to qualify for the safe harbor. The amended membership requirement specifies that, effective January 1, 2002, firms with more than 500 SEC clients must, among other things, have an automated system to identify investments of partners and managers that might impair independence.

No matter how many SEC clients a firm has, for the firm to qualify for the safe harbor, the SEC rules specify that the quality control system encompass "at least all employees and associated entities of the accounting firm participating in the engagement, including employees and associated entities located outside the United States." Accounting firms with more than 500 SEC clients have until December 31, 2002 to implement the eight features in offices outside the U.S. Prior to that date, to come within the safe harbor, those foreign offices must meet a "reasonable assurance" standard for compliance with independence standards.

Revised Concurring Partner Review Requirement

At its January 2002 meeting, the Executive Committee approved a revision to the concurring partner review requirement that is designed to enhance the reliability of interim financial information. Effective for quarters ending on or after March 31, 2002, concurring partners must be involved in reviews of interim financial information in Form 10-Q or 10-QSB. Member firms are expected to have policies and procedures in place that require concurring partners to discuss with the engagement team, before completing an interim review, any matters identified in the review that involve a significant risk of material misstatement of the financial statements, including the footnotes. That involvement is required to be documented.

PITF Practice Alerts

The Executive Committee's Professional Issues Task Force issued three Practice Alerts: *Common Peer Review Recommendations, Audit Considerations in Times of Economic Uncertainty, and Communications with the Securities and Exchange Commission*. These are available on the SECPS web site (www.aicpa.org/members/div/SECPS) and in the AICPA Technical Practice Aids. The Board's staff participates in the accumulation and consideration of practice issues at PITF meetings.

SECPS Public File Now on the Web Site

Beginning in December 2001 the public files of SECPS member firms became accessible on the SECPS web site identified above. The available information includes the most recent peer review report, letter of comments (if any), and the firm's response (if applicable). In addition, the firm's three most recent annual reports to the Practice Section and other relevant documents are available, for example, a description of an undertaking by a firm that is not yet completed to demonstrate to the Peer Review Committee's satisfaction that significant quality control deficiencies have been eliminated.

Peer Review Process

Virtually all U.S. accounting firms that audit publicly held companies belong to the SEC Practice Section and are required to submit to a triennial peer review of their accounting and auditing practice. The objectives of peer review are to evaluate whether the reviewed firm (1) designed its system of quality control for its accounting and auditing practice to meet the requirements of the Quality Control Standards established by the AICPA, (2) complied with its quality control policies and procedures to provide reasonable assurance of complying with professional standards, and (3) complied with the membership requirements of the SECPS, in all material respects. A peer review consists of tests directed at the design of and compliance with the reviewed firm's system of quality control to provide the firm with reasonable, not absolute, assurance of complying with professional standards. Consequently, an unmodified opinion on a firm's system of quality control is not intended to, and does not, provide assurance with respect to any individual audit conducted by the firm or that none of the financial statements audited by the firm will be restated.

The SECPS Peer Review Committee sets the standards for conducting and reporting on peer reviews and oversees the administration of the peer review program. The PRC considers each peer review, evaluates the reviewer's competency and performance, and examines every report, letters of comments if any, and accompanying response from the reviewed firm. Once accepted by the PRC, the reports and letters of comments and response are placed in a public file maintained at the AICPA and are also placed on the AICPA web site.

POB Oversight of the Peer Review Process

Over a three-year period, all 1,230 U.S. accounting firms that belong to the SECPS undergo a peer review. This POB annual report discusses the peer reviews conducted during the 2000-2001 peer review year. The peer reviews were conducted in 2000, and were processed by the PRC in 2000 and 2001. In addition, the report discusses the significant improvements in the peer review process that were implemented on selected reviewed firms in a pilot-test for peer reviews conducted in the 2001-2002 peer review year.

During the 2000-2001 peer review year, 368 SECPS peer reviews were performed, including 256 reviews of firms that audit SEC registrants and 112 reviews of firms with no SEC clients. During the 2001-2002 peer review year, 410 SECPS peer reviews were scheduled, including 274 reviews of firms that audit SEC registrants and 136 reviews of firms with no SEC clients.

The Board's staff performs some level of oversight of every peer review. The levels of oversight are: on-site oversight and working paper review, working paper review only, and selective working paper review. The level of oversight varies with the profile of the firm and the peer reviewer. Firms with large numbers of public clients, a history of performance problems (including litigation, regulatory enforcement actions, and prior reviews resulting in modified reports), and firms undergoing their initial SECPS peer review receive more intensive oversight than other firms. Similarly, the Board's staff closely monitors peer reviewers who have had past performance problems.

Oversight of Large Firms' Peer Reviews

2000-2001 peer review year

During the 2000-2001 peer review year, there was one "Big 5" firm peer review, that of PricewaterhouseCoopers LLP (PwC). That review resulted in an unmodified report, accompanied by a letter of comment, both of which are available on the AICPA web site.

The Board's staff conducted comprehensive, "real-time" oversight of the PwC peer review. POB staff was involved in planning the review, visiting several practice offices during the conduct of the review, reviewing detailed and summarized findings, developing the appropriate report and letter of comment, and communicating the review findings to PwC's senior management at the firm-wide exit conference. The Board's Vice Chairman served as the Board's liaison member on this review and participated in the firm-wide exit conference.

2001-2002 peer review year

As discussed in the Board's 2000 annual report, the SECPS Executive Committee approved the PRC's plan to modify significantly the approach to conducting and reporting on peer reviews. The PRC decided, before developing new detailed peer review standards and procedures, to conduct a pilot program during the 2001-2002 peer review season on selected large and small firms. The largest firms were identified, at least initially, as the 12 firms with 100 or more accounting and auditing professionals and 30 or more SEC audit clients. Those 12 firms were designated as "Tier B" firms. Subsequently, two SECPS member firms merged and, as a combined firm, met the criteria for Tier B, increasing the number to 13.

The disproportionately large number of peer reviews of the larger firms scheduled for the 2001-2002 peer review year made it especially difficult to perform expanded oversight of the peer review process in an effective manner. In order to implement the recommendations of the Panel on Audit Effectiveness and the Peer Review Process Task Force and effectively monitor the results, the PRC decided, with the concurrence of the SECPS Executive Committee, to change the peer review cycle of four large firms (none of which is a Big 5 firm). The peer reviews of three of them were deferred to 2002 or 2003, and the peer review of the fourth was deferred from 2002 to 2003.

On July 20, 2001 the Chair of the PRC wrote to the Chief Accountant of the SEC and the Managing Director, Financial Management and Assurance, of the U.S. General Accounting Office, informing them of the decision to defer the four firms' peer reviews. Those agencies also were informed that each of those firms would have its peer reviewer perform and publicly report on a review of the design of the firm's system of quality control for its accounting and auditing practice and on the firm's policies and procedures related to the SECPS membership requirements. Copies of the letter were sent to other regulatory bodies, such as the Federal Deposit Insurance Corporation, the Rural Utilities Service, and the state boards of accountancy. Also on July 20, 2001, the POB's Chair wrote the same parties informing them that the Board concurred with the SECPS's decision to defer the triennial peer reviews of the four large firms.

Full Scope Reviews. Full scope triennial peer reviews were conducted on five Tier B firms during the 2001-2002 peer review year (Arthur Andersen LLP, Ernst & Young LLP, McGladrey & Pullen LLP, Crowe Chizek and Company, and Richard A. Eisner LLP). Under the active oversight of the POB, the PRC completed guidance to be pilot-tested for these firms and a sample of other firms. Peer reviewers used that guidance on a sample of engagements. They also conducted focus group sessions of seniors and managers within the offices reviewed and increased their interviews of engagement staff whose audits were being reviewed. The reviews of the three largest firms are discussed below.

Andersen Peer Review. Less than a week before the scheduled exit conference for Deloitte & Touche's peer review of Andersen, one of Andersen's largest clients, Enron, announced that it would be restating its audited financial statements for the prior four years and the unaudited financial statements for the first two quarters of 2001. Shortly thereafter, Andersen was named as a defendant in litigation alleging, among other things, deficiencies in its audits of those financial statements. In connection with D&T's reassessment of the scope of its peer review prior to concluding on the review, D&T obtained information related to the restatement and the litigation, and determined that it would perform additional review procedures. Andersen also requested that D&T perform additional work.

The additional procedures included reviewing a sample of audit engagements in Andersen's Houston office, which was primarily responsible for the Enron audit and which had not been previously selected for review. The additional procedures also included specifically reviewing Andersen's policies, guidance materials, training programs, and practice aids with respect to those areas that had been identified in the restatements, namely, special purpose entities, issuance of equity instruments (e.g., shares, warrants, and rights) for receivables, energy trading contracts, related party transactions, and waived adjustments. D&T also reviewed those areas on a sample of engagements in the office primarily responsible for the Enron audit and in three other offices. The additional procedures did not include reviewing Andersen's audits of Enron, since engagements for which there is pending litigation are typically excluded from a peer review under the SECPS's standards for performing peer reviews. In the near future, however, the QCIC will be considering Andersen's audits of Enron.

The POB staff extended its oversight on this peer review, devoting about 700 hours to overseeing this peer review on a real-time basis, including extensive oversight of the additional review procedures described above. The staff's procedures included reviewing D&T's planning for the peer review and its working papers, findings, and analyses of those findings; visiting a majority of the offices that D&T reviewed while the reviews were in process; attending numerous meetings involving D&T and Andersen personnel; being consulted during the development of D&T's report and letter of comments; and attending, along with a member of the POB, the overall exit conference with Andersen's senior management and the exit conference for the Houston office. Based on its oversight procedures and analyses of D&T's findings, the staff concurred with D&T's decision to issue an unmodified peer review report and with the contents of D&T's letter of comments and Andersen's response to that letter. These documents are available on the AICPA web site.

Ernst & Young LLP Peer Review. The POB staff devoted over 400 hours to overseeing KPMG LLP's peer review of E&Y's quality controls. The staff participated in this review from initial planning through final analysis of the peer review findings and development of the report, letter of comments, and exit conference agenda. The staff had extensive field oversight involvement, monitoring KPMG's peer review at one-half of the offices that were peer reviewed. The Board's chairman participated with the staff in evaluating the peer review findings and KPMG's reporting decisions and communicating several suggestions to KPMG relating to the letter of comments before the final exit conference at which KPMG reported its peer review findings to E&Y firm management. The POB chair, another member, and staff actively participated in the exit conference. The unmodified peer review report, the letter of comments and the firm's letter of response are available on the AICPA web site.

McGladrey & Pullen LLP Peer Review. The E&Y peer review of McGladrey & Pullen resulted in the issuance of a modified report because of "instances in certain recently merged practices where pre-issuance reviews should have been more comprehensive." This condition resulted in certain engagements (not involving SEC registrants, insured financial institutions, or audits performed under Government Auditing Standards) not complying with professional standards, as well as instances of non-compliance with the Firm's policies and procedures in several quality control areas.

The POB staff devoted about 300 hours to overseeing this peer review, from the planning phase through the reporting phase. The staff reviewed E&Y's planning for the review, attended the Webcast training program for reviewers, reviewed the findings and the summarizations and analyses of those findings, visited several of the reviewed offices while the reviews were in progress, attended meetings with engagement personnel and focus group sessions with professional staff, attended meetings with M&P and E&Y personnel and Peer Review Committee task forces to consider the appropriateness of the report, and participated, along with the POB Vice Chairman, in a telephonic exit conference with McGladrey's senior management. The modified peer review report and the firm's letter of response are available on the AICPA web site.

Design Reviews and Specified Annual Procedures Reviews. The four Tier B firms that had their full scope triennial reviews deferred (BDO Seidman LLP, BKD LLP, Grant Thornton LLP, and Moss Adams LLP) underwent design reviews during the 2001-2002 peer review year. All received an unmodified peer review report without a letter of comments. The reports are available on the AICPA web site.

The PRC developed a set of specified annual procedures for all Tier B firms not undergoing a full scope triennial peer review or a design review during the 2001-2002 year. However, while substantially all of the review procedures were applied to the four firms (PricewaterhouseCoopers LLP, Deloitte & Touche LLP, KPMG LLP, and J. H. Cohn LLP), none of the reviews was completed or reported upon. (See "Efforts to Enhance Peer Review" elsewhere in this report.)

The POB staff performed extensive oversight over the design reviews and specified annual procedures reviews. The oversight procedures included reviewing the planning for each of the reviews, the reviewers' working papers, findings, and analyses of those findings; visiting an office of the reviewed firm while the reviewers were observing and testing the firm's monitoring procedures; and, for the design reviews, reviewing the reports issued and attending the overall exit conference with the firm's senior management.

Oversight of the Other Firms' Peer Reviews

2000-2001 peer review year

During the 2000-2001 peer review year, the Board's staff directly participated, through on-site visits, in the reviews of 48 other firms with SEC clients. During those visits, the staff reviewed the peer review working papers, evaluated the qualifications of the reviewers, reviewed the scope and findings with the review team, and participated in the final exit conference with representatives of the reviewed firm. Also, the staff often reviewed clients' financial statements and the auditors' supporting working papers to obtain a better understanding of the review findings and to test the comprehensiveness of the reviewers' work. Twenty of the firms visited had more than five SEC clients, three had received modified or adverse reports on their previous peer review, and eleven were undergoing their initial review. The Board's staff visited and participated in the reviews of 41% of the firms with more than five SEC clients, 21% of the firms with SEC clients that received modified reports during their previous peer review, and 26% of the firms undergoing their initial peer review.

In addition to the on-site visits, the Board's staff reviewed the peer review reports and all the underlying working papers for reviews of 99 firms. The staff discussed significant issues and findings with the review team, determined whether the reviewers had the industry and regulatory qualifications to perform the review, and obtained explanations and clarifications of matters regarding the scope of the review, the significance of systemic and engagement findings, and the consistency of findings in the peer review reports. The Board's staff concluded that all significant matters were properly addressed, resolved, and reported on in accordance with the peer review standards.

