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AICPA MEDIA GUIDE:

QUESTIONS AND ANSWERS ON PROFESSIONAL ISSUES

January 1994

AICPA MEDIA GUIDE: QUESTIONS AND ANSWERS ON PROFESSIONAL ISSUES

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AICPA MEDIA GUIDE: INTRODUCTION

These questions and answers are meant to serve as a guide in formulating responses to questions from the media. They are not meant to be distributed to the press. The questions cover topics that are current media concerns or that are likely to be raised by the media in the future. This list has been updated since the last edition was issued in April 1993. It will continue to be updated periodically to ensure that you have timely information. To discuss specific media inquiries, please call the Institute's Communications Division at (212) 596-6108.

HEALTH OF THE PROFESSION

The media continues to be keenly interested in the health of the accounting profession, and quick to seize on signs of weakness. Reporters look to the profession for reasons, and answers to their questions, such as:

1. **Q. Is the accounting profession financially healthy?**
 - A. Yes, the accounting profession is healthy. It's true that in difficult economic times, CPA firms, like everyone else, encounter problems, and these problems can be exacerbated by legal fees and litigation awards or settlements. However, there are about 45,000 CPA firms

in this country providing a broad range of services to their clients, and most are doing well.

- 2. Q. With the economy showing signs of improvement, have there been any changes in the overall health of the profession, or in the operations of the AICPA?**

A. Many CPA firms, like other businesses, took steps to respond to the recession while continuing to provide a high level of service. The AICPA also curtailed some of its activities, but is continuing to serve members in all essential areas. CPAs are helping clients streamline operations so that they are well positioned to take advantage of the economic upturn.

- 3. Q. What does the AICPA do to assist CPA firms experiencing economic difficulties?**

A. The AICPA provides information and advice through its practice management area and its Continuing Professional Education (CPE) offerings. While the AICPA does not provide financial assistance to CPA firms in difficulty, the Management of an Accounting Practice (MAP) Committee provides guidance to help firms negotiate their way through difficult times. For example, Managing the Malpractice Maze

was published to assist firms in avoiding or defending litigation claims. Other publications including the Management of an Accounting Practice Handbook, Managing by the Numbers, International Business, The Marketing Advantage and Strategic Planning are MAP practice aids designed to alert firms to trends that affect their practices and provide guidance on how to deal with them. Also, a series of audit risk alerts help CPA firms understand and deal with the developments affecting their clients.

An annual conference and The Practicing CPA newsletter, both sponsored by the Private Companies Practice Section, help keep members up-to-date on how to manage current issues to maintain both quality service and profitability.

Moreover, by advocating limitations on unreasonable accountants' liability, the AICPA indirectly works to provide all CPA firms with relief from high liability insurance rates and expensive lawsuits.

4. Q. Is accounting a wise career choice?
- A. Absolutely. CPAs are an integral part of the business and financial fabric of our country, and in today's information society their role is

expanding. Moreover, a CPA certificate is a recognized mark of competence and ethical behavior.

According to the AICPA's annual supply/demand survey, more than 22,500 new graduates with accounting degrees were hired by public accounting firms in 1992, an increase of nearly 2,000 compared to the previous year. The AICPA anticipates that large-, medium- and small-size public accounting firms will generate a total demand of between 20,000 to 25,000 jobs each year until the year 2000. In addition, thousands of accounting grads will also be hired each year by business, industry, government and education.

AUDITOR RESPONSIBILITIES

The "expectation gap" — the difference between what the public believes auditors are responsible for and what auditors themselves believe their responsibilities are — still exists. Certain members of Congress continue to push for legislation that would change auditors' responsibilities to the public. Pressure on the profession will continue as long as business failures occur. The media typically focuses on the following questions:

5. **Q. What is the value and purpose of an audit?**
- A. The purpose of an audit, performed under generally accepted auditing standards (GAAS), is to render an opinion on whether an entity's financial statements present fairly, in all material respects, the company's financial position, the results of its operations, and cash flows in conformity with generally accepted accounting principles (GAAP). GAAP encompasses the conventions, rules and procedures necessary to define accepted accounting practice at a particular time.

GAAS requires auditors to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement resulting from fraud or error. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. It also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. Auditors are also required to consider whether substantial doubt exists about an entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year from the balance sheet date under audit.

6. Q. **How is it possible for a company to fail soon after receiving a "clean opinion" on its financial statements?**
- A. This happens very infrequently. When it does, it may be the result of undetected, collusive management fraud or the result of events occurring after year-end, such as a decision by a company's lender not to renew a significant loan. Also, it's important to remember that an auditor's job is to assess whether there is substantial doubt about a company's ability to continue as a going concern. If the auditor has substantial doubt, he or she is obligated to add an explanatory paragraph to the audit report calling attention to the matter.
7. Q. **It's been said that insurance companies may be the next S&L crisis. Will accountants be partly to blame if this happens?**
- A. Our committees are working hard to put us out front of developing problems in various industries. The insurance industry has suffered many problems and has received special attention. The AICPA's insurance companies committee is active in providing guidance to practitioners about insurance enterprises (see current Audit Risk Alerts: Insurance Companies). Also, the broader area of disclosures for insurance companies is under study.

