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AICPA MEDIA GUIDE:

QUESTIONS AND ANSWERS ON PROFESSIONAL ISSUES

September 1995

AICPA MEDIA GUIDE: QUESTIONS AND ANSWERS ON PROFESSIONAL ISSUES

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INTRODUCTION

These questions and answers are meant to serve as a guide in formulating responses to questions from the news 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 January 1994. It will continue to be updated periodically to ensure that you have timely information. To discuss specific media inquiries, please contact the AICPA Communications Division, and we will provide you with additional assistance.

STATE OF THE PROFESSION

The media continues to be keenly interested in the health and state 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. In more difficult economic times, CPA firms, like everyone else, will encounter problems. There are about 45,000 CPA firms in this country providing a broad range of services to their clients, and most are doing well. Like most endeavors, most will be successful, but a few may fail. For the most part, CPAs have met the dual challenges of increased competition and greater complexity.

2. Q. **What does the AICPA do to assist CPA firms facing management challenges?**

A. The AICPA provides information and advice through its practice management area and its Continuing Professional Education (CPE) offerings. The Management of an Accounting Practice (MAP) Committee provides guidance to many firms. 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 AICPA's 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.

3. 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. A degree in accounting provides "360 degrees of opportunity," and a CPA certificate is a foundation for careers in many different areas.

According to the AICPA's annual supply/demand survey, more than 21,400 new graduates with accounting degrees were hired by public accounting firms in 1994. The rest are hired each year by business, industry, government and education.

4. Q. **Could you explain why states are adopting requirements that accountants have 150 semester hours of education in order to become certified public accountants?**

A. The reason for licensing and regulating Certified Public Accountants is to protect the public from incompetent individuals who might attempt to

sell them auditing services. CPAs and their equivalent are regulated throughout the industrialized world because no economy can operate without properly prepared financial information that is independently validated by outside auditors.

The 150 semester hour requirement for new CPAs is a response to demands to protect the public by improving the quality of education and the work of CPAs.

The college education required for a CPA should prepare him or her for a career in a very complex and rapidly changing profession. The business world in which the CPA works is changing so rapidly that it is impossible to know what accounting topics to teach today that the CPA will use 25 or 30 years from now. A broad general education that includes communication skills, mathematics, computer science, ethics -- even literature -- will give future CPAs the breadth of vision and intellectual curiosity needed for their work and continuing education.

While the purpose of the 150-hour requirement is not to prepare for the CPA examination, it does cause a dramatic jump in the passing rate. In Florida, for example, where the requirement has been in place for several years, the rate of passage of the exam has more than doubled.

Possibly more important has been a tremendous reduction in the number of people who take the exam multiple times and still never pass, wasting their time and the state's resources.

5. Q. **How many states have passed the requirement for 150 hours of academic education as a condition for becoming a CPA?**

A. Today 32 jurisdictions require 150 hours of academic education as a prerequisite to becoming a CPA. Some jurisdictions will not be able to pass the law in time to be effective by the year 2000. However, many CPA candidates will choose to complete 150 semester hours, even if they are from a jurisdiction which has not yet passed the requirement because 150 hours will be necessary to be licensed in another state and for membership in the AICPA.

The National Association of State Boards of Accountancy, the organization of boards that regulates the practice of accounting in every state, fully supports the 150-hour requirement. Those boards have the complete authority to license accountants, and they have recognized for years that the accounting profession they regulate has become so complex that more education is needed for future CPAs.

AUDITOR RESPONSIBILITIES

In spite of aggressive efforts on the part of the profession to anticipate and respond to change, the "expectation gap" — the difference between what the public believes auditors are responsible for and what auditors themselves believe their responsibilities are — still exists. Pressure on the profession will continue as long as business failures occur. The media typically focuses on the following questions:

6. 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 used to prepare financial statements.

GAAS, on the other hand, 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 appropriateness of 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.

7. 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 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. In rare cases, business failure may occur because of undetected, collusive fraud.

8. Q. **Given the staggering losses we've seen incurred by corporations, investment funds and others from the use of derivative financial instruments, should accountants or auditors be held to blame for any part of it?**

A. Profits and losses that may occur from using derivatives are driven by operating decisions by management, which is responsible for operating the entity. Insurance companies, manufacturers, banks, not-for-profit organizations, local government entities -- including the federal government -- are all using derivatives. The related risks and uncertainties have stirred intense public debate. But the questions ultimately are: How much financial risk should entities assume? How much uncertainty can investors and decision-makers -- corporate managers, boards of directors, regulators, or Congress -- tolerate? Wherever these questions may ultimately lead, managements of entities that use derivatives must be aware of and take responsibility for the risks and uncertainties these instruments pose.

CPAs have been helping management understand related accounting, auditing and internal control issues. For example, one question is how should financial statements inform investors, creditors, and other financial statement users about the related risks and uncertainties. The Financial Accounting Standards Board (FASB) has completed a project on disclosure and is continuing an ongoing financial instruments project that could result in significant changes in the way entities recognize and measure derivatives. The AICPA has published a compilation of the existing literature on accounting for and auditing of derivatives

transactions. [*Derivatives—Current Accounting and Auditing Literature* (AICPA Product No. 014888).]