For the 221 firms (of which 112 have SEC clients) not subject to the more intensive visitation and working paper review oversight programs, the POB staff performed a review that was limited to reading the peer review reports and selected working papers. In those instances, the SECPS staff performed either an on-site visit or a detailed review of the peer review reports and working papers. The SECPS staff performed a more limited review of the peer review reports and working papers for the peer reviews on which the POB staff performed either an on-site visit or a working paper review.

2001-2002 peer review year

For the 2001-2002 peer review year, the Board's staff is currently overseeing the peer reviews of 398 firms (13 Tier B firms and 385 smaller firms) and expects to oversee 12 additional reviews of Tier A firms that have not yet been performed. The staff participated in on-site oversight of 50 of the smaller firms, is reviewing the peer review reports and working papers for 102 firms, and is performing a more limited review of the peer review reports and working papers for the remaining 233 firms (of which 98 have SEC clients).

PRC's Consideration of Peer Review Reports and Imposition and Monitoring of Corrective Actions

After either the Board's staff or the SECPS staff reviews a peer review, the report is presented to either the entire PRC or the Evaluations Task Force (ETF) of the PRC. The ETF meets once or twice a month to consider and accept the individual peer review reports. Because of the high public interest in firms with many SEC clients, reports on firms with 30 or more SEC clients are considered and accepted by the entire PRC. During those meetings, the Board and SECPS staffs participate in the discussions and communicate significant matters that arose in the course of their oversight. Once the ETF or the PRC accepts the reports, they are placed in the public files at the AICPA and on the AICPA web site.

As part of its processing of peer review reports, the PRC and ETF consider whether the findings warrant additional follow-up to assure that the public interest is properly protected and the firm is taking appropriate corrective actions to address its peer review findings.

When the PRC concludes that the corrective actions proposed by a reviewed firm in response to the peer review findings are not adequate or that similar deficiencies have occurred on successive peer reviews, the committee usually requests that the reviewed firm implement additional specific corrective actions. In addition, if the design or compliance deficiencies are particularly severe, the PRC may ask the firm to demonstrate that the corrective actions have been implemented to the satisfaction of the review team captain or another outside party. The firms reviewed in the 2000-2001 peer review year that were subject to such actions have agreed to accept all the remedial corrective actions requested by the Committee. Table I summarizes Committee-imposed corrective actions.

The PRC and ETF have considered and processed all 368 of the 2000-2001 peer reviews and as of March 31, 2002, 284 of the anticipated 410 2001-2002 peer reviews.

The PRC met four times in 2000-2001 and nine times in 2001-2002. A Board member, staff member, or both participated in each of those meetings. The ETF met 24 times to consider the 2000-2001 peer review reports, and through March 31, 2002, 19 times to consider the 2001-2002 peer review reports; the Board's staff participated in all of those meetings.

Sanctions Imposed on a Member Firm

One member firm, Harold Y. Spector, CPA, received an adverse report on its 1999 peer review. The PRC accepted the adverse report with the understanding that the firm had agreed to certain remedial actions. Those actions were not taken, and as a result the committee recommended to the SECPS Executive Committee that the firm be sanctioned. On December 17, 2001 a Hearing Panel of the SECPS Executive Committee voted to expel the firm from the Section, and to report that expulsion in The CPA Letter. On February 8, 2002 an Appeal Panel upheld the decision of the Hearing Panel.

SEC Oversight of Peer Reviews

Since 1982, the SECPS and the Board have had a formal "Memorandum of Understanding" with the SEC that provides it with access to the peer review process and the POB staff's oversight procedures. The purpose of SEC oversight, as described in the Memorandum, is to enable the SEC staff to make its own independent evaluation of the peer review standards, the effectiveness of the application of those standards in assuring the quality of audits performed by those who practice before the SEC, and the effectiveness of the POB's monitoring and oversight of the peer review program. For the 2000-2001 peer review year, the SEC staff visited the Board's offices and reviewed the peer review reports, peer review working papers, and Board oversight files on the reviews of 38 firms. The SEC staff also reviewed the Board's oversight files on the reviews of an additional 52 firms.

In January 2002 the SEC published its Annual Report for the year ended September 30, 2001, which discussed the SEC staff's oversight of the SECPS peer review process and the POB oversight process. As was the case with the SEC's 2000 Annual Report and unlike in certain prior years, the SEC's 2001 Annual Report did not provide an evaluation of whether the profession's peer review process is an effective means of improving the quality control systems of member firms.

Summary and Conclusions

The Board believes that the peer review process continues to contribute to improvements in the quality control systems of member firms and to the quality of auditing performed in the United States. The report of the Panel on Audit Effectiveness contained many recommendations to improve the effectiveness of peer reviews. Unfortunately, some of the major recommendations have not been acted upon and others have been rejected. By way of example, the Panel on Audit Effectiveness recommended that the SECPS should "[m]ake clear to peer review team captains and reviewers that the POB, not the firm being reviewed, is the primary client. Peer reviews are performed to enhance the public's confidence in independent auditors; the POB, as the public's representative, should be viewed as the principal stakeholder in this process." (Section

6.40 of the Panel on Audit Effectiveness Report and Recommendations dated August 31, 2000 at page 148.) The PRC rejected the Panel's recommendation saying that the PRC, not the POB, is responsible for maintaining and administering the peer review program. The PRC did adopt a related Peer Review Process Task Force recommendation to address the peer review reports to both the PRC and the reviewed firm, but did not adopt the recommendation of the Panel that the POB be the primary client of peer review.

In its White Paper, the POB recommended that firm-on-firm peer review be discontinued for firms that audit more than 100 public corporations each year. In its place, employees of the proposed IIA would conduct thorough and comprehensive yearly reviews of such firms.

The Panel on Audit Effectiveness recommended that the POB and its staff expand their oversight throughout the reviews of the largest firms by attending important meetings and interviews with firm personnel and by reviewing draft peer review reports before they are provided to others. Notwithstanding the increased involvement that the POB and its staff had in their oversight of the reviews of the largest firms, there were occasions when discussions of the preliminary engagement findings between the reviewers and engagement personnel preceded POB staff involvement. In addition, the drafts of some reports were discussed with the reviewed firms before they were provided to the POB.

***Table I*—Major Corrective Actions Imposed by the Peer Review Committee to Ensure that Quality Control Deficiencies are Corrected**

	Number of Actions	
Action	**12 Months Ended 6/30/01**	**Since Inception (1978)**
Accelerated peer review	1	55
Employment of an outside consultant to perform preissuance reviews of financial statements or other specified procedures	19	137
Oversight by the peer reviewers or by a Peer Review Committee member to monitor progress made by the firm in implementing corrective actions	17	251
Oversight of the firm's internal monitoring program	38	476
Changes made in the firm's quality control document or other guidance materials	7	51
Continuing professional education in specified areas	21	92*

** Since July 1, 1988, as data for prior years are no longer available.*

Quality Control Inquiry Process

The Quality Control Inquiry Committee ascertains whether allegations of audit failures against member firms involving SEC registrants and certain other entities indicate (a) a need for the respective firms to take specific corrective actions to improve their quality control systems, or (b) profession-wide issues that need to be addressed. The QCIC's inquiry is sufficiently detailed to determine whether there are possible performance issues that the reporting firms need to address. The quality control inquiry process is critical to the profession's self-regulatory program and is a necessary complement to the peer review process.

Reporting of Cases

Member firms are required to report to the QCIC, within thirty days of service, all litigation alleging deficiencies in the conduct of an audit of the financial statements of a SEC registrant. Pursuant to its organizational document, the QCIC also may identify a significant public interest in an alleged audit failure that the member firm is otherwise not required to report. The committee screens those alleged failures, and if it determines that the allegations indicate a possible need for corrective measures by the member firm, the QCIC requests the member firm to voluntarily report the case. If a member firm refuses to do so, the SECPS Executive Committee determines whether the case should be added to the QCIC's agenda.

This section reports on cases reported to and acted upon by QCIC from July 1, 2000 through March 31, 2002. During that period, the committee screened two cases that would otherwise not have been required to be reported. One involved litigation by the FDIC against a member firm alleging an audit failure in the audit of a bank. The other involved litigation brought by a state attorney general against a member firm alleging an audit failure in the audit of a large not-for-profit entity. Both firms voluntarily reported the cases.

Oversight of the Quality Control Inquiry Process

The Board and its staff have access to the QCIC process and actively participate in the discussion of the implications of the allegations in each case that takes place at meetings of the committee. For each case, the POB staff reviews the complaints submitted by the member firm, SEC Accounting and Auditing Enforcement Releases against company personnel and accountants, relevant financial statements and regulatory filings, and other publicly available documents. The Board's staff participated in virtually all QCIC task force meetings (99) with member firms during the period covered by this report. The information obtained from participation at those meetings and from reading the aforementioned documents serves as the basis for a comprehensive report prepared by the POB staff on each case, which is discussed at a Board meeting.

QCIC Activity

The QCIC began the period with 51 cases on its agenda. Ninety-six new cases were opened during the period, and 95 cases were closed. At March 31, 2002 there were 52 open cases.

As part of its initial analysis of each case reported by a member firm, the QCIC reviews the complaints, applicable financial statements and regulatory filings, and other relevant public documents. During the period, the QCIC determined that there were no quality control or personnel issues to pursue on 7 cases and closed them after its initial analysis.

For the other 88 cases that were closed, the QCIC task forces met with firm representatives to gain an understanding of the work performed in the areas of alleged audit failure and the potential implications for the firm's quality control policies and procedures. Where appropriate, the QCIC task forces reviewed firm guidance materials and, on occasion, selected engagement working papers relevant to particular allegations.

Cooperation of Firms with the QCIC

The QCIC monitors the timeliness with which member firms report cases to the committee. During the period, one Big 5 firm reported a number of cases late. Senior management of the firm was informed, and they have subsequently advised the committee that the firm's procedures for reporting complaints have been revised to ensure future timely reporting.

The committee advised another Big 5 firm that its personnel were not sufficiently prepared to respond to the committee's inquiries, and as a result it was necessary to have more than one meeting for a number of that firm's cases. The firm's general counsel was informed and a liaison audit partner met with the QCIC and POB staffs in an effort to understand the committee's concerns. It appears that this firm is working to improve its communications with QCIC's task forces.

Enron

As noted earlier under "POB Actions Relating To Enron Collapse," the Board wrote to the QCIC requesting that it review the performance of Andersen, the audit partners, and other senior members of the audit engagement team on Enron as soon as possible to determine if the facts indicate deficiencies in Andersen's system of quality controls or its performance on the audits. The POB suggested that particular attention be given to off-balance sheet financing and energy trading contracts, among other matters. The Board also requested that the QCIC inquire about discussions between Andersen and Enron's audit committee concerning Andersen's evaluation of the critical accounting policies used in Enron's financial statements and the implications for auditor independence of the non-audit services provided to the company.

The QCIC has assigned a task force to the case, one member of which participated in the firm-wide exit conference for Andersen's 2001 peer review in December 2001, at which D&T reported the results of its expanded peer review to Andersen management. The QCIC also has forwarded the Board's letter to Andersen. The QCIC staff has analyzed the allegations in the many complaints filed to date alleging audit failure. A meeting with Andersen representatives is planned for a future date.

Communications with Standards Setters and the PITF

The Panel on Audit Effectiveness recommended that the QCIC bring its considerable experience to bear in assisting the Auditing Standards Board in improving auditing standards and other guidance to auditors regarding fraud detection. The QCIC formed a task force that met with the ASB's Fraud Task Force as it prepared the Exposure Draft of a proposed Statement on Auditing Standards (SAS), *Consideration of Fraud in a Financial Statement Audit*, which is discussed elsewhere in this report. The chair of the ASB's Fraud Task Force also met with the QCIC to discuss proposed procedures to facilitate the detection of fraud by auditors.

At the QCIC's February 2002 meeting, the committee decided that the QCIC task force should comment on the Exposure Draft. The ASB Chair plans to attend the QCIC's May 2002 meeting to discuss this and other matters.

The QCIC considered a case in which the registrant changed its method of evaluating certain reserves and recorded a significant increase in those reserves. The auditor concluded that this was a change in estimate that did not require an explanatory paragraph in its report. The committee questioned whether the report should have had an explanatory paragraph disclosing a change in accounting principle inseparable from a change in estimate. The QCIC conducted a survey of the Big Five firms and only one would have included an explanatory paragraph in its report. Consequently, the QCIC asked the ASB to consider this issue. The ASB plans to do so.

The committee noted that additional audit guidance also is needed in the area of alternative procedures to the confirmation of receivables arising from the sale of software licenses, when confirmations are not received from customers or distributors. For example, an alternative procedure typically applied is the examination of shipping documents; however, shipping documents do not exist for the sale of software licenses. The QCIC plans to discuss this matter with the chair of the ASB at its May 2002 meeting.

The QCIC noted a lack of uniformity among firms in identifying and communicating certain internal control matters that are defined in the professional literature as "reportable conditions." The QCIC also plans to discuss this matter with the ASB chair.

The QCIC believes that additional guidance is necessary for auditors performing interim reviews in situations where a client's internal control system is weak and, accordingly, plans to ask the ASB to give consideration to this issue during its re-evaluation of SAS 71, Interim Financial Information.

Consultation with Industry Specialists

The Panel on Audit Effectiveness recommended that the QCIC establish a panel of industry specialists and experts, whose members would be drawn from the profession and industry, to consult with it as required.

Each QCIC member completes a form indicating his or her industry and functional knowledge. This inventory is used as the basis for assigning members to cases and for identifying members who might serve as consultation resources.

In addition, the QCIC looks to the largest firms to provide consultation on industry or functional (e.g., derivative valuation) issues. The committee concluded that the consultation knowledge the QCIC needs can be found within the firms.