Once again, remember that the auditor reports on the financial statements, including the adequacy of the disclosures in those statements. The fact that the investing public knows that many insurance companies have serious problems is evidence that the financial statements are telling the story.

- 8. Q. Does the profession support the new banking law (FDICIA)?**
- A. The AICPA has not taken a formal position on the entire new banking law because it contains many provisions that do not relate to accounting and auditing. The AICPA does support the required financial statement audits for insured depository institutions with an exemption for smaller institutions. With respect to the required management and auditor reports on internal controls over financial reporting and compliance with laws and regulations, we support those provisions because the auditor will use the attestation standards set in the private sector. Further, we believe that whenever policy makers require management reporting on such matters, an independent accountant's attestation on management's reports can make a positive, cost-effective contribution to improving user confidence in the integrity and reliability of those reports.

9. Q. Were accountants responsible for the S&L crisis or could auditors have prevented it?

A. Let's be quite clear here. The S&L crisis had its origin 20 years ago and informed people noticed it. The problem arose because S&Ls invested in long-term mortgages at fixed rates, but found more and more that they could attract deposits only for the short term and at changing rates. To compensate for this, S&Ls began to make riskier investments. Still, many were losing money, and Congress and some state regulators responded by making various changes in the regulations governing the industry. The situation reached a crisis with the depression in the real estate, oil and agricultural industries. At the same time, regulatory examinations were being cut back.

The bulk of the S&L insurance losses are concentrated in the Southwest and in California where state regulators permitted the institutions to engage in even more risky activities. The major causes of the S&L failures were deregulation, severe regional recessions, poor management and inadequate oversight by regulators. Auditors did not cause the crisis nor could they have prevented it.

10. Q. How could auditors miss what are now seen as very obvious indicators that conditions at certain financial institutions were precarious?
- A. The regulators, Congress and the public -- through the news media -- knew the precarious conditions of many of the financial institutions in the 1980s. In fact, because the S&L insurance fund did not have enough money to shut down those institutions that were in precarious positions -- referred to as the "walking dead" -- the regulators adopted ways to keep their capital at a level that would not require shutting them down. This was called "forbearance."

Many believed -- or hoped -- that these institutions could work their way out of their financial difficulties if they were given more time. This optimistic viewpoint did not materialize. Instead, things got worse and when those financial institutions were eventually closed, the cost to the taxpayer was dramatically increased. The profession is on record as commenting every time a regulatory accounting technique was used to mask these conditions.

11. **Q. How can a CPA firm be an objective party when it is paid by the client company?**

A. Those who are attracted to accounting as a profession place great value upon the requirements of their ethical code for integrity, independence, objectivity and technical competence. If CPAs and CPA firms don't adhere to those requirements, they face enormous risks -- damage to professional reputation, large awards in lawsuits and even loss of license to practice -- that should provide the public with reasonable assurance that CPAs will remain objective.

12. **Q. How does the auditor serve the public interest?**

A. The auditor serves the public interest by adding independent credibility to the reliability of financial statements that are an integral part of the reporting system on which our capital markets depend. Partly because of the audit function, the United States boasts the finest and most comprehensive financial reporting system of any country and has the largest capital market in the world.

13. Q. Does the profession have any restrictions on auditors going to work for clients?
- A. Under the independence rules of the AICPA's Code of Professional Conduct, a CPA who is in employment discussions with a client is not permitted to participate in the audit of that client. Moreover, the AICPA has recommended that the partner in charge of the audit of a public company not be employed by a client for at least one year after that individual has ceased serving the client.

ISSUES PERTAINING TO FRAUD

14. Q. Are we seeing an increase in business fraud or fraudulent financial reporting? If so, how are CPAs responding to the trend?
- A. While there is some concern that the current trend toward downsizing will create an environment for fraud, we have not seen an increase in fraud or fraudulent financial reporting. Most of the financial statements are prepared with integrity, or else our capital market system would not work. But, there are -- and probably always will be -- a relatively small number of unscrupulous individuals who try to issue fraudulent financial information. As CPAs, we audit those financial statements to determine if they are fairly presented.

Sometimes the fraud goes undetected because employees and others work together to lie to the auditor or documents are forged, etc., or because the fraud was too small to find.

Although the annual number of cases of fraudulent financial reporting of public companies is relatively small and that number has remained relatively constant over the last decade, we have been and are working to reduce that number. We sponsored the Commission on Auditors' Responsibilities in the '70s and the Treadway Commission (the National Commission on Fraudulent Financial Reporting) in the '80s. We continually review and update our auditing standards, and recently the AICPA board of directors issued a public commitment aimed at -- among other things -- seeing if we can do more.

(Note: See Q&A No. 50 for additional information concerning fraudulent financial reporting and related litigation.)

15. Q. What is the AICPA doing to strengthen auditing standards relating to fraud detection?
- A. The current standard, Statement on Auditing Standards No. 53, The Auditor's Responsibility to Detect and Report Errors and

Irregularities, was published in April 1988. The standard is clear in that it obligates auditors in every audit to design their work to detect material fraud. The requirements of that standard continue to be appropriate. In addition to defining the auditor's responsibility regarding fraud, the standard includes useful guidance on situations that may signal the existence of fraud.