Referral of Individuals to the Professional Ethics Division

In 1998 the QCIC and the Professional Ethics Division developed a Memorandum of Understanding to avoid duplication of efforts and to streamline the ethics process. Prior to the Memorandum, the Ethics Division opened an investigation in the majority of cases that QCIC closed. The 1998 agreement between the two committees was designed to focus the Ethics Division's efforts by categorizing each case the QCIC closes into one of four categories, ranging from frivolous with a recommendation for no action by the Division with respect to engagement personnel to an explicit recommendation that the Division open an investigation.

Since July 1, 2000, the QCIC informed the Division of 16 cases in which it believed there may be significant engagement personnel issues and recommended that the Division determine whether or not to open an investigation. The Division has reviewed all of these cases and decided to open investigations in 15 of them. In addition, the QCIC recommended to the Division that an investigation be initiated in 12 other cases; the Division opened investigations for each of those cases.

The QCIC also becomes aware of CPAs who are employed by companies that are audited by member firms and whose behavior may warrant investigation. During the period, the QCIC referred 19 such CPAs, principally chief financial officers and other accounting officers, to the Ethics Division, which opened cases on those individuals who were AICPA members.

Statistical Summary of Closed Case Questionnaires

The QCIC has established a database of information about litigation and enforcement actions against auditors to identify problem areas and trends. The database includes information on all cases closed since 1999 and, to the extent information is available, on other cases closed since December 1997. It does not identify either the registrant or the auditor.

A report, *QCIC Summary of Closed Case Questionnaires*, which summarizes information on 177 cases, was distributed to all SECPS member firms. In 57 cases, the QCIC recommended that the Ethics Division either open an investigation or evaluate whether to open one. The QCIC noted indications of management fraud in 65 cases; nevertheless, in 34 of these cases, the committee questioned the adequacy of the auditors' performance.

Registrants in the computer hardware and software industry and other high-tech companies represented 30% of the cases. Other observations included: (1) 60% of the cases involved companies with revenue of less than $200 million, (2) 40% of the cases involved companies whose initial public offering was within the three years preceding the litigation, (3) 36% of the cases involved restated financial statements, and (4) 18% involved a change in auditors during the three years prior to the period covered by the complaint.

Implementation of New Self-Disciplinary Membership Requirement

A new self-disciplinary membership requirement was implemented for cases reported to the QCIC after January 1, 2001. When the QCIC has concerns about the performance of individual auditors, it refers the case to the Professional Ethics Division to determine whether or not individual performance-specific issues warrant investigation. The Division defers its investigation, however, until all litigation is concluded, with deferral often extending several years. The new requirement is designed to protect the public from possible substandard performance during the period between the referral to the Division and the conclusion of the Division's investigation.

Once the deferral takes place, the member firm must select one of three options with respect to the audit engagement partner (and sometimes other members of the engagement team). The implementation of the option the member firm selects is subject to review during the member firm's peer review and by the POB. The options are:

- Terminate or retire the individual from the member firm.
- Remove the individual from performing or supervising audits of public companies until the Division's ethics enforcement process is complete.
- Subject the individual to additional oversight on all audits of public companies in which the individual is involved.

Since January 1, 2001, the effective date of the new membership requirement, the QCIC closed 23 cases, of which three were subject to the requirement, and the Division decided to investigate them at the suggestion of the QCIC. One firm has elected the second option and another firm has elected the third option. The firm involved in the third case has not yet elected an option; however, the engagement partners on the audit in question are not presently serving as engagement partners.

This new membership requirement has increased significantly the importance of the QCIC's evaluation of the performance of personnel involved in alleged audit failures. The Board supports the QCIC's role in the disciplinary process, and recognizes the potential effects on the careers of individual engagement partners. The POB believes that the committee has been diligent in discharging this new responsibility.

SEC Access to the QCIC Process

As part of its responsibilities for oversight of the accounting profession, the SEC actively monitors the QCIC process. After each QCIC meeting, the SEC staff visits the POB's offices to review the SECPS's and the POB's closed-case files and to discuss them with the QCIC and POB staffs. The Chief Accountant of the SEC participated in a recent SEC oversight visit and has been invited to attend a portion of the QCIC's May 2002 meeting.

Summary and Conclusions

The Board believes that the QCIC process is functioning as designed and effectively complements the peer review process. The Board believes the recent revisions to the self-disciplinary process are in the public interest and commends the QCIC for the work they have done this year. The QCIC process is valuable in identifying needed improvements to the firms' quality control systems and areas where the profession would benefit from additional standards or guidance.

We note that the QCIC does not meet with the individuals who conducted the allegedly deficient audit, and only occasionally reviews work papers. The committee's ratings are based largely on the review of publicly available information and inquiries of firm personnel who have reviewed the audit (and other audits performed by members of the engagement team on the allegedly deficient audit) so they can respond to the committee's inquiries.

In its White Paper, the POB has recommended that the proposed IIA be given the privilege of confidentiality as well as the power of subpoena to compel testimony and produce documents. This would allow investigators to interview individuals who conducted the allegedly deficient audit and obtain relevant work papers.

Table II– **QCIC Activity**

	12 Months ended 6/30/01	9 Months ended 3/31/02	Inception (11/1/79) through 3/31/02
Actions Related to Firms			
Either a special review was made, the firm's regularly scheduled peer review was expanded, or other relevant work was inspected	8	1	85
A firm took appropriate corrective measures that were responsive to the implications of the specific case	11	6	152
Actions Related to Standards			
Appropriate AICPA technical bodies were asked to consider the need for changes in, or guidance on, professional standards	1	3	54
The Professional Issues Task Force was asked to consider the issuance of a Practice Alert	2	-	28
Actions Related to Individuals			
Cases opened by the AICPA Professional Ethics Division as a result of QCIC's concern about the performance of senior audit personnel	19	8	96
	41	18	415

(Note: Frequently more than one action is taken by the QCIC or by the firm on an individual case.)

The Auditing Standards Board

The Auditing Standards Board promulgates auditing, attestation, and quality control standards to be observed by members of the AICPA in accordance with its Bylaws and Code of Professional Conduct. The ASB is composed of 15 members, including representatives from international, national, regional, and local firms, as well as representatives from accounting education and state government. The POB's Charter, adopted in February 2001, expanded the POB's oversight authority to include the ASB. This oversight includes:

- *Consulting with the AICPA Board of Directors on new ASB member nominations and concurrence with nominations for the ASB chair.*
- *Attending ASB meetings.*
- *Evaluating the implementation of ASB standards through the peer review process.*
- *Recommending issues for consideration for inclusion on the agenda of the ASB.*
- *Evaluating the effectiveness of the ASB and the adequacy of its resources.*

POB Oversight of the ASB's Process of Setting Auditing Standards

During 2001 the Board and its staff initiated their oversight of the ASB. The POB's primary concern in its oversight role is that the process of setting auditing standards is one that promotes the public interest by improving the way that audits are performed and increasing the reliability and credibility of financial statements.

A POB member reviewed information about the qualifications and experience of the five individuals nominated in 2001 for membership on the ASB and consulted with the AICPA about them. Members for the ASB's 2001-2002 year include one representative from each of the eight largest accounting firms, five from local or regional firms, one from academia, and one from government. The chair continued in his second year in that role.

A Board member and staff attended all meetings of the ASB and had the privilege of the floor to comment and raise questions. A staff member also attended and participated in selected meetings of ASB task forces, including the:

- Audit Issues Task Force, whose activities include overseeing the ASB's planning process.
- Fraud Task Force, which has developed proposals for an auditor's consideration of fraud in a financial statement audit.
- SAS No. 71 Task Force, which is revising standards for reviews of interim financial information.

A staff member also attended liaison meetings of the ASB with the SEC and the FASB.

The ASB advises the POB of its agenda and provides copies of all documents to be discussed at the meetings. The POB has full access to ASB members, including the chair, as well as the AICPA Audit and Attest Standards staff to discuss draft documents and offer comments and suggestions. The POB also has the opportunity to interact with the ASB members and the AICPA staff to aid in its evaluations.

We have reported separately on the status of responses to the recommendations of the Panel on Audit Effectiveness, many of which were addressed to the ASB. The ASB has devoted significant attention to the recommendations and its agenda has reflected responses to many of them. Our oversight includes monitoring the ASB's responses.

Enron

On January 17, 2002, the Board communicated to the chairs of both the QCIC and the ASB issues requiring their attention relating to alleged deficiencies in the audits of Enron's financial statements. (See "POB Actions Related to Enron Collapse" in this report for further discussion of those communications.)

New Standards

Since our oversight began, the ASB has issued the following new standards:

- SAS No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit*, which expands existing standards to provide guidance to auditors about the effects of information technology on internal control and the assessment of control risk.
- SAS No. 95, *Generally Accepted Auditing Standards*, which establishes a hierarchy of auditing literature by identifying the body of literature and clarifying the authority of its various components, thereby reducing uncertainty about those publications with which the auditor must comply.
- SAS No. 96, *Audit Documentation*, which replaces a prior SAS on working papers with more specific guidance and requirements designed to improve the quality of audit documentation.

Proposed Fraud Standard

In February 2002 the ASB issued an exposure draft of a proposed SAS, *Consideration of Fraud in a Financial Statement Audit*. This proposal would establish standards and provide guidance to auditors in fulfilling their responsibilities as they relate to fraud.

The proposed SAS, which expands the current guidance in SAS No. 82, is intended to effect a substantial change in auditors' performance, thereby improving the likelihood that they will detect material misstatements due to fraud. The proposal increases the focus on professional skepticism. Auditors would set aside any prior beliefs they may have about management's honesty and integrity when considering the possibility of fraud, and should not be satisfied with audit evidence that is less than persuasive because of a belief that management is honest.

Auditors would plan responses to identified risks of material misstatement due to fraud, which, in the audits of most public companies, would include revenue recognition. Responding in part to the risk of management override of controls, the proposal also specifies other audit procedures that would be applied in the audit of every public company.

If adopted, the proposal would be effective for audits of financial statements for periods beginning on or after December 15, 2002.

Other Publications

Since the POB's oversight began, the ASB has issued or reviewed a variety of other documents issued by the AICPA, including three interpretations of the SASs, two Statements of Position, and four Audit Guides.

International Projects

The ASB has undertaken several steps to help converge national and international auditing standards. The ASB and the International Auditing Practices Committee (IAPC) coordinate their activities by attending each other's meetings, forming joint committees, and observing and monitoring the activities of each other's task forces.

In January 2002 the ASB issued an invitation to comment on an IAPC proposal for auditing fair values, with the intent that both organizations will issue similar standards. The IAPC also is monitoring closely the progress of the ASB's proposed fraud standard.

A major effort is underway to review and amend the basic audit risk model, under the direction of the Joint Risk Assessments Task Force, a combined effort of the IAPC and the ASB. The task force is reviewing the auditor's consideration of the audit risk process, including the necessary understanding of the entity and its environment, the entity's response to risk, and how the auditor should use risk assessments in planning audit procedures.

Summary and Conclusions

On the basis of our oversight activities, we believe that (1) the ASB operated effectively in 2001, (2) the ASB members had the appropriate qualifications and performed professionally and diligently, and (3) the resources made available to the ASB were adequate.

A White Paper From

The Public Oversight Board

On

Legislation to Create a New Private Sector

Regulatory Structure for the Accounting Profession

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Introduction

On January 20, 2002, the Public Oversight Board (POB) - created in 1977 to oversee the voluntary self-regulatory structure for the accounting profession in the United States - voted to terminate its existence not later than March 31, 2002. For the POB, this action was taken as a matter of conscience and principle.

In a report prepared for the Senate Committee on Governmental Affairs in August 1980, the Securities and Exchange Commission (SEC) pointed out that for a self-regulatory program for the accounting profession to be successful, strong leadership from the POB is essential. The POB, wrote the SEC, "should serve as the conscience and critic of the self-regulatory effort." The POB's charter makes it clear that it is independent and the purpose of its oversight activities is "to represent the public interest on all matters that may affect public confidence in the integrity, reliability and credibility of the audit process."

At the time the POB was created, there were concerns that it might not be the right solution. John C. Burton, a distinguished professor of accounting at Columbia University and the chief accountant at the SEC in 1977, warned in congressional testimony in 1978 that "it is highly doubtful that a part-time group [POB] can either in fact or perception" provide an effective substitute for statutory regulation.

Meanwhile, Harold M. Williams, who was chairman of the SEC at the time the current self-regulatory system was being created in the late 1970s, warned in a speech in January 1978, that "[t]he effectiveness and credibility of the Public Oversight Board depends on its independence, including its willingness to be critical when called for and its ability to make public its conclusions, recommendations, and criticisms." Chairman Williams also made the point that an effective POB could only be effective "if it is not impeded in performing its functions and responsibilities."

Following its decision to terminate, the POB decided to prepare this paper to outline its proposals to create a new regulatory structure for the accounting profession. These proposals stem from the POB's extensive experience with the profession's voluntary self-regulatory system, its knowledge of problems that confront that system, and its insights on the need for change. The primary purpose of this paper is to present the case for legislative action creating an independent regulatory organization in the private sector.

The POB felt it would be helpful to provide a brief history of how the current regulatory structure came into being; to discuss problems affecting the present regulatory structure; to provide the POB's views on enforcement, discipline, and several other issues facing the profession; and to discuss the POB's decision to terminate.

Executive Summary

Over the past two years, the POB has faced increasing obstacles that have impeded its ability to carry out its oversight functions. As a consequence, the POB feels it must perform its role as "conscience and critic" because events of recent months have demonstrated that the warnings of Dr. Burton and Chairman Williams have come to pass.

Three events are noteworthy in how the POB has been frustrated in its ability to effectively carry out its responsibilities.

- On May 3, 2000, the SEC Practice Section (SECPS) - an organization within the American Institute of Certified Public Accountants (AICPA) - took the unprecedented step of notifying the POB that it would refuse to pay for special reviews of public accounting firms. The special reviews in question had been sought by the SEC to determine whether the firms had complied with SEC and professional independence standards. The decision of the SECPS to deny funding to the POB was a serious blow to independent oversight of the accounting profession. Melvin Laird, the former congressman and Secretary of Defense, who served on the POB longer than any other member, said that this was “the worst incident in my 17 years” on the POB.

- Following the decision to cut off funding of the POB’s special reviews requested by the SEC, the largest accounting firms - the Big 5 - agreed with the SEC that the POB should instead conduct more limited independence reviews of the large firms. Despite this agreement, the next 21 months were marked by delay and lack of progress. The POB, in the end, was unable to conduct the reviews.

- For years, the POB had carried out its oversight responsibilities under a set of bylaws adopted after it was created in 1977. The POB felt that a formal charter would improve the independence of the Board, and a charter was one of the primary recommendations in 2000 of the Panel on Audit Effectiveness, created by the POB at the request of the SEC. However, objections from the AICPA and the Big 5 caused negotiations to drag on for more than a year. Ultimately, a new charter took effect in February 2001.

When the POB voted to terminate its existence, the lack of progress in connection with the independence reviews and the frustrations that stemmed from the funding cut off and slow negotiations over the new charter all played a role. But the precipitating factor was the decision of the SEC to develop a new regulatory structure in private talks with the AICPA and the Big 5 firms, with no consultation with the POB. The SEC did not consult with the POB even though the POB had been established by the AICPA, in consultation with the SEC, to protect the public interest.

When the POB initially learned of these talks, it asked to be included in the process and was promised that it would be consulted. That consultation never took place. In the end, the POB was simply informed - on the day of the announcement of the proposed new structure - that there was no continued role for the POB in this structure, rendering it a “lame duck.” The POB determined that it could not effectively oversee the activities of the accounting profession under the circumstances, and that it would mislead the public to appear to do so. Furthermore, the POB was concerned that if it were to continue during an interim period before a new governance structure was in place, it would leave the impression that the POB approved of the SEC proposal, which it did not. Thus, as a matter if principle, it voted to terminate its existence.

The Public Oversight Board strongly believes that a new regulatory structure for the accounting profession is essential and that, to be effective, it must be based on the foundation of federal legislation.

The Board recommends that Congress create a new Independent Institute of Accountancy - the IIA - and center all regulation under its auspices. A seven-member board would run the Institute totally independent of the AICPA, the Big 5, and other firms. The chair and vice chair would be full time employees of the Institute; five other members would serve on a part time basis. All would be appointed by a panel composed of the chair of the SEC, the chair of the Federal Reserve Board and the Secretary of the Treasury. Once named, the chair of the IIA would join these three in naming other members of the board. Members of the IIA board could be removed only by a two-thirds vote of the board itself.

The SEC would have oversight of the IIA, and the SEC’s Office of the Chief Accountant would be the liaison to the IIA.

Important functions of the Institute would include:

- The IIA would exercise oversight for all standard setting for accounting, auditing, and independence, and their interpretation. Accounting standards are just as important as auditing and independence standards. For this reason, the POB believes the Financial Accounting Standards Board (FASB) should be brought under the umbrella of the IIA, which would take responsibility for its oversight and funding.

- Firm-on-firm peer review would be discontinued for firms that audit more than 100 public corporations each year. In its place, IIA employees would conduct comprehensive and thorough yearly reviews of the annual internal inspections of such firms. Unlike peer review, no activities of a firm would be off limits to Institute reviewers and the process would produce informative public reports. Substantial staff resources to conduct these reviews will be needed.

  In addition to the reviews, IIA employees would conduct special reviews, when warranted. Similar to those the SEC originally asked the POB to undertake, these reviews would take a systemic, in-depth look at a firm's systems, policies, procedures, and operations. If necessary, such special reviews would delve into questions affecting the firm's compliance with applicable professional standards. As with the yearly reviews, reports of these special reviews would be public.

- An Office of Enforcement and Discipline within the IIA would have full authority to investigate allegations of wrongdoing by public accounting firms and their personnel. The POB recommends giving the IIA the privilege of confidentiality as well as the power of subpoena to compel testimony and produce documents. Cases of alleged misconduct could be brought before hearing examiners. When warranted, these examiners could recommend to the IIA board the imposition of sanctions, ranging from fines to expulsion from the profession. Cases could be referred to the Justice Department for possible prosecution, or to the SEC, state boards of accountancy, or other agencies, as appropriate.

- Funding would be provided through fees imposed on public corporations in amounts sufficient to cover the costs of the Institute. The POB strongly believes that the funding mechanism must be beyond the reach of the profession to prevent it from withholding necessary funds, as it did in May of 2000.

- The IIA would be charged with coordinating international liaison and overseeing continued professional education for those in the profession.

Beyond these functions, the POB recommends that:

- With regard to non-audit services for audit clients, the POB recognizes that there has been disagreement on restricting scope of services and that various models have been suggested for what should be allowed and what should be excluded.

  The POB strongly agrees with a point made in President Bush's 10-point reform plan that "Investors should have complete confidence in the independence and integrity of companies' auditors." The specifics on the President's plan recognize the importance of prohibiting certain non-audit services in order to safeguard auditor independence.

  The POB takes note of a statement issued by the AICPA on February 1, 2002, in which it affirmed that it "will not oppose federal legislation restricting the scope of services that accountants may provide their public audit clients, specifically in information technology and internal audit design and implementation."

Against this background, the POB proposes that SEC regulations concerning independence be legislatively codified with appropriate revisions to update restrictions on scope of services involving information technology and internal audit services as noted above. At the same time, the POB believes such legislation should affirm that tax work not involving advocacy and attest work by audit firms in connection with SEC registration and other SEC filings be allowed. The POB also believes that small public businesses, to be defined by the SEC, should not be subject to any restriction on non-audit services for audit clients. Further, with respect to non-public corporations, it is the POB's position that such corporations and the accounting firms that audit them should not be subject to any restriction on non-audit services. We expressly emphasize this to avoid misunderstanding and any consequences to small business and small audit firms.

The IIA Office of Standards should be empowered by legislation to promulgate appropriate rules affecting independence to cover changing circumstances.

The POB believes there should be no prohibition against an audit firm offering non-audit services to non-audit clients.

- Auditors should be rotated every seven years. As a corollary, public corporations would be prohibited from firing auditors during their term of service unless such action is determined by the audit committee to be in the best interest of shareholders, with prompt notice to the IIA and the SEC. Such action would be required to be publicly disclosed by corporations in current reports and proxy statements filed with the SEC.
- Engagement and other partners who are associated with an audit should be prohibited from taking employment with the affected firm until a two-year "cooling off" period has expired.
- The Institute should expand on the recommendations of the recent Blue Ribbon Committee which made it clear that the external auditor should be accountable to a firm's board of directors and its audit committee and not to management. Specifically, the audit committee should take full responsibility for hiring, evaluating, and - if necessary - terminating an audit firm.
- To discourage conflicts of interest involving public corporations, Congress should amend the Securities Exchange Act of 1934 to require more meaningful and timely disclosure of related party transactions among officers, directors, or other affiliated persons and the public corporation. Such disclosures should be made promptly in current reports as well as in proxy statements filed with the SEC.
- Management of public corporations should be required to prepare an annual statement of compliance with internal controls to be filed with the SEC. The corporation's chief financial officer and chief executive officer should sign this attestation and the auditor should review it. An auditor's review and report on the effectiveness of internal controls would - as the General Accounting Office (GAO) found in a 1996 report - improve "the auditor's ability to provide more relevant and timely assurances on the quality of data beyond that contained in traditional financial statements and disclosures." Both the POB and the AICPA supported the recommendation when the GAO made it, but the SEC did not adopt it.

A Brief History of Self-Regulation

The Stock Market Crash of 1929 and Its Aftermath

The 1929 crash revealed a general absence of accounting and auditing standards, thereby permitting public companies to report financial position and results of operations that sometimes bore little relation to economic reality. The crash and ensuing depression led to congressional hearings, which in turn led to several pieces of reform legislation, beginning with the Securities Act of 1933 and the

Securities Exchange Act of 1934. The Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, and the Investment Company Act and Investment Advisers Act of 1940 followed. These acts require, or permit the SEC to require, as the SEC summarized in 1994, "that financial statements filed with the Commission by public companies, investment companies, broker/dealers, public utilities, investment advisors, and others, be certified (or audited) by independent accountants."

Although audits of public corporations were common before the federal securities acts of 1933 and 1934, they had not been required by statute. Beginning in April 1932, the New York Stock Exchange (NYSE) requested corporations applying for listing to agree to have their annual financial statements audited by independent accountants.

The 1929 market crash revealed improper accounting practices at large public companies that had become bankrupt. In 1939, the AICPA's Committee on Accounting Procedure issued the first Accounting Research Bulletin and the AICPA's Committee on Auditing Procedure issued the first Statement on Auditing Procedure. At present, accounting standards are issued by FASB, auditing standards are issued by the AICPA's Auditing Standards Board (ASB), and interpretations of the Code of Professional Conduct are issued by the AICPA's Professional Ethics Executive Committee - all of which are private sector bodies.

The 1970s - Expansion of the Regulatory Structure

The major reforms of the 1930s and the regulatory system they created survived for more than 40 years with only minor modifications. That the regulation of the accounting profession remained unchanged for so long may be attributed in part to the relatively few allegations of audit failures during most of that period, at least in comparison with later years.

To this day, the responsibility for promulgating auditing and ethical standards resides within the AICPA. The AICPA also was responsible for promulgating accounting standards until mid-1973 through its Committee on Accounting Procedure and its successor body, the Accounting Principles Board. Both of those committees were comprised principally of practicing auditors, often those who were responsible for their firms' accounting policies. In 1973, responsibility for promulgating accounting standards passed to FASB in the belief that the setting of accounting standards by an independent body with no ties to either auditors or preparers of financial statements would enhance the public's confidence in the financial reporting process. At the same time, the Financial Accounting Foundation was created to raise funds for FASB, among other tasks, and a Financial Accounting Standards Advisory Council was created to advise FASB on its agenda and deliberations. That structure remains largely unchanged today.

A series of cases involving alleged audit failures in the 1970s led the AICPA to create the Commission on Auditors' Responsibilities, chaired by Manuel F. Cohen, a former chairman of the SEC. Those cases involved fraudulent financial reporting and illegal or questionable corporate acts, such as bribes, political payoffs, and kickbacks. The Cohen Commission's *Report, Conclusions, and Recommendations* issued in 1978 made numerous recommendations to improve audit practice in several areas. Those recommendations led to the promulgation of Statements on Auditing Standards (SAS) that increased the auditor's responsibility to detect and report fraudulent financial reporting and illegal acts by corporate management. Several other auditing standards can be traced either to Cohen Commission recommendations or to specific audit failures and the litigation that they spawned.

The same cases that spawned the Cohen Commission also led to hearings by both the Senate and House of Representatives in 1977 and 1978. In particular, the Senate's Subcommittee on Reports, Accounting, and Management of the Committee on Government Operations (the Metcalf subcommittee) held hearings to determine whether additional governmental regulation of the accounting profession was necessary or a system of professional self-regulation was sufficient.

In response to these hearings, the AICPA, in consultation with the SEC, created a voluntary self-regulatory framework consisting of the SEC Practice Section (SECPS) of the Division for CPA Firms, with an independent POB to oversee the activities of the Practice Section and to monitor and comment on matters that affect the public interest in the integrity of the audit process - a structure that exists to this day. While no additional governmental regulation was imposed once the voluntary self-regulatory system was created in the 1970s, Congress did pass the Foreign Corrupt Practices Act (FCPA) in 1977, following Senate hearings which revealed the payment of bribes by American corporations to foreign officials. The FCPA made it clear that bribery of foreign officials by American companies is an unacceptable and illegal practice. The act required SEC registrants to maintain a system of internal accounting controls to provide reasonable assurance that certain objectives would be achieved. For example, transactions must be executed consistent with management authorization and be recorded to permit preparation of financial statements in conformity with generally accepted accounting principles and to maintain accountability for assets. In addition, the FCPA required public corporations to make and keep books and records which, in reasonable detail, accurately and fairly reflect underlying transactions.

The 1980s and 1990s - Congressional Hearings and Legislation

As noted in a September 1996 report of the GAO, *The Accounting Profession - Major Issues: Progress and Concerns*, “In the 1980s, continued business failures, particularly those involving financial institutions, led to a series of congressional hearings on auditing and financial reporting under the federal securities laws.” Two major pieces of legislation resulted from those hearings: the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) and the Private Securities Litigation Reform Act of 1995. While those laws increased responsibilities for auditors, they did not address the regulatory structure of the accounting profession.

FDICIA added Section 36 to the Federal Deposit Insurance Act to provide early identification of needed improvement in financial management at banks and savings and loan institutions. Management’s responsibilities under regulations implementing Section 36, which apply to institutions with total assets of $500 million or more, include reporting on management’s responsibility for and assessment of the effectiveness of the institution’s internal controls over financial reporting. Each institution is required to have an audit committee composed of outside directors independent of management. Audit committees of institutions with $3 billion or more in assets must include members with relevant banking or financial expertise, have access to their own outside counsel, and exclude large customers. Under Section 36, the independent accountant must examine and report on management’s assertions about the institution’s internal controls over financial reporting, using the AICPA attestation standards. This requirement constitutes one of the few statutory or regulatory requirements that independent auditors report publicly on client internal controls.

The Private Securities Litigation Reform Act of 1995 addressed the concerns of Congress and regulators about auditors’ responsibilities with respect to their clients’ compliance with laws and regulations and about how instances of noncompliance were reported. Those concerns led to inclusion in the act of a requirement that auditors of public companies notify the SEC of material illegal acts when an entity’s management and board of directors have failed to take timely and appropriate remedial action.