In the AICPA document Meeting the Financial Reporting Needs of the Future: A Public Commitment From the Public Accounting Profession (June 1993), the AICPA emphasizes its support of proposed federal legislation known as the Financial Fraud Detection and Disclosure Act which would strengthen the audit function by providing earlier notification to the government of possible illegal activity.

In this AICPA document the Institute also points out that "advisors such as attorneys, should be called upon to bring to the independent auditor's attention instances of suspected financial fraud so that the auditor can, to the extent possible, confirm or dispel those suspicions. Regulators who possess such knowledge should also be required to make that information known to the auditors."

The AICPA also calls for the establishment of a "systemic process for reviewing past cases of fraud to learn how financial statements were manipulated, how detection was initially avoided, what procedures did detect or might have detected the illegality, and how audits can be changed to prevent a reoccurrence."

The AICPA supports the Public Oversight Board's recommendations contained in the POB's special report In the Public Interest: Issues Confronting the Accounting Profession (March 5, 1993). These recommendations call for new guidelines to assist auditors in assessing the possibility of management fraud, additional auditing procedures where there is a heightened likelihood of fraud, and a renewed and tough-minded emphasis on the importance of professional skepticism.

16. **Q. How would a CPA go about trying to detect fraud?**
- A. First, the CPA assesses the risk of material fraud. The CPA looks at various incentives (such as the company being put up for sale) and opportunities (such as a weak control system) to assess that risk. If that risk is high, the engagement may be changed in a number of ways. Ordinarily, higher risk suggests the need to assign more experienced personnel to the engagement and to provide more

supervision. Higher risk also suggests the need to expand the extent of the audit procedures applied, to change the timing of the procedures or to modify the nature of the procedures to obtain more persuasive evidence. Most importantly, higher risk will cause the CPA to exercise a heightened degree of professional skepticism when conducting the audit. In some situations, such as when management integrity is in question, the auditor may decide that the best course of action is to withdraw from the engagement.

17. **Q. Should CPAs approach each audit as if fraud were committed?**
- A. CPAs are aware that they are obligated by professional standards to design the audit to detect fraud that is material to financial statements. However, a presumption of fraud or management dishonesty is contrary to the accumulated experience of auditors. An audit conducted under a presumption of management fraud or dishonesty would be never-ending. Moreover, if dishonesty were presumed, the CPA would need to question the authenticity of all client records and documents. An audit conducted on these terms would be unreasonably costly and impractical. But neither does the CPA approach each audit as if all client personnel are completely honest and competent. An

approach that reflects objective, professional skepticism is the answer, and that is what our professional literature requires.

18. Q. Why have CPAs failed so often to detect fraud?

A. Material fraud is infrequent, but when it does occur, it often involves elaborate schemes to conceal it through management collusion with other employees and/or outside parties and forged documents. Therefore, there are cases in which even a prudent auditor will not detect fraud on a timely basis.

19. Q. If CPAs cannot detect fraud, what good is an audit — just to check arithmetic?

A. CPAs do detect fraud! CPAs are obligated by authoritative standards to design their audits to detect material errors and fraud. The fact that the effects of some acts of fraud have become so extreme before being detected simply illustrates the difficulty of catching criminals in the act.

20. Q. What is the AICPA doing to reduce the incidence of fraudulent financial reporting and strengthen the audit process?

A. The profession has taken many important steps to help prevent and detect fraudulent financial reporting. The AICPA co-sponsored the Treadway Commission (the National Commission on Fraudulent Financial Reporting), a top-level group that studied the financial reporting system in the United States and made specific recommendations for top management, independent public accountants, regulators, and others to reduce the incidence of fraud. One recommendation involved the development of more guidance on internal control — an important element in business management. That recommended guidance was issued in September 1992 in a report titled Internal Control — Integrated Framework.

In addition, the AICPA has taken other significant steps to strengthen the audit process.

- In 1988, the AICPA required all CPA firms represented in its membership to submit to a review of their audit and accounting practices every three years. And, in 1990, the AICPA required all firms that audit SEC registrants to join the SEC Practice Section of the AICPA Division for CPA Firms. This subjected

those firms to added requirements, such as audit-partner rotation, concurring partner reviews, and reporting instances of alleged audit failure for investigation.

- In 1988, the AICPA issued nine new statements on auditing standards which, among other things, more sharply defined the auditor's responsibility to detect fraud.
- In 1989, the AICPA required a CPA firm to report to the SEC when an audit engagement has been terminated by either the firm or the client. Such a report is a "red flag" to the SEC, alerting it to possible fraud by company management.
- In 1991, the AICPA initiated a study to reexamine current financial reporting processes in light of users' needs. A report is expected from the AICPA's Special Committee on Financial Reporting in the late spring of 1994.

(Note: See Q&A No. 30 for additional information concerning the AICPA's Special Committee on Financial Reporting.)