The 1996 GAO report, which was commissioned by Rep. John Dingell (D-Mich.), the ranking minority member of the House Committee on Energy and Commerce, identified five major issues discussed in the various studies concerning the accounting profession from 1972 through 1995: (1) auditor independence, (2) auditor responsibilities for fraud and internal controls, (3) audit quality, (4) the accounting and auditing standard-setting processes and the effectiveness of financial reporting, and (5) the role of the auditor in the further enhancement of financial reporting.

The report summarized the results of these reviews as follows:

> GAO's analysis of the actions taken by the accounting profession in response to the major issues raised by the many studies from 1972 through 1995 shows that the profession has been responsive in making changes to improve financial reporting and auditing of public companies. Further, GAO's analysis of statistical data on the results of peer reviews of accounting firms that audit public companies registered with the SEC shows that most firms now have effective quality control programs to ensure adherence with professional standards. However, GAO's review of the studies' findings shows that the actions of the accounting profession have not been totally effective in resolving several major issues. Issues remain about auditor independence, auditor responsibility for detecting fraud and reporting on internal controls, public participation in standard setting, the timeliness and relevancy of accounting standards, and maintaining the independence of FASB.

While the profession and the SEC subsequently have addressed several of the issues that the GAO review identified as being unresolved in 1996, a number of them, such as reporting on internal controls, remain unresolved in 2002.

Changes in the Practice and Culture of Accounting Firms

The business model that describes the practice of the large accounting firms - a wide array of financial services performed both domestically and internationally for both audit clients and others - has existed for many years.

Each of the large public accounting firms provide accounting and auditing services, tax services, and management consulting services, and the largest firms provide those services globally through overseas offices and foreign affiliates. These characteristics have existed for decades. As the Cohen Commission noted in 1978:

> Before independent audits became widespread in the United States, public accountants were already performing a variety of other services. Public accountants in the early 1900s offered advice on accounting systems, kept accounting records, prepared financial statements and tax returns, and performed a variety of consulting services, including appraisals.

The Cohen Commission also noted that "large corporations typically operate at a number of different locations. A public accounting firm must provide services at many places throughout the country and the world." The Panel on Audit Effectiveness, citing SEC data, noted in its 2000 report that:

> the number of foreign companies that have registered securities in the United States has almost tripled since 1990. . . . The securities of many U.S. companies registered with the SEC are traded outside of the United States, and the financial statements of those companies may be filed with non-U.S. regulators. The financial statements of many U.S. companies and foreign companies are available to investors or creditors in numerous countries, irrespective of the jurisdiction that regulates such companies.

While multi-faceted practices of the international accounting firms described above have existed for many years, the extent to which non-audit services are provided to audit clients and the globalization of the profession have changed over the years. Superimposed on the growth of non-audit services and globalization is the high level of competition among the firms for audit clients in recent years that many believe has changed the culture of auditing practice.

Certain non-audit services provided to audit clients - particularly the design and implementation of large integrated information systems and internal audit and valuation services - have long raised concerns about both the fact and the appearance of auditor independence, and thus about the quality of audits. The size of the fees from those services in many cases and their relationship to the amount of audit fees from the same client has added to those concerns. Similar concerns about audit quality are a natural result of a firm's international practice in countries that do not have the same level of accounting, auditing, and quality control standards as the United States. Lastly, some fear that excessive competition for audit clients has driven audit fees down to a level that cannot support a quality audit but that serves primarily to provide the firm with "a foot in the door" for marketing other services.

Some have suggested that an increasing appetite for growth and profits is now driving the "culture" and "tone" of most accounting firms. Accounting firms sometimes seem to view their clients - even their audit clients - as "business partners." There are also those who contend that audits are sometimes used as "loss leaders" to build a relationship with a client for the marketing of the accounting firm's non-audit services.

One can question whether, together with the natural reluctance to lose the audit fee, a diminished professionalism makes it more difficult for a firm to reject a client's proposed accounting treatment. There seems to be little doubt that the forces described in this section as presenting challenges to audit quality were present in several of the widely publicized recent business and audit failures. And that, in turn, suggests the need for additional regulation of the profession and a degree of oversight that significantly exceeds what exists at present.

The SEC's 1998 and 2000 Initiatives

In a September 1998 speech at the New York University (NYU) Center for Law and Business, SEC Chairman Arthur Levitt noted that "qualified, committed, independent and tough-minded audit committees represent the most reliable guardians of the public interest." He announced that the NYSE and the National Association of Securities Dealers had agreed to sponsor a "blue-ribbon" panel to develop recommendations "to empower audit committees and function as the ultimate guardian of investor interests and corporate accountability." The committee's report was issued in February 1999.

The SEC responded with new disclosure rules in December 1999. Among them is the requirement that a report by the audit committee be included in the company's proxy statement, indicating whether the audit committee has, among other things:

- reviewed and discussed the audited financial statements with management;
- discussed with the independent auditors the matters required to be discussed by auditing standards (which includes the quality of the accounting principles and underlying estimates reflected in the financial statements); and
- discussed with the auditors their independence.

In addition, the SEC adopted a rule requiring that independent accountants review a company's interim financial information before the company's quarterly report is filed.

The major stock exchanges also responded to the committee's recommendations by enacting rules covering the independence, qualifications, and composition of audit committees, including a requirement that committee members be financially literate. The exchanges further required that the audit committee adopt a formal written charter approved by the board of directors; the exchanges also specified that the charter should contain minimum audit committee responsibilities.

Also in 1999, the Independence Standards Board (ISB) adopted Independence Standard No. 1, *Independence Discussions with Audit Committees*. The standard requires that, at least annually, an auditor intending to be considered an independent accountant with respect to a specific entity under the federal securities acts shall:

a. disclose to the audit committee of the company (or the board of directors if there is no audit committee), in writing, all relationships between the auditor and its related entities and the company and its related entities that in the auditor's professional judgment may reasonably be thought to bear on independence;

b. confirm in the letter that, in its professional judgment, it is independent of the company within the meaning of the Acts; and

c. discuss the auditor's independence with the audit committee.

In his 1998 NYU remarks, Chairman Levitt also proposed that "the Public Oversight Board form a group of all the major constituencies to review the way audits are performed and assess the impact of recent trends on the public interest." In response, the POB formed the Panel on Audit Effectiveness. Its report and recommendations, issued in August 2000, are discussed below.

In November 2000, the SEC adopted amendments to its auditor independence rules. These amendments to the independence requirements placed limits on certain services, particularly information technology and internal audit services, that accounting firms may provide to their audit clients without impairing their independence. In those two areas in particular, the final independence rule was not as restrictive as the rule originally proposed - it did not completely prohibit auditors from providing them to their audit clients. In early 2002, in apparent response to concerns emanating from the Enron collapse, the five largest accounting firms announced their intent to no longer provide any internal audit or certain information technology services to their audit clients.

The release containing the SEC's revised independence rules noted the risk of compromised independence when a former partner, principal, stockholder, or professional employee of an accounting firm is hired by an audit client of the firm. Accordingly, under the Commission's final rule, as under the then existing requirements, an auditor's independence is impaired when such an individual is employed in an accounting or financial oversight role at an audit client, unless certain conditions are met. Both the SEC and the ISB considered the notion of a mandatory "cooling off" period before accounting firm personnel join an audit client. Neither body adopted it because of concerns it would unnecessarily restrict the employment opportunities of former firm professionals.

The POB's Role in the Voluntary Regulatory Structure

As previously noted, the POB is a private sector body - independent of the accounting firms, the AICPA, and the SEC - that was created in 1977 by the AICPA in consultation with the SEC for the purpose of overseeing and reporting on the self-regulatory programs of the SECPS.

In addition to its ongoing monitoring and oversight responsibilities, the POB has undertaken or commissioned special studies and reviews over the years. The reports emanating from them have had a significant effect on regulation of the accounting profession and the quality of audits. The following are examples of these reports:

- *In the Public Interest: Issues Confronting the Accounting Profession*, which contained recommendations designed to enhance the usefulness and reliability of financial statements, strengthen the performance and professionalism of auditors, and improve self-regulation (1993).

- *Strengthening the Professionalism of the Independent Auditor*, which contained recommendations in the areas of auditor independence, involvement of audit committees and boards of directors with independent auditors, litigation reform, and the relationships among the accounting profession, standard-setting bodies, and the SEC (1994).

- Report and Recommendations of the Panel on Audit Effectiveness, which is discussed below (2000).

In addition to its ongoing oversight of the peer review and quality control inquiry processes, the POB's principal activities in 2001 and 2002 centered around monitoring the implementation of the recommendations of the Panel on Audit Effectiveness, overseeing the ASB, and preparing for the reviews of the firms' systems, procedures, and internal controls relating to independence, as discussed below. Over the past year, the POB has made significant additions to its full-time and part-time staff to carry out expanded oversight and monitoring responsibilities called for in the new charter.

The POB's charter affirms that it is independent and specifies that the purpose of the POB's oversight activities is, as noted above, "to represent the public interest on all matters that may affect public confidence in the integrity, reliability and credibility of the audit process." The public interest is represented by the quality, breadth, integrity, and stature of the members of the POB, which the Board believes should serve as a model for the future membership of any successor oversight body. The POB's first chairman was John J. McCloy, former high commissioner for Germany who also served his country in many other capacities over a long and distinguished career. He was followed by Arthur Wood, former CEO and chairman of Sears, Roebuck & Co., and then by another distinguished public servant, A. A. Sommer, a former SEC commissioner and securities lawyer. Other former board members included Melvin R. Laird, former member of Congress and Secretary of Defense, who served on the POB for 17 years, and Paul H. O'Neill, who resigned from the board to become Secretary of the Treasury. The current Board consists of Charles A. Bowsher, former Comptroller General of the United States, who was appointed to the Board in 1999 to serve as its chairman; Norman R. Augustine, former chairman and CEO of Lockheed Martin; Aulana L. Peters, former SEC commissioner; and John H. Biggs, chairman and CEO of TIAA-CREF. Donald J. Kirk, former chairman of FASB, resigned as vice chairman on January 18, 2002.

The Panel on Audit Effectiveness

As previously indicated, in October 1998, at the request of SEC Chairman Arthur Levitt, the POB appointed the Panel on Audit Effectiveness to examine the way independent audits are performed and to assess the effects of recent trends in auditing on the public interest. The panel issued its report and recommendations on August 31, 2000. Its recommendations were addressed to many constituencies - standard setters, accounting firms, the SECPS, audit committees, the SEC, and others - and covered a wide range of matters, including:

- Conduct of audits, including the auditor's responsibility for the detection of fraud (including earnings management when it constitutes fraud).
- Leadership and practices of audit firms.
- Effects on auditor independence of non-audit services provided to audit clients.
- Governance of the auditing profession.
- Strengthening the auditing profession internationally.

The panel's report received widespread endorsement. SEC Chairman Levitt, for example, stated that "[i]mplementation of the specific recommendations made by the [p]anel to improve the audit process through more comprehensive and vigorous audit methodologies and standards will engender greater confidence among investors that they are receiving high-quality audits." He also commended the members of the panel "for their proposals to improve the self-regulatory framework of the profession." POB Chairman Bowsher predicted that the report would play an important part in setting a future course for the accounting profession.

No conclusions can yet be drawn about the extent to which the actions taken to date to implement the panel's recommendations have enhanced audit effectiveness. The panel's report was published less than two years ago, and the process of responding to the panel's recommendations is incomplete.

Experience With Self-Regulation

The POB experience with self-regulation of the accounting profession has varied throughout the period of its existence. For years, the profession and the AICPA were responsive to the POB and the need to improve audits to enhance investor confidence in financial statements of public corporations.

The environment changed in recent years as accounting firms expanded greatly the scope of their services which, in turn, led to a re-examination of the concept of independence by the SEC. During the late 1990's, the relationship between the accounting profession and the SEC became very strained, with division among the Big 5 on whether to support or oppose the SEC.

During the same period, the relationship between the accounting profession and the POB also became strained over the adoption of a charter for the POB, particularly with respect to the section in the charter dealing with funding. In effect, the proposed POB charter became hostage to the dispute among the accounting profession and the SEC over resolution of proposed revisions to the independence requirements and rules. But, even during this period, several of the Big 5 supported the POB.

The relationship between the accounting profession and the POB was further strained when the POB, at the SEC's request, attempted to conduct reviews of the Big 5 firms' policies, procedures and internal controls related to independence. The SEC and the firms had agreed to these reviews, and requested the POB to conduct such reviews and issue written reports on them. Some of the firms, unfortunately, adopted an approach that resulted in delay and a lack of progress. This did not permit the POB to conduct the reviews.

In the final analysis, the experience with voluntary self-regulation has been mixed in recent years. The AICPA and several of the Big 5 firms, in the view of some, saw the POB's role as one of a "shield" for the profession rather than as an independent overseer.

Mr. Levitt, the former SEC chairman, also described this problem in testimony before the Senate Banking Committee in February 2002. "More than three decades ago," he said, "Leonard Spacek, a visionary accounting industry leader, stated that the profession couldn't 'survive as a group, obtaining the confidence of the public…unless as a profession we have a workable plan of self-regulation.' Yet, all along the profession has resisted meaningful oversight."

Problems with Current System of Self-Regulation

The current system of self-regulation of the accounting profession has significant problems.

First, the funding of the POB is subject to control by the firms through the SECPS, which in the past has cut off that funding in an effort to restrict POB activities.