- The AICPA has also streamlined the procedures under which it produces and updates audit and accounting guides to speed up

the issuance of new guidance. It also issues annual industry audit alerts to warn auditors about troublesome conditions and new developments in industries in which they may have audit clients.

(Note: See section "AICPA Financial Reporting Improvement Initiatives" for additional information concerning the AICPA's efforts to prevent and detect fraud.)

- 21. Q. What is the AICPA doing to help firms train their CPAs and better equip them to detect fraud?**
- A. To help CPAs better assess the risk that financial statements may contain material misstatement due to error or fraud, the AICPA annually publishes specialized information to alert auditors to significant auditing-related developments. The Institute also publishes 17 industry-specific "audit risk alerts," as well as audit manuals, various practice aids, specialized publications and checklists for CPAs. In addition, the AICPA conducts an extensive number of continuing education courses that help CPAs to maintain and upgrade their auditing skills.**

The AICPA supports the Public Oversight Board's recommendations contained in the POB's special report In the Public Interest: Issues Confronting the Accounting Profession (March 5, 1993). These recommendations call for new guidelines to assist auditors in assessing the possibility of management fraud, additional auditing procedures where there is a heightened likelihood of fraud, and a renewed and tough-minded emphasis on the importance of professional skepticism.

22. Q. What are CPA firms doing to train CPAs, especially young CPAs, to do a better job of fraud detection?
- A. In their audit training, CPA firms are emphasizing the importance of an assessment of the risk of fraud and the use of professional skepticism.
23. Q. Are auditing standards used today "obsolete"? Are they "tough enough"? When was the last time auditing standards were reviewed and changed by the AICPA?
- A. Auditing standards are continually being reviewed and updated to insure that they address current problems. Statement on Auditing Standards No. 53, The Auditor's Responsibility to Detect and Report Errors and Irregularities, was published in 1988. That standard is not

obsolete and it is tough. It calls upon the auditor to have reasonable assurance -- there is no such thing as absolute assurance in an uncertain world -- that the financial statements are not materially misstated by fraud or error. And it provides specific guidance on what should be done when a material fraud is found. In the case of a public company, this will lead to notification of the SEC through appropriate disclosure in the financial statements or through other means, including notification of the resignation of the auditor.

24. Q. Do CPAs have the skills to detect fraud?

A. Yes, and CPAs are constantly honing their risk assessment skills, especially as related to fraudulent financial reporting and other management fraud. However, it's essential to remember that because of the characteristics of fraud, particularly those involving forgery and collusion, even a properly designed and executed audit may not detect a material fraud.

25. Q. **Should CPA firms do postmortems on major fraud cases? Should they communicate the results to the public and government agencies?**

A. When frauds occur, the entire profession must learn how the financial statements were manipulated, how detection was initially avoided, what audit procedures (if any) might have discovered the fraud, and what should be done to make sure the chance of future fraud detection is increased. The Quality Review Inquiry Committee of the AICPA's SEC Practice Section has the responsibility of considering allegations of audit failure involving public companies and has prepared and published articles on lessons auditors need to learn from alleged audit failures. We are currently studying other ways to obtain and disseminate such information.

26. Q. **What auditing standards apply to fraud detection?**

A. Statement on Auditing Standards No. 53, The Auditor's Responsibility to Detect and Report Errors and Irregularities, published in 1988, applies to fraud detection.

27. Q. If fraud is found by an auditor, what are the CPA's professional and legal responsibilities? Are CPAs required to report fraud they have found to the public or the government?

A. When fraud is found, the CPA is obligated to report the fraud to the audit committee of the client company's board of directors. If the financial statements are materially misstated as a result of the fraud, the CPA must also make sure that the statements are revised and, if they are not, express a qualified or adverse opinion on them. If the client hinders the CPA's investigation of the matter or refuses to accept the audit report, the CPA should withdraw from the engagement.

In addition, when deciding whether to continue the client relationship, the CPA considers the diligence and cooperation of senior management and of the board of directors with regard to their investigating the circumstances of fraud and taking remedial action. If the client is a public company, upon withdrawal, the CPA is obligated to submit a letter to the SEC stating agreement or disagreement with the client's disclosure of the factors causing the auditor's resignation as filed on Form 8-K.

28. **Q. Will the newly proposed Wyden “Whistle Blowing” legislation help reduce fraudulent financial reporting?**
- A. The Wyden bill (H.R. 574, “Financial Fraud Detection and Disclosure Act”) requires, among other things, more rapid notification of corporate illegal activities and reaffirms the CPA’s obligation to assess an audited company’s continued existence. This legislation should bolster public confidence in the nation’s financial reporting system.
29. **Q. Why can’t independent CPAs be the public "watchdog"?**
- A. CPAs are public watchdogs! They accept their public responsibility to detect and report fraud or error within the parameters of generally accepted auditing standards. When CPAs find problems, they are dealt with in conformity with those standards. This includes, if necessary, the issuance of a qualified or adverse report by the auditor. In the case of publicly held companies, those problems may have to be reported to the SEC in 8-K reports.