Second, the disciplinary system is not timely or effective. Disciplinary proceedings are deferred while litigation or regulatory proceedings are in process. This results in years of delay and sanctions have not been meaningful. The Professional Ethics Division of the AICPA, which handles disciplinary matters against individuals, does not have adequate public representation on its Board. Investigations by the Quality Control Inquiry Committee of the SECPS, which handles allegations of improprieties in litigation against member firms arising out of audits of SEC clients, do not normally include access to firm personnel and work papers. The disciplinary system does not include the power to issue subpoenas or compel testimony. Thus, investigators must rely on the cooperation of the individual being investigated. The QCIC has no access to the complaining party or the client involved. Furthermore, there is no privilege or confidentiality protection for investigations or disciplinary proceedings, and disciplinary actions are often not made public.

Another problem is that monitoring of firms' accounting and auditing practices by the peer review process has come to be viewed as ineffective, as either a diagnostic or remedial tool. More important, the process has lost credibility because it is perceived as being "clubby" and not sufficiently rigorous. Finally, the peer review team does not examine the work of an audit that is under investigation or in litigation.

Other problems include the fact that the current governance structure does not have the weight of a congressional mandate behind it. There is also a perceived lack of candid and timely public reporting of why and how highly publicized audit failures and fraud occurred and what actions have or will be taken to ensure that such problems do not recur.

Auditing Standards and Termination of the ISB

The Auditing Standards Board (ASB) was not subject to oversight by an independent entity until it was put under the oversight of the POB in February 2001. In contrast, under the SEC's proposed governance structure for the accounting profession announced in January by SEC Chairman Harvey Pitt, there will be no oversight of the ASB other than by the profession's trade association, the AICPA. Most of the members of the ASB are associated with the eight largest public accounting firms.

The auditing standards promulgated by the ASB have not provided sufficiently specific and definitive guidance, a weakness noted in the Panel on Audit Effectiveness Report and Recommendations issued on August 31, 2000.

During a speech in January 1978, then-SEC Chairman Harold Williams stated, "The issue of independence is the key one" for the accounting profession. The Independence Standards Board (ISB), which was established in 1997, was terminated in July 2001 because both the AICPA and SEC, for different reasons, did not agree with what the ISB had done. The ISB was established to create, codify, and interpret independence standards for auditors of public companies. Its termination has left a significant void.

The Public Oversight Board Charter

For more than two decades, the POB operated under a set of bylaws, but without the benefit of a charter. Creation of a charter to provide expanded and greater assurances of POB independence became a priority of the Board in December 1999, and was one of the key recommendations of the Panel on Audit Effectiveness, which issued its draft report in May of 2000 and its final report in August of the same year. Yet it took over a year - from December 1999 to February 2001 - to negotiate a new charter.

The primary reason for this delay was the resistance of the AICPA and the large firms to various points. For example, the AICPA and accounting profession, contrary to the recommendation of the Panel on Audit Effectiveness, wanted limitations on POB funding. In addition, for many months they opposed giving the POB authority to approve nominations for the chairs of the SECPS executive committee and the ASB, even though they acknowledged that in the past, the POB, in effect, had approved those nominations informally.

In the end, the POB adopted a pragmatic attitude in order to further the public interest. A charter was approved which gave the POB expanded oversight and an enlarged budget and staff. It took effect in February 2001.

The recommendations of the Panel on Audit Effectiveness, including a formal charter for the POB, were designed to improve the existing voluntary self-regulatory system, not to create a new regulatory structure for the profession. At the time of the panel's recommendations in August 2000, neither the POB nor members of the panel thought it was likely that Congress would approve a statutory regulatory organization to govern the profession.

Independence Reviews

In a letter to the POB dated December 9, 1999, then SEC Chief Accountant Lynn Turner expressed concern that public accounting firms possibly lacked adequate quality controls for independence. As a step to "safeguard the public interest," he "strongly recommend[ed]" that the POB undertake "a special review of SECPS member firms' current compliance" with independence requirements. On December 21, 1999, the POB agreed to do so. Two weeks later, on January 6, 2000, the SEC announced that an internal investigation at PricewaterhouseCoopers LLP (PwC) had disclosed more than 8,000 independence violations there. At this time, there were publicly expressed concerns that the widespread independence violations at PwC might also be found at other large accounting firms if they were subject to a similar compliance review. Against this background, the POB commenced preliminary work on the special reviews in January 2000, and had meetings with the firms to discuss the reviews.

Then, in early May 2000, the POB's work on the special reviews was stopped by a decision of the SECPS to cut off funding for them. Mr. Levitt, the Chairman of the SEC, stated that this was "a significant setback to self-regulation and independent oversight" and raised "serious questions as to the profession's commitment to self-regulation." Melvin Laird, former Congressman and Secretary of Defense and the longest-serving member of the POB, said that this was "the worst incident in my 17 years" on the POB.

The special reviews did not go forward, but shortly afterward, in June 2000, the SEC and the Big 5 firms entered into a "Term Sheet for Independence Look-Back Testing Program" (term sheet), which called for the POB to conduct more limited independence reviews.

Subsequently, on October 10, 2000, the POB received a letter from Mr. Turner asking that the POB do the independence reviews called for by the term sheet "in lieu of" the special reviews previously requested in his December 1999 letter to the POB. The POB agreed to do so, and commenced preliminary work on these reviews in November 2000. Between then and January 2002, a period of more than a year, the POB did a substantial amount of work preparing to conduct the independence reviews. This work included a request for documents sent to the firms and the SEC staff in July 2001 as well as comprehensive work programs for both phase I (evaluation of design and implementation effectiveness) and phase II (testing and evaluation of operating effectiveness) of the reviews, sent to the firms and SEC staff in October 2001 and January 2002, respectively. In addition, the POB was involved in working with the firms on a confidentiality agreement for the independence reviews. The POB's efforts to enter into a confidentiality agreement with the firms, going back to July 2001, met with no success. In addition, by the middle of January 2002, the POB still had not been able to obtain from the firms documents it had requested for the independence reviews in July 2001. This lack of progress in conducting the independence reviews was one of the factors that led to the POB voting to terminate its existence.

In a letter to the SEC and the firms dated March 5, 2002, the POB set forth its position on the transfer of its responsibility for conducting the independence reviews to an independent person and discussed the background of the independence reviews. This letter can be found on the POB's web site at *www.publicoversightboard.org*.

The POB Decision to Terminate

As noted above, although the POB commenced preliminary work on the independence reviews in November 2000, by January 2002, it still had not been able to obtain information and documents it had requested from the firms in July 2001. The POB was concerned that the lack of progress on the independence reviews would continue. This lack of progress was one of the considerations that caused the POB to vote its intention to terminate its existence no later than March 31, 2002.

However, the precipitating factor in the POB's decision to terminate was the announcement of a proposed new self-regulatory structure by SEC Chairman Pitt. The POB was not consulted on this new proposed governance structure for the accounting profession, announced by Mr. Pitt at a press conference on January 17, 2002, even though the POB had requested and been assured that it would have the opportunity to provide input as the proposals were being developed and prior to any public announcement. Instead, without including the POB in the process, the SEC worked privately with representatives of the AICPA and the Big 5 firms and developed the new SEC proposal. Thus, the private sector entity which was charged with oversight of the profession's self-regulatory activities and with representing the public interest had no input into what may well be the most significant change in regulating the accounting profession in the last 30 years.

A January 23, 2002 article in *The Wall Street Journal* reported that a spokesman for PwC confirmed that chief executives of the Big 5 firms, including PwC, had held a series of private meetings with the SEC chairman in Washington between December 4, 2001, and January 17, 2002, on this matter, and that the gatherings "took place at Mr. Pitt's invitation."

On the same day that one of these meetings was being held, December 4, 2001, Charles Bowsher, Chairman of the POB, had a discussion with Barry Melancon, President and CEO of the AICPA, at the John J. McCloy dinner hosted by the POB. During this discussion, which also included James Castellano, Chairman of the AICPA, Mr. Melancon told Mr. Bowsher that the profession and the SEC were working on proposed changes to the governance structure of the accounting profession. Mr. Bowsher specifically asked that the POB be included in any such discussions so that it would be able to provide input before any public announcement of a proposed new structure. Mr. Melancon assured Mr. Bowsher that this would be done.

At a meeting of the SECPS executive committee on January 4, 2002, Mr. Bowsher, Aulana Peters, a POB member, and Jerry Sullivan, the POB Executive Director, were told that a proposed governance structure for the profession would be announced within a month. Messrs. Bowsher and Sullivan and Ms. Peters asked that the POB be "brought in the loop" and be given an opportunity to participate. They were told the POB would be consulted.

The SEC did not seek input from the POB on the new regulatory structure. While Chairman Pitt had left a voice message for Mr. Bowsher on January 10, 2002, and Mr. Bowsher had called back twice, in the end Mr. Bowsher did not receive a return call and the two men did not speak before the press conference.

On January 17, 2002, Mr. Bowsher received a call from Mr. Melancon and Robert Kueppers, Chairman of the SECPS executive committee, a few hours before Mr. Pitt announced the new SEC proposal at a press conference. In this call, Mr. Bowsher asked specifically if there would be a place for the POB in the new structure. Mr. Melancon replied that there was no place for the POB in the new regulatory structure to be announced by Mr. Pitt and that the POB would be a redundancy. Subsequently, the POB was advised by the Chairman of the SECPS that the SECPS working group had provided the SEC with an outline of a proposal a week before the January 17, 2002 press conference.

The POB believes that one of its primary functions is to facilitate communication. The Panel on Audit Effectiveness found that "The POB should serve as the oversight body to whom the SEC, the state boards of accountancy, the auditing profession and the public should look for leadership. This leadership position is intended to enhance communications among the profession's self-regulatory bodies in order to facilitate the profession's continuous improvement efforts and identify and resolve important issues on a timely basis." The panel recommended that the SEC should "[s]upport the POB's authority as enumerated in its charter to enable the POB to serve as an independent, effective, unifying leader of the profession's voluntary self-regulatory process."

During Chairman Pitt's press conference on January 17, he was specifically asked whether there would be a role for the POB in the new SEC proposal. He did not answer the question.

John Coffee, the distinguished Columbia Law School professor who has written extensively about securities regulation, faulted the SEC chair for the way in which the new regulatory structure was created. Professor Coffee said that "It's not the high watermark of public accountability when the industry to be regulated designs its own regulatory structure in negotiations with its former lawyer."

The foregoing was the context in which the POB voted unanimously on January 20, 2002, its intention to terminate its existence pursuant to Section IX of the POB's charter no later than March 31, 2002. The reason for this action was that the new SEC proposal had been worked out by the SEC, in collaboration with the AICPA, SECPS executive committee and representatives of the Big 5 firms, without any consultation with the POB, which is charged with representing the public interest. The new proposal rendered the POB a "lame duck". In making its decision, the POB was also cognizant of the experience of negotiating its new charter, the fact that the SECPS had cut off funds for the special reviews, and that there had not been progress in connection with the reviews to which they had agreed. The POB believed it could not effectively oversee the activities of the accounting profession under the circumstances and that it would mislead the public to appear to do so. Furthermore, if the POB were to continue during an interim period before a new governance structure were in place, it believed it would leave the impression that it approved of the Pitt proposal. As the "conscience and critic" of the profession, the POB felt it had no choice but to terminate its existence to protect the public interest. What the POB did was akin to what an auditor does when it believes it must resign from a client engagement because of a fundamental disagreement.

The POB Proposal for Reform

The Public Oversight Board is mindful that there are many suitable models that could be adopted as part of a reform program for regulation of the accounting profession. Congress will undoubtedly consider many of the available options in coming weeks as decisions are made on regulatory changes in the aftermath of the Enron debacle. Whatever the details of reform, the POB strongly believes that a legislative foundation for any future regulatory structure is crucial.

Because it has had oversight responsibility for a good portion of the voluntary self-regulatory structure of the accounting profession for the past 25 years, the POB has first-hand knowledge of the strengths and weaknesses of the existing system and, thus, a unique perspective on regulatory reform. The POB considered a number of options for reform based on the present system, but ultimately came to the conclusion that a complete overhaul is essential. The Board believes that the existing system has become ineffective.

Dating back to the 1970s, when bribery of foreign officials by American corporations was first uncovered, followed by the audit failures associated with the bankruptcy of the Penn Central railroad - the Enron failure of its day - reforms have been largely incremental and piecemeal. The creation of the POB and other early reforms grew out of hearings in the House and Senate that followed the Penn

Central bankruptcy and the "sensitive payments" scandal. While the POB believes that many of these early reforms served a useful purpose and strengthened the profession, it is also clear that in recent years, regulatory oversight and attempts at further reforms have been met with resistance or outright rejection by the profession. As noted earlier in this paper, the profession over the past two years has acted to preserve the status quo and has resisted major reform efforts.

Faced with this opposition, the Public Oversight Board believes the time for legislative action has come. The current system needs to be replaced. To accomplish this, the POB believes it is essential that all critical elements of regulation - including all standard setting, inspections and reviews of accounting firms, enforcement and discipline, and other functions - be placed under the aegis of a single regulator operating under statutory authority. This new entity - an Independent Institute of Accountancy (IIA) - would employ a professional staff of individuals unaffiliated with the profession or any of the Big 5 accounting firms and would be run by a seven-member Board, which itself would be totally independent of the profession.

The SEC would have oversight of the IIA, and the SEC's Office of the Chief Accountant would be the liaison to the IIA. A chart showing the organizational structure of the IIA is attached as Appendix A.

The Board

Under the POB's model, the chair and vice chair of the IIA board would be employed on a full-time basis. Five other members would serve on a part-time basis. Each member, including the chair and vice chair, would serve a five year term and no member could serve more than two consecutive terms. To assure future continuity, it is anticipated that the initial membership of the Board would have staggered terms. While qualified persons with accounting experience, such as retired accounting professionals, would be allowed to serve on the Board, the majority of members would have no ties whatever to the profession.