FINANCIAL REPORTING PROCESS

The AICPA has identified concern among its various constituencies that generally accepted accounting principals (GAAP) are not meeting the basic needs of many users of financial information. The most common objection to GAAP is that it looks backwards through its focus on transactions that have already occurred. Investors and creditors, two of the major users of financial statements, base their decisions on what they think is likely to happen in the future and want information to help them make their predictions. As a result, we can expect questions from the media such as:

- 30. Q. Historical-based financial information may not meet all the needs of individuals such as bankers and analysts who use that information. Many people would like greater emphasis on future-oriented, value-based information. What is the AICPA doing to respond to this concern and to make the financial reporting system more relevant to the needs of investors, creditors and the public?**
- A. The AICPA is taking the lead in determining the needs of the users of financial reports and in learning whether those needs call for changes in financial reporting and in the auditor's role. In April 1991, the AICPA board of directors approved the formation of the Special Committee on Financial Reporting to study the needs of the users of**

financial reports. This high-level committee is analyzing GAAP -- the authoritative set of financial accounting rules -- to see if factors like inflation, new financial instruments and the emerging global marketplace have reduced GAAP's relevance. If the committee identifies user needs that are not being met, the accounting profession will work to change the system.

The Special Committee on Financial Reporting is looking at ways to improve the current accounting model and is considering an entirely new model. It is considering non-financial business reporting and elements such as customer satisfaction and backlog information to see what role, if any, they play in the reporting process. It is also considering the needs of the users of financial reports.

In November 1993, the Special Committee issued its initial findings concerning users' needs in its booklet The Information Needs of Investors and Creditors: A Report on the AICPA Special Committee's Study of the Information Needs of Today's Users of Financial Reporting. Further, the Special Committee will conduct a survey of a broader selection of investors, creditors and their advisors to make

sure the tentative recommendations the committee develops based on users' information needs are responsive to these needs.

A final report is scheduled for late spring of 1994, with interim progress reports to the AICPA board of directors.

31. Q. Does the AICPA consider the present auditing standards to be adequate?
- A. Yes, but standards are always evolving to respond to public expectations in a cost-beneficial fashion. Right now, the AICPA is supporting efforts to expand the attest function to other areas, for example to include reports on internal controls. Such reports are now a requirement for certain types of financial institutions included in the Federal Deposit Insurance Corporation Improvement Act of 1991.
32. Q. How might accounting rules change?
- A. Over the long term there may be significant changes in the financial statement model. For example, some believe that companies, and particularly financial institutions, should make wider use of market-value information in the financial statements. Also, one of the questions the AICPA Special Committee on Financial Reporting is

considering is whether a company should publish, and whether an auditor should report on, financial forecasts and projections.

33. **Q. What is the AICPA's position regarding the Financial Accounting Standards Board's (FASB's) Accounting for Stock-Based Compensation exposure draft that would require companies to treat stock options as expenses, considering that the corporate community is strongly against this accounting change?**
- A. The FASB is currently following its due process requirements by circulating this exposure draft to the public to solicit commentary, with a deadline of December 31, 1993. The AICPA's Accounting Standards Executive Committee (AcSEC) will provide its position within the deadline of the FASB's comment period. The AICPA opposes any effort to deal with this issue legislatively, as has been suggested by some. Standard setting should remain in the private sector.

AICPA FINANCIAL REPORTING IMPROVEMENT INITIATIVES

The AICPA and other organizations have called for action and presented ambitious goals to improve the financial reporting system. Given the prominence of AICPA pronouncements such as Meeting the Financial Reporting Needs of the Future: A Public Commitment from the Accounting Profession (June 1993), the media will ask questions concerning AICPA initiatives and progress regarding system improvements.

34. Q. What goals has the AICPA presented in its broad initiative Meeting the Financial Needs of the Future: A Public Commitment From the Accounting Profession (June 1993)?
- A. In Meeting the Financial Reporting Needs of the Future, the AICPA is undertaking reforms in the pursuit of five principal goals:
- improving the prevention and detection of fraud;
 - enhancing the utility of financial reporting to those who rely on it;
 - assuring the independence and objectivity of the independent auditor;
 - discouraging unwarranted litigation that inhibits innovation and undermines the profession's ability to meet evolving financial reporting needs; and

- strengthening the accounting profession's disciplinary system.

These goals cannot be fully achieved through the efforts of accountants alone. Improving financial reporting invites the collaborative participation of not only the accounting profession, but also management, boards of directors, legislators, regulators, legal advisors and the users of financial information.

35. Q. **What action has the AICPA taken, what progress has been made and what future action is planned to achieve the goals presented in the AICPA initiative issued in June 1993, Meeting the Financial Reporting Needs of the Future: A Public Commitment From the Public Accounting Profession, and in the Public Oversight Board's special report In the Public Interest: Issues Confronting the Accounting Profession issued in March 1993?**
- A. Responsibilities for acting on the recommendations of these two documents have been assigned to a number of committees and special task forces within the Institute. Those groups are reporting monthly on their progress to a committee of the board of directors headed by the AICPA board chairman Dominic Tarantino, who has identified implementation of the recommendations as his highest priority. We

do not have specific results yet because implementation of the recommendations is not an easy task or one that can be accomplished overnight, but we will have some results soon.

REGULATION

Regulation of the profession has been an important issue for more than a dozen years. Given the prominence of some lawsuits and periodic government reports on the quality of accounting work, we expect that regulation will continue to attract media attention.

When we answer media questions on regulation, we have an excellent opportunity to demonstrate the strength of the current system of self-regulation.

36. Q. Why aren't CPAs regulated?

A. CPAs are regulated, by government, by the courts and by self-regulating groups. The states set requirements for licensing CPAs and discipline those who fail to adhere to established requirements and standards. For public companies, the SEC also sets independence requirements and disciplines CPAs who have not conducted audits in accordance with established standards. The courts discipline

substandard performance. Taken together with the profession's self-regulatory system, the AICPA Code of Conduct, educational standards and quality review, the regulation picture is complete.

And regulation of the profession is continually monitored and updated to reflect changing times and conditions. For example, 30 states have now passed a requirement that individuals must have 150 semester hours of education including a baccalaureate degree prior to certification.

37. Q. How does self-regulation work?

A. The accounting profession's program of review and regulation of its members is unique among the professions. The CPA profession has shown that it is able, qualified and effective in regulating itself. To begin with, the AICPA establishes technical and ethical standards that govern the conduct of CPAs and CPA firms. Our standards, taken as a whole, are more comprehensive than those of any other country.

To maintain competence, and stay current on professional developments, all AICPA members in public practice must participate in 120 hours of continuing professional education every three years.

Additionally, the individual CPA firm is required to set up its own quality control system for its auditing and accounting practice to ensure that partners and staff adhere to professional standards. The AICPA's practice monitoring programs determine that firms' quality control systems work; every three years, a team of independent reviewers visits the firm to review policies and procedures and to assess whether they are being properly applied on auditing and accounting engagements.

For firms with public-company clients, the AICPA has additional requirements to ensure quality. AICPA members practicing with firms that audit registrants of the SEC may only belong to the Institute if their firm is a member of the SEC Practice Section (SECPS). The SECPS conducts its own peer review program and has specific membership requirements pertaining to audits and other services provided to public company clients. There is a special committee -- the Quality Control Inquiry Committee (QCIC) -- that investigates and acts on allegations of audit failure. All SECPS activities are overseen by an independent body -- the Public Oversight Board -- and by the SEC.

38. Q. Since audit failures still occur, doesn't that mean that the AICPA self-regulatory programs are useless?

A. Certainly not! That's like saying that no one should fly because there are some plane crashes. Like plane flights, the vast majority of audits go without a hitch. In part, that's because the AICPA's self-regulatory programs are effective.

Every firm that performs auditing or accounting services and with which AICPA members practice must have its practice reviewed every three years. And almost every firm that undergoes review acknowledges that it is a better firm for having gone through the process. We believe that many potential audit failures have been prevented -- and a substantial number have been detected and corrected -- because of the practice monitoring programs.

In fact, our review programs increase the public's and federal regulatory agencies' confidence in the profession. That's because a review identifies weaknesses or deficiencies in a firm's system of quality control, and the firm is required to take actions to fix them. We are vigilant in conducting follow-up activity to make sure that any problems do not recur. According to the SEC, "Oversight has shown

that the peer review process contributes significantly to improving the quality control systems of member firms and, therefore, that it should enhance the consistency and quality of practice before the Commission."

SEC enforcement actions document that point. Since 1979, almost twice as many actions have been brought against firms that did not have a review than against those with a review.

39. Q. Did any of the six largest firms ever get a "modified" or "qualified" peer review report?
- A. The largest firms have the greatest need for maintaining effective quality control systems and have taken great pains to make certain they are in place and working. Because they are compelled to address this issue if their large organizations are to operate effectively, there is little likelihood that their peer reviews would ever be "modified" or "qualified," and in fact, this has been the case. But these firms receive suggestions for ways to improve their quality control systems, which they act on.

40. Q. How does the profession deal with a modified report?
- A. A "modified" report indicates a significant problem in a firm's quality control system. The reviewers and the appropriate committee will consider the nature of the problem and suggest ways for the firm to correct the problem. Remedial actions can take several forms, usually revision of procedures or increased education. But there have been some cases where firms have been required to hire outside parties to review all their work before an audit report can be issued. The firm is monitored closely -- sometimes another review is mandated -- to see that any remedial actions have been taken.
41. Q. Does the AICPA investigate allegations of audit failure?
- A. The AICPA investigates all allegations of alleged audit failure. Those that are in litigation generally are not pursued until the litigation has been completed to protect the rights of all parties. The AICPA is currently exploring the possibility of a more timely process. Meanwhile, however, the Quality Control Inquiry Committee (QCIC) of the SEC Practice Section considers the implications of allegations of audit failure involving public companies and financial institutions on a firm's system of quality control. Since its inception in late 1979 through June 30, 1993, that committee has considered 540 cases.