The importance of independence cannot be stressed enough. Independence removes any conflict of interest - real and apparent - on the part of Board members. Independence enhances the likelihood that when the narrow needs of the profession conflict with the broader public interest, it is the public interest that will be served. Independence will also serve the interests of the accounting profession itself. Because the accounting profession depends on the trust of investors and the public, that trust will wither and die if the profession is seen to be self-serving in its actions. The best way to keep that trust is to place regulatory decisions at arms-length in an independent, legislatively mandated oversight structure within the private sector.

The chair of the Board would be selected by a committee composed of the chair of the SEC, the chair of the Federal Reserve Board and the Secretary of the Treasury. Once named, the IIA chair would become a member of the selection committee and would join in selecting the vice-chairman and the other members. To assure independence, members could be removed only by a two-thirds vote of the IIA board itself. Having a selection committee of these individuals would enhance the credibility of the Institute.

Standards and Interpretation

The POB charter gave it authority to oversee the issuance and interpretation of auditing and independence standards for the profession by the ASB and the ISB. Accounting standards have been set for nearly three decades by FASB.

The POB believes it is time to consolidate all standard setting bodies under one roof. Thus, a basic and critical function of the new Institute would be oversight of the issuance and interpretation of accounting, auditing and independence standards for the profession. To accomplish this end, an Office of Standards would be created by the IIA board and would report to it. Within the Office of

Standards, separate bodies would be created to issue accounting standards, auditing standards, and independence standards. While the POB envisions a system in which the IIA board would have overall authority to create the structure under which standard setting would take place and to make appropriate rules for the standard setting process, the standard setting bodies within the Office of Standards would be given considerable autonomy in carrying out their work. A well-staffed and funded research arm within the Office of Standards would support the standard setting entities. The Office of Standards would also be charged with issuing interpretations of standards and be subject to monitoring by the IIA board.

With respect to FASB, the POB is cognizant of its hard work in setting accounting standards for nearly three decades, but believes it should be integrated along with all standard setting bodies into one unified and coordinated structure under the aegis of the IIA. Placing the responsibilities of FASB under the new IIA would lessen the chances of it being influenced by those whose its standards affect and could likely help alleviate what some - including the current SEC chairman - have said is a slow process for promulgating standards. As Lee Seidler, Deputy Chairman of the 1978 AICPA Commission on Auditor's Responsibilities, testified before the Senate Banking Committee in March 2002, "FASB has been beset by enormous outside pressures." Also, former SEC Chairman David Ruder expressed similar concerns before the same committee in February 2002, noting that "FASB continually faces difficulties in financing its operations."

These problems would be alleviated because FASB's independent funding would be guaranteed by the IIA. Further, one of the major advantages to placing the activities of FASB under the new IIA would, as Mr. Turner testified before that committee in February 2002, be "the accounting standard setting, and enforcement of those standards, residing within a single organization. In turn, when the disciplinary process identifies shortcomings in the standards, they could then be promptly referred to the standard setter for timely action."

With respect to auditing standards, the POB believes that standards promulgated by the current ASB have not provided guidance that is sufficiently specific and definitive, a problem noted in the recommendations of the Panel on Audit Effectiveness. The ASB is controlled by the AICPA, and eight of its 15 members are partners of the eight largest accounting firms. As with other standard setting entities, it should be placed under the aegis of the newly created Institute.

As discussed earlier, the termination of the ISB - established to create, codify and interpret independence standards for auditors of public corporations - has left a significant void. The POB believes this void should be filled by creating a new entity independent of the profession and operating under the aegis of the Institute, with sufficient resources and staff to issue clear, unambiguous standards of independence.

As to the membership of the separate bodies that would be created under the Office of Standards of the IIA, the POB believes a majority of their members should be independent of the profession. The new Office of Standards with separate bodies would help alleviate the concerns expressed by former SEC Chief Accountant Michael Sutton, who testified in February 2002 before the Senate Banking Committee that "standard setters too often pull their punches, backing down from solutions they believe are best - perhaps because of a perceived threat to the viability of private sector standards setting - perhaps because of the sometimes withering strains of managing controversial, but needed change - perhaps because of a loss of focus on mission and concepts that are supposed to guide their actions." Public representation would assure that, at the least, the public had a voice and a vote in the process.

Annual and Special Reviews

Since 1977, peer review of one accounting firm by another has been the backbone of the voluntary self-regulatory system in the United States, and the POB has been charged with overseeing this process. The POB believes that peer review resulted in major improvements in the profession. The recommendations that flowed from peer reviews in the early days led to substantive improvements in the quality controls at accounting firms, large and small. At the same time, as former SEC Chairman Williams testified on February 12, 2002, before the Senate Banking Committee, peer review "in its present form [has become] too incestuous. A system needs to be established which is independent of the accounting profession."

Because it is not a transparent system (details of peer reviews are not made public) and is limited in scope (audits subject to investigation or litigation are not looked at as part of a peer review), peer review has come under considerable criticism from members of Congress, the media, and others. "You scratch my back, I'll scratch yours" is the prevailing cynical opinion of peer review raised by many.

The Public Oversight Board is of the opinion that peer review, as it has been conducted, should be discontinued in favor of a more thorough, independent, and transparent system. Each accounting firm now carries out an internal inspection each year. The POB would mandate that, for firms that audit more than 100 public corporations each year, these inspections would be subject to a comprehensive and thorough review, carried out by an independent professional staff hired by the Institute. While these reviews would usually look at a representative sample of a firm's work, IIA reviewers would have the authority, unlike current peer reviewers, to look at any aspect of a firm's operations it might find appropriate. Details would be compiled in reports that would be made available to the public. Reviews of smaller audit firms would be performed by other firms selected and paid by the IIA. Their reports would be addressed to the IIA as the client of the reviewer.

Professor Joel Seligman, who testified before the Senate Banking Committee in March 2002 stated that "the most significant issue may prove to be who conducts periodic examinations and inspections. To paraphrase the classical adage: Who will audit the auditors? I would urge serious consideration be devoted to replacing peer review with a professional examination staff in the new SRO. Peer review has been, to some degree, unfairly maligned. But even at its best it involves competitors reviewing competitors. The temptation to go easy on the firm you review lest it be too critical of you is an unavoidable one."

But these reviews are only one piece of an updated oversight structure. To supplement them, the POB believes that special reviews should be carried out, when warranted, on a case-by-case basis. These special reviews, similar to those the SEC originally asked the POB to undertake of the Big 5 firms, could take a more systemic and in-depth look at a firm's systems, policies, procedures and operations. If necessary, they would delve deeply into questions affecting a firm's compliance with SEC rules and applicable professional standards. As with annual reviews, an independent professional staff hired by the Institute would carry out any special reviews and results would be public.

Enforcement and Discipline

One of the most pervasive complaints about the current voluntary system is that firms and their personnel are rarely disciplined by the profession for infractions in carrying out audits or other work.

Dave Cotton, a member of the AICPA's Professional Ethics Committee's Technical Standards Subcommittee, wrote in a January 2002 *Washington Post* article that, while the Ethics Committee expels someone from the AICPA five to 10 times a year, "[m]ore typically, when [that] committee finds that a CPA has violated professional standards, it orders continuing professional education classes. A CPA found to have violated an accounting standard in connection with a multibillion-dollar corporate collapse, causing massive damage to investors and the public, might receive this sort of minimal sanction."

When discipline is imposed by the present system, it almost always comes years after the fact because of procedures which delay the process, including sanctions, until after the outcome of litigation. Mr. Cotton noted in the *Washington Post* article cited above that, as a result of delays in the disciplinary system, "accountants who have committed the most egregious ethical lapses - the ones resulting in SEC investigations, bankruptcy and litigation - can often continue to practice for 10 years or more after the alleged violation until all the cases are resolved." Bevis Longstreth, a former SEC commissioner and member of the POB's Panel on Audit Effectiveness, stated in his congressional testimony in February 2002 that the present system "results in long delays in investigation and, as a practical matter, renders the disciplinary function a nullity in almost all instances."

The POB believes these concerns about the present system have validity and that an effective mechanism for timely and effective discipline is essential to any reform effort.

One reason for the delay in the current system stems from the fact that those charged with administering the system lack privilege to ascertain facts. Privilege would give the investigative entity the authority to protect information it uncovers from outside demands until any enforcement action is concluded. At present, firms will not disclose documents or other information that is likely to wind up in the hands of litigants in legal proceedings. As Shaun O'Malley, Chairman of the POB's Panel on Audit Effectiveness and former Chairman of Price Waterhouse, pointed out in his testimony in March 2002 before the Senate Banking Committee, the present system has been "hampered by distrust and by concerns that the materials developed were not protected. Providing confidentiality will expedite and vastly improve the review, investigatory, and disciplinary processes."

Further hampering those charged with discipline in today's system is the lack of subpoena power. Because of this, the system may not be able to obtain important information from auditors or audit clients. Also, sanctions are limited; the most that can be done is expel someone from membership in the AICPA. Further, the disciplinary process is not transparent, so the public is often unable to determine what, if any, action has been taken, even with respect to major audit failures.

The POB suggests that an Office of Enforcement and Discipline be formed within the new IIA to have full legal authority to investigate allegations of wrongdoing by public accounting firms and their personnel, including subpoena power. The office would be staffed by accounting and other professionals, as well as investigators. Cases of alleged improper professional conduct would be brought before IIA hearing officers, who would be charged with recommending, where warranted -after public notice and opportunity for public hearing - that the IIA board impose sanctions that would range from fines to suspension or expulsion from the profession. Cases could be referred to the Justice Department for possible prosecution, or to the SEC, state boards of accountancy, or other agencies, as appropriate.

Allegations brought before the Office of Enforcement and Discipline would go forward to investigation regardless of any pending litigation, unlike the present system. Disciplinary hearings and decisions would be public.

Funding and Staff

If the Institute is to be successful in all that it is charged with overseeing and regulating, it must be appropriately funded and it must have an adequate, well-trained staff. It is clear that to attract a talented staff, competitive salaries must be available. Further, the Institute must be assured that the funds will be there when needed.

Former SEC Chairman Williams testified before the Senate Banking Committee in February 2002 that the POB "is not adequately funded and is beholden for its funding to the very people it is supposed to oversee. I suggest that the SEC consider a requirement that a percentage of the audit fees of public companies be assessed to pay for independent oversight, whether it is the Public Oversight Board or a successor body, so that its funding is assured."

Another former Chairman of the SEC, David Ruder, said in testimony the same day that: "Independent and adequate funding is crucial. An independent body that depends upon sporadic voluntary contributions from industry or the financial community may risk loss of financial support if it takes positions seen as contrary to the best interest of those it regulates."

The POB recommends that funding be provided through fees imposed on public corporations in an amount that would be sufficient to cover the costs of the Institute. The fees would vary according to the total revenues of the corporation. The POB strongly believes that the funding mechanism must be beyond the reach of the profession to prevent it from withholding necessary funds, as it did in May of 2000.

International Liaison

Convergence of international accounting and auditing standards is one of the most pressing issues facing the profession. In an era when major firms either own or are affiliated with large accounting entities throughout the world and major corporations engage in global trade, common accounting and auditing standards are fast becoming a critical need. The Public Oversight Board believes that international liaison should be a primary function of the Institute.

Paul Volcker, the former Federal Reserve Chairman and Chairman of the trustees of the International Accounting Standards Board (IASB), told the Senate Banking Committee in February 2002 that FASB and IASB were working together on a number of issues and that the "result should be convergence and significant improvement in both bodies of standards." Since the IIA would oversee accounting standard setting as well as auditing and independence standard setting, the Institute would be in the best position to act as international liaison to promote convergence and significant improvement to U.S. and international standards. This is a POB function under its charter and should be transitioned to a new regulatory body.

Continuing Professional Education

Education has always been a hallmark of the accounting profession, and accountants and auditors are required to accumulate 80 hours of continuing professional education credits every two years. As important as education has been in the past, however, it will become even more crucial in years to come. The ability of auditors to deal with audits of companies involved in cross border offerings and derivatives and other new financial instruments that are constantly being invented is largely dependent upon their ability to understand them - and that is a function of education. Similarly, convergence of standards across international boundaries will present new and unprecedented challenges to accountants and auditors and only continuing education will make it possible for the profession to remain on top of new developments. For these reasons, continuing education should be a primary focus of the new Institute.

Other Matters Affecting the Profession

Beyond the regulatory structure of a new system, the POB believes there are a number of other issues that should be addressed as part of legislation creating a charter for the new Institute.

Auditor Independence

The POB recognizes that there are several models available to deal with the matter of auditor independence and that there continue to be disagreements on this matter.

The Panel on Audit Effectiveness, for example, was split on the issue of scope of services for audit clients. Some panel members wanted to essentially ban non-audit services for audit clients. But these members would have allowed a "carefully circumscribed exception" if the client's audit committee (composed only of independent directors) found that the best interests of the company and its shareholders would be served by retaining its auditor to render such non-audit services in cases where "no other vendor of such service can serve those interests as well." This proposal would also have required submission of such a finding to the SEC and POB and disclosure in the corporation's proxy statement of the finding and the amount paid for the non-audit services.

On the other hand, those on the panel who opposed restricting non-audit services - a majority - held that "audit firms can provide both audit and non-audit services to the same public audit client, and with proper safeguards and disclosures, can maintain independence and objectivity." Those taking this view believed that "nothing in the long history of the profession's providing non-audit services has indicated otherwise."

Mr. Volcker said during the September 2000 public hearings on the SEC's proposed independence rules that

> The extent to which the conflict has in practice actually distorted auditing practice is contested. And surely, instances of overt and flagrant violations of auditing standards in return for contractual favors-an auditing capital offense so to speak-must be rare. But more insidious, hard-to-pin down, not clearly articulated or even consciously realized, influences on audit practices are another matter.

Importantly, President Bush's 10-point plan "to improve corporate responsibility and protect America's shareholders," announced in March 2002, provides that "Investors should have complete confidence in the independence and integrity of companies' auditors." The specifics on this plan recognize the importance of prohibiting certain non-audit services in order to safeguard auditor independence.