As of June 30, 1993, in 58 cases, the QCIC required the firm involved to undergo special review, expand its regularly scheduled peer review or inspection, or inspect other relevant work of the individuals responsible for the allegedly deficient audit. In 78 cases the firm was required to take corrective measures to address the circumstances presented in the specific case. In the majority of other cases, the committee determined that there was no need for the firm involved to take corrective action because the cases misstated reporting requirements or auditing standards. In fact, many alleged audit failures are actually business failures in which investors are trying to recoup losses.

The actions of the QCIC do not replace the work of the courts, the SEC or other regulatory agencies, which determine whether the auditing firm or individual auditors were at fault under the law and impose punishment. Nor does it replace the work of the Institute's other self-regulating processes including ethics investigations.

42. **Q. Have the QCIC investigations ever led to changes in professional standards?**

A. In about 10 percent of the cases, the AICPA has determined that the alleged audit failure pointed to a need for the profession to consider changing the rules by which CPA firms operate. Such findings are discussed with AICPA technical committees for review and action. There are occasions when investigations result in new or changed standards. For example, the standard on related parties was a direct result of recognizing a deficiency in auditing standards. As a result, procedures are now required for auditors to consider to identify related party transactions, and to gain satisfaction that such transactions are disclosed as required in financial statements.

43. **Q. Should the federal government mandate sanctions against firms for conducting substandard audits?**

A. The SEC and other regulatory agencies have the power to discipline CPAs who audit entities under their jurisdiction. The SEC has occasionally barred CPA firms from engaging in audits of publicly-held companies. The AICPA believes that its improved disciplinary system -- which is under development -- would be relied on by federal

(and state) agencies, rather than incurring the cost of expensive, duplicative investigations.

44. Q. How can you say that the QCIC process is credible when the AICPA's investigations are confidential?

A. The process is credible because it is closely overseen by an independent body, the Public Oversight Board, and the SEC has access to the results. The Securities and Exchange Commission has publicly endorsed the QCIC process, saying it provides added assurance, as a supplement to the SECPS peer review program, that major quality control deficiencies, if any, are identified and addressed in a more timely fashion. Thus, the QCIC process benefits the public interest.

45. Q. Why don't auditors notify regulators or other regulatory agencies of the government when they find something wrong with financial statements?

A. They don't have to because in almost all cases the problems auditors uncover are corrected by management. When auditors find something wrong during the audit, they discuss it with management to make sure it is corrected to the auditor's satisfaction. If the financial statements

are not corrected, the auditor modifies his or her opinion on the financial statement or resigns from the engagement. When an auditor resigns from a public company engagement -- for any reason -- the firm must notify the SEC, which may then investigate. This system has been in place for years and it works for publicly traded companies. In the past several years, the AICPA has speeded up the notification process even more.

46. **Q. Do auditors adopt any additional safeguards in times of recession?**
- A. Auditors have a responsibility at all times to evaluate a company's ability to continue as a going concern. Additionally, to help auditors plan their audits to address increased risk, such as that created by harsh economic times, the AICPA publishes annual audit risk alerts for 17 different industries, one general alert applicable to all industries and other specialized publications. This is the most up-to-date guidance an auditor can get.
47. **Q. How can auditors be independent on an audit when they do consulting work for the same client?**
- A. The possibility that consulting work can affect an auditor's independence has been a subject of many studies by academics,

regulators and the AICPA. None of these groups has found any evidence whatsoever that an auditor's independence is impaired by other work the firm does for an audit client. Indeed, the more the auditor knows about the client's business operations, the better the audit. Without access to the skills that CPAs possess, the more difficult it is for companies -- particularly smaller ones -- to have access to cost-effective consulting services.

48. Q. Isn't regulation of the profession by the AICPA meaningless when the most the AICPA can do is throw someone out of the organization?

A. First, self-regulation is effective. Whenever a complaint is lodged about a particular CPA who is a member of AICPA and of a state CPA society participating in the Joint Ethics Enforcement Program (JEEP), that complaint is referred to the AICPA Ethics Division to determine if the CPA requires additional training, needs to raise quality control standards, or should be dealt with by the Joint Trial Board.

State boards of accountancy monitor the results of trial board hearings.

The states can and do act on those results by revoking or suspending

an individual's license to practice. That is one reason the AICPA makes public the trial board hearings that result in a guilty finding.

Even if the individual is permitted to retain the license to practice, there is a definite stigma involved with losing AICPA and/or state CPA society membership.

ACCOUNTANTS' LIABILITY

Liability is a serious, damaging issue for the profession. As long as this is the case, and as long as the AICPA continues to place a high priority on changing tort laws, the media will continue to ask these questions:

49. **Q. Why is the AICPA working to let CPAs off the hook by trying to reform tort laws? Shouldn't CPAs pay the price for substandard work?**
- A. Yes. A firm that is at fault should be held accountable. However, it is entirely appropriate for the accounting profession and others to seek changes in state law and federal securities laws, which are applied in ways that are manifestly unfair.**

The concept of joint and several liability, which subjects each defendant to liability for the entire amount of a plaintiff's losses regardless of his or her degree of responsibility, is an egregious example of this situation. Similar provisions exist in certain securities laws. The AICPA is working to correct this unfair situation.

50. Q. How does the accounting profession support its claim that there is a "liability crisis" characterized by an explosion of private securities class action lawsuits warranting a change in the system, while, on the other hand, the AICPA claims that the "annual number of cases of fraudulent financial reporting of public companies is relatively small and that number has remained relatively constant over the last decade. . . "?

(Note: See Q&A No. 14 where the above quote appears.)

- A. It is true that the annual number of lawsuits filed each year alleging deficiencies in the performance of an audit of a public company has remained relatively constant over the last decade. However, the number of cases being filed should not be the yardstick for the magnitude of the problem. The crisis arises from the monetary amounts being sought or awards made in those suits, not the number of suits.

Although many of those lawsuits are dismissed before trial, or settled for a fraction of the amounts sought, the cost of defending oneself and the risk of paying the entire amount -- under the principle of joint and several liability -- could bankrupt even the largest firms, depending upon the number and size of the suits. As a result, settlements at times become economical, even when the allegations are unwarranted.

CPAs should not pay for the mistakes of others. CPAs should pay for their own actions, that's why we seek replacement of the system of joint and several liability with "proportionate liability" except in cases of "knowing fraud."

51. Q. What has the AICPA done to bring accountants' liability exposure within reasonable limits?
- A. In addition to campaigning for changes in tort laws, the AICPA, by vote of its membership, changed its Code of Conduct. In January 1992, the ballot on Rule 505 was approved by the membership giving CPA firms the right to organize in any form permitted by the states in which they practice, including limited liability forms. This added flexibility should provide a further degree of protection against unreasonable liability suits.

52. Q. If an accounting firm takes on the client of a bankrupt firm, is it automatically liable for problems that the former firm may have caused?
- A. No, unless the new auditor fails to follow the applicable professional standards, that auditor bears no responsibility for substandard work of prior auditors.

For example, the new auditor is required by auditing standards to try to communicate with the previous auditor and review existing workpapers. If the previous auditor's workpapers aren't available, the new auditor must perform additional auditing procedures to obtain enough information to render an opinion. If that is not possible, the CPA must modify the report to disclaim an opinion because of the scope limit.

TAX ISSUES

With a sluggish economy, budget deficits at municipal, state and federal levels, trade imbalances and a host of other financial problems, and with the approach of any new tax season, the media begins to write more tax-oriented stories. Therefore, we can expect tax-related inquiries such as:

53. Q. The tax laws seem to get more and more complex. Can anything be done to assure that new tax laws decrease rather than add to complexity?

A. Given the political process, there is no assurance that things will get simpler or easier. However, the profession has made overall tax simplification a top legislative priority. In that respect, it has established good working relations with the Congressional tax-writing committees as well as with the Treasury Department and the IRS, which must administer the laws. It has developed a tax complexity index which the AICPA is urging the administration and Congress to use in evaluating proposed legislation.

The result is that the profession's voice is heard more and more often on proposed laws and on the proposed regulations to implement those laws. We have been successful in removing undue complexity from some tax laws. But Congress has not yet heeded us on others; for example, the 1991 unemployment benefits extension legislation lengthened these benefits by changing estimated tax rules for some individuals in an incredibly complex manner.

Recognizing that we can only have simpler, not simple, tax laws, the profession will continue to urge simplicity on those who write the laws.

54. Q. Regarding the new tax law, the Omnibus Budget Reconciliation Act or OBRA, what position does the AICPA take concerning the laws complexity? Does it decrease or increase tax complexity?

A. A simpler tax system is one that first defines the tax base more directly and then raises revenue through adjustments to the rates. While the Institute does not take a position on what is the correct tax rate structure, it recognizes that the OBRA '93 increase in tax rates is the simplest, most straight forward, type of tax law change. In addition, OBRA '93 made a number of important simplifying changes. However, it added complexity to the way the tax base is calculated. Also, change, in and of itself, adds complexity as taxpayers must relearn the tax law. The effect is a net overall increase in the level of complexity in the tax law.

55. **Q. What effect does the AICPA anticipate the new tax law will have on low-, middle- and high-income individuals?**
- A. The OBRA '93 changes will have minimal impact on most low- and middle-income taxpayers. The bulk of the changes (increased rates and limitations on deductions) will generally result in higher taxes for upper-middle and high-income individuals.
56. **Q. Given the obvious need to raise revenue, does the profession favor any kind of a value-added tax?**
- A. The profession has studied VATs, which are widely used in Europe, and has concluded that they merit serious consideration. However, while simplicity of taxes is essential -- and VATs are quite simple to the consumer who pays them -- equity must also be a consideration. The Tax Division of the AICPA continues to study the applicability of VATs to the U.S.
57. **Q. Can the profession do anything to help overcome the federal budget deficit?**
- A. Budgets are complex creatures that include political, economical, social, and national defense considerations. The profession is not in a position to suggest ways to overcome the budget deficit. However,

policy makers need good financial information to make informed decisions. The profession was instrumental in passage of the Chief Financial Officers' Act of 1990 which, if implemented and carried out in full, will improve the manner in which the federal government controls, records and reports its money.