On February 1, 2002, the AICPA issued a statement, which said it "will not oppose federal legislation restricting the scope of services that accountants may provide their public audit clients, specifically in information technology and internal audit design and implementation."

In considering this matter, the POB started from the premise that the accountant's audit and report add significant credibility and reliability to a corporation's financial statements in the process of capital formation and that the foundation of that credibility is auditor independence.

To effectively assure independence, the POB believes legislation governing non-audit services to audit clients is necessary. The POB proposes that SEC regulations concerning independence be legislatively codified with appropriate revisions to update restrictions on scope of services involving information technology and internal audit services as noted above.

The POB believes such legislation should also affirm that tax work not involving advocacy and attest work in connection with SEC registration and other SEC filings be allowed, and that small public businesses, to be defined by the SEC, should not be subject to any restriction on non-audit services. Further, with respect to non-public corporations, it is the POB's position that such corporations and the accounting firms that audit them should not be subject to any restriction on non-audit services. We expressly emphasize this to avoid misunderstanding and any consequences to small business and small audit firms.

The IIA Office of Standards should be empowered to promulgate appropriate rules affecting independence to cover changing circumstances. The POB also believes that non-restricted, non-audit services should require approval by the audit committee if it finds such services to be compatible with maintaining independence. Also required would be prompt notification to the IIA Office of Standards and public disclosure in current reports and proxy statements filed with the SEC.

The POB believes there should be no prohibition against an audit firm offering non-audit services to non-audit clients.

Auditor Rotation and Retention

The POB believes that the time has come to require rotation of auditors every seven years. The one effective way to prevent the emergence of too close a relationship between a corporation and its auditor is to make certain that auditors are rotated periodically. While there is merit to the argument that a long-term relationship helps the auditor do a better job, it is also true that a new auditor every seven years would provide the corporation with the benefit of a fresh perspective.

The POB agrees with its member, John Biggs, who testified in February 2002 before the Senate Banking Committee that auditor rotation is a "powerful antidote" to auditor conflicts of interest, which "reduces dramatically the financial incentives for the audit firms to placate management". In addition, as Mr. Biggs stated, rotation "reduces the problem of cross-selling other services and is likely to eliminate the revolving door that allows former auditors to become the top financial officers of the audited company." The POB also supports Mr. Biggs' idea, described in his testimony, that the new auditor at the time of rotation should do "an exhaustive review of the former audit work papers" that would assure "transactions and documentation were fully transparent." In addition, the new auditor could do "a brief, signed peer review report" on its predecessor.

As a corollary to auditor rotation, the POB recommends that public corporations be prohibited from firing auditors during their term of service. As former SEC Chairman Williams stated in his testimony before the Senate Banking Committee, the benefit of such a retention requirement is that "the auditor would be assured of the assignment and, therefore, would not be threatened with the loss of the client and could exercise truly independent judgment."

The POB recommends allowing an exception to this retention requirement if the audit committee determines that an exception is in the best interest of shareholders, with prompt notice to the IIA and the SEC. Such action would be required to be publicly disclosed by corporations in current reports and proxy statements filed with the SEC. The POB also believes that audit committees, in engaging the auditor, should give primary consideration to the quality of the audit firm and its audit plan, and not to the lowest price.

The POB is cognizant that if an auditor rotation regulation is included in legislation, action will have to be taken to phase in the new system. The POB recommends giving the IIA authority to promulgate new rules governing the transition to an auditor rotation system. Actual rotation of auditors would begin only after those rules are in place.

Cooling Off Period

For many years, members of Congress and senior federal government officials have been required to enter a "cooling off" period during which they are prohibited from taking certain actions, such as lobbying, on behalf of their new employer. The objective is obvious: to guard against undue influence by former colleagues and friends when it comes to making government decisions that could benefit the new employer of the former official.

The POB believes such a cooling off period is sound policy and feels a variant of it should be applied to the accounting profession when senior partners leave their firms. Specifically, the POB recommends that engagement and other partners who are associated with an audit be prohibited from taking employment with the affected firm until a two-year period has expired. This would end the current situation in which there is at least the appearance of impropriety in audit firms being unduly influenced by former colleagues who have taken senior positions with existing audit clients.

As Mr. Seidler said in his testimony this February, “the former auditor knows exactly how his or her former firm conducts the audit,” and also “knows how far former compatriots can be pushed to accept results preferred by management.” Mr. Seidler added that “’we are all friends’, is not exactly the appropriate relationship between independent auditor and client.”

It is also important to recognize that in the cases of Lincoln Savings and Loan, Waste Management and, most recently, Enron and Global Crossing, senior financial officers at the company came from the outside audit firm.

Under the POB proposal, the IIA board would have the authority to adopt specific rules affecting this proposed cooling off period.

Audit Committees

The POB believes that the Institute should expand on the recommendations of the *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees*, which made it clear that the external auditor should be accountable to a firm’s board of directors and its audit committee and not to management. Specifically, the POB believes audit committees should take full responsibility for hiring, evaluating, and - if necessary - terminating an audit firm.

Conflicts of Interest

To discourage conflicts of interest involving public corporations, Congress should amend the Securities Exchange Act of 1934 to require more meaningful and timely disclosure of related party transactions among officers, directors, or other affiliated persons and the public corporation. Such disclosures should be made promptly in current reports as well as in proxy statements filed with the SEC.

Internal Controls

In the 1980s, a series of major business failures, particularly those involving financial institutions, led to congressional hearings on auditing and financial reporting matters. Out of those hearings, the FDICIA became law. This Act required among other things, that management report on internal controls and, further, that the independent auditors examine and report on those management assertions.

The Special Report by the POB dated March 5, 1993 on “Issues Confronting the Accounting Profession” recommended that the SEC require public companies to include with their annual financial statements “(a) a report by management on the effectiveness of the entity’s internal control system relating to financial reporting; and (b) a report by the [entity’s] independent accountant on the entity’s internal control system relating to financial reporting.” The POB, in support of this recommendation, stated: “The Board believes that requiring auditors to assess management’s reports on the quality of internal controls will benefit the public. First, the auditing profession’s evaluation of internal control systems will lead to improvements in those systems. Second, as long as companies’ boards and top management demand conformity with those systems, the improved systems will make management fraud and manipulation of financial reporting more difficult.”

Just a few months later, in a June 1993 position statement, the AICPA Board of Directors stated:

> To provide further assurance to the investing public, we join the POB in calling for a statement by management, to be included in the annual report, on the effectiveness of the company’s internal controls over financial reporting, accompanied by an auditor’s report on management’s assertions. An assessment by the independent auditor will provide greater assurance to investors as to management’s statement. The internal control system is the main line of defense

> against fraudulent financial reporting. The investing public deserves an independent assessment of that line of defense, and management should benefit from the auditor's perspective and insights. We urge the SEC to establish this requirement.

The General Accounting Office discussed this issue of reporting on internal controls in its 1996 report, "The Accounting Profession". The GAO pointed out that the POB had said "it was disappointed by the failure of the SEC to take action to mandate issuer and auditor reporting on internal controls. The POB agreed with us that such action would add immeasurably to the ability to prevent and detect fraud and would in general enhance the quality of finance reporting." The GAO stated that the SEC was "the key player" here and, further, that the SEC should move forward on this important issue. So far, the SEC has not done so.

Management of public corporations should be required to prepare an annual statement of compliance with internal controls to be filed with the SEC. The corporation's chief financial officer and chief executive officer should sign this attestation and the auditor should review it. An auditor's review and report on the effectiveness of internal controls would - as the GAO found in its report - improve "the auditor's ability to provide more relevant and timely assurances on the quality of data beyond that contained in traditional financial statements and disclosures."

In addition, strengthened internal controls over financial reporting should improve quarterly statements, interim disclosures and earnings estimates that are the basis for many market price changes during the year. They should also be helpful in avoiding restatements that are now seen so frequently.

Conclusion

The Public Oversight Board has not come lightly to its recommendations for reform. For many months, members of the POB hoped that patient negotiation and discussion would prevail. In the end, however, it became apparent to the POB that real reform will take place only when Congress requires it through legislative action.

A decade ago Congress acted in the public interest when it voted major reforms in the banking industry - reforms that were widely opposed by the banks and their lobbyists. Opponents then predicted gloom and doom for the industry should the proposed reforms be enacted. In reality, the reforms contained in the FDICIA repaired flaws in regulation of the nation's banking industry. More important, they significantly strengthened the industry.

Today the Congress again is called upon to institute reform. In the wake of the Enron debacle, the POB, acting as the "conscience and critic" of the profession, strongly believes that to protect investors and the public, the old system of voluntary self-regulation for the accounting industry must be replaced. While many will urge that Congress act with caution and that the profession be again given the opportunity to fix the present system with marginal changes, the POB believes it is time to resist the continuation of the status quo and move ahead with fundamental change.

In short, the POB believes it is time for Congress to enact the kind of reform that will make a real difference.

The John J. McCloy Award

In 1988, the POB initiated a program to honor those who have made significant contributions to strengthening audit quality control and effectiveness in the United States.

2001 Recipient

The Public Oversight Board selected J. Michael Cook as the recipient of the 2001 John J. McCloy Award for outstanding contributions to the auditing profession in the U.S.

His leadership and commitment to improving the reliability and enhancing the credibility of the financial reporting process have characterized Mr. Cook's career. That leadership and commitment have been exhibited through his outstanding contributions to his firm, the accounting and auditing standards-setting processes, the governance of the profession, and the business community at large.

Mr. Cook served as Deloitte & Touche's Chairman and Chief Executive Officer from June 1986 until May 1999. He has served on the Board of the AICPA, and as the Institute's Chairman. He served as the Chairman of the Board of Trustees of the Financial Accounting Foundation - the overseer of the FASB and the GASB. On the international level, he has chaired the World Congress of Accountants.

Mr. Cook currently is the Chairman of the General Accounting Office's Accountability Advisory Panel, which provides guidance to the Comptroller General and other GAO executives.

Previous Recipients:

1988 - Donald L. Neebes and James B. Luton, Jr.

1989 - LeRoy Layton

1990 - Thomas L. Holton

1991 - Barbara H. Franklin

1992 - A. Clarence Sampson

1993 - Wallace E. Olson

1994 - Philip L. Defliese

1995 - David B. Pearson

1996 - David L. Landsittel

1997 - Vincent M. O'Reilly

1998 - Dan M. Guy

1999 - Ralph S. Saul

2000 - Shaun F. O'Malley

Other Members Who Served Through December 31, 2000

JOHN J. McCLOY
(1978 - 1984)
One of the original Board members; POB Chairman from inception to 1984; former Partner in law firm of Milbank, Tweed, Hadley & McCloy; Assistant Secretary of War during World War II; received AICPA's Medal of Honor for distinguished service to the accounting profession. Mr. McCloy's service to the profession is honored each year with the POB's McCloy award, presented to a distinguished individual from the accounting profession. Died on March 11, 1989.

RAY GARRETT, JR.
(1978 - 1980)
One of the original Board members; POB Vice-Chairman from its inception to February 1980; Chairman of the Securities and Exchange Commission, 1973-1975; retired Partner of law firm, Carton & Douglas. Died on February 3, 1980.

WILLIAM L. CARY
(1978 - 1982)
One of the original Board members; Chairman of the Securities and Exchange Commission, 1961-1964; former Professor of Law, Columbia University. Died on February 7, 1983.

JOHN D. HARPER
(1978 - 1985)
One of the original Board members; former Chairman of the Board and Chief Executive Officer of ALCOA, 1970-1975; member of a Presidential Commission; a director of several public companies. Died on July 26, 1985.

ARTHUR M. WOOD
(1978 - 1986)
One of the original Board members; POB Chairman, 1984-1986; POB Vice Chairman, 1982-1984; former Chairman of the Board and Chief Executive Officer of Sears, Roebuck & Co., 1973-1978; a director of several public companies.

ROBERT K. MAUTZ
(1981 - 1995)
Vice Chairman, 1987-1995; former Director of the Paton Accounting Center and Professor of Accounting, University of Michigan; former Professor, University of Illinois; former President of the American Accounting Association; former member of AICPA Board of Directors; former member of the Cost Accounting Standards Board; received the AICPA's Gold Medal Award for Distinguished Service.

A. A. SOMMER, JR.
(1983-1999)
Chairman, 1986-1999, Vice Chairman, 1985-1986; received the AICPA's Medal of Honor for his distinguished service to the accounting profession; Partner with the law firm of Morgan, Lewis & Bockius; SEC Commissioner, 1973-1976. Died on January 14, 2002.

MELVIN R. LAIRD
(1984-2001)
Served as the Vice Chairman from 1997-1999. Mr. Laird served as Representative in the U.S. Congress from Wisconsin for nine terms (1953-1969), Secretary of Defense from 1969 to 1973, and Counselor to the President for Domestic Affairs, 1973-1974.

PAUL W. McCRACKEN
(1985-1997)
Vice Chairman from 1995-1997; Chairman of the President's Council of Economic Advisers, 1969-1971; President of the American Enterprise Institute for Public Policy Research, 1986; distinguished Professor Emeritus of Business Administration, Economic and Public Policy, University of Michigan.

ROBERT F. FROEHLKE
(1987-2000)
Secretary of the Army, 1971-1973; Chairman of the Board of Equitable Life Assurance Society 1982-1987; former President and CEO of IDS Mutual Fund Group.

PAUL H. O'NEILL
(2000-December 31, 2000)
Chair and CEO of ALCOA, 1987-2000; President of International Paper Company, 1977-1987; Deputy Director of U.S. Office of Management and Budget, 1974-1977; resigned to become the U.S. Secretary of the Treasury.

PUBLIC
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BOARD

One Station Place
Stamford, CT 06902
(203) 353-5300