Another question asked by some parties is whether corporate oversight is adequate to ensure that derivatives activities are well-managed and controlled. In June 1994, the AICPA published six common-sense questions that the board of directors and management of an entity engaged in derivatives activities could use as a reality check on related corporate oversight. Further, the Committee of Sponsoring Organizations of the Treadway Commission (COSO, of which the AICPA is a member) has a project underway to develop tools by which entities can use COSO's September 1992 report, *Internal Control—Integrated Framework*, to develop or assess controls over derivatives activities.

9. 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 code of professional conduct for integrity, objectivity and competence as a desirable goal. If CPAs and CPA firms don't adhere to those requirements, they face enormous risks -- damage to professional reputation, large awards in lawsuits and disciplinary

actions, including loss of license to practice. While there is a natural desire to please clients, countervailing pressure provides the public with adequate assurance that CPAs will remain objective.

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

A. The auditor serves the public interest by adding independent assurance to the credibility of financial statements that are an integral part of the total 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 and has the largest capital market in the world.

11. Q. **Does the profession have any restrictions on auditors going to work for clients?**

A. In an open society where people are free to change positions, there can be no restrictions on job opportunities. However, under the independence rules of the AICPA's *Code of Professional Conduct*, a CPA who begins employment discussions with a client must remove himself or herself from the engagement. Moreover, the AICPA has recommended that the appropriate regulatory bodies adopt a requirement 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

12. 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 corporate downsizings of the last several years 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, otherwise 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 in conformity with generally accepted accounting principles. 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 number of instances of fraudulent financial reporting is relatively small and that number has remained relatively constant over the last decade, the AICPA has been working to improve detection. The

AICPA sponsored the Commission on Auditors' Responsibilities in the '70s and the Treadway Commission (the National Commission on Fraudulent Financial Reporting) in the '80s. The AICPA also continually reviews and updates its auditing standards, and issues "audit risk alerts" annually to focus auditors on potential problem areas.

(Note: See Section on Legislative Reform for additional information concerning liability reform and fraud.)

13. 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. In addition to defining the auditor's responsibility regarding fraud, the standard includes useful guidance on situations that may signal the existence of fraud.

The Auditing Standards Board is considering issues relating to fraud. Specifically, the Board is considering:

- Clarifying the auditor's responsibility for the detection of fraud, as described in SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*.
- Revising factors that may indicate increased risk of management fraud and providing separate indicators of employee fraud, such as defalcations.

The Board hopes to issue an exposure draft of an SAS on fraud in early 1996.

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."

14. 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 audit may be changed in a number of ways. Ordinarily, higher risk suggests the need to assign personnel more experienced with higher-risk situations to the audit 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 convincing evidence that there is material fraud. 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 resign from the engagement.

15. Q. **Should CPAs approach each audit as if fraud were committed?**

A. CPAs are obligated by professional standards to design the audit to detect fraud that is material to financial statements. However, 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.

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

A. Material fraud is very 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/or forged documents. Therefore, the auditor may not detect the fraud.

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

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

18. Q. What is the AICPA doing to reduce the incidence of fraudulent financial reporting?

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 comprehensive guidance on internal control — an important element in business management. That recommended guidance was issued in September 1992 in a report entitled, *Internal Control — Integrated Framework*, which deals with controls over operations and compliance with laws and regulations, as well as financial reporting.

19. Q. What has the Institute done to strengthen the audit process?

A. The AICPA has taken 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. Those considerations continue.
- In 1989, the AICPA began requiring CPA firms to report within five days to the SEC whenever 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 disagreements between companies and their auditors.
- In 1991, the AICPA initiated a study to re-examine current financial reporting processes in light of users' needs. A report was issued by the AICPA's Special Committee on Financial Reporting in the Fall of 1994.
- In 1994, the AICPA appointed a special committee to study the entire "assurance function" in today's changing, technologically sophisticated environment.

(Note: See section "Business and Financial Reporting" 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.

  The AICPA's Auditing Standards Board is currently considering issues relating to fraud and hopes to issue an exposure draft on fraud in early 1996.

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

20. 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 (POB) recommendations contained in the POB's special report, *In the Public Interest: Issues Confronting the Accounting Profession* (March 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.

21. 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.

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.

22. Q. **Should CPA firms do post-mortems 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. Practice Alerts published by the SEC Practice Section are recent examples of expanded communications designed to improve overall audit performance. We are currently studying other ways to obtain and disseminate such information.

23. 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.

24. 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 top management and 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, and the firm terminates the client relationship, 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.

25. 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 modified 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.

BUSINESS AND FINANCIAL REPORTING

The AICPA has identified concern among its various constituencies that business reporting is not meeting the basic needs of many users of business information. The most common objection to current business reporting is that it looks backward 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:

26. Q. **Historical-based business 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 information. What is the AICPA doing to respond to this concern and to make business reporting more relevant to the needs of investors, creditors and the public?**

A. The AICPA has taken the lead in determining the needs of the users of business reports and in learning about changes required in business reporting and in the auditor's role to better serve those needs. In April 1991, the AICPA Board of Directors approved the formation of a Special Committee on Financial Reporting to study the needs of the users of business reports. The Special Committee looked at ways to improve the current accounting model and considered needed additional information -- nonfinancial business reporting and elements such as customer satisfaction and backlog information -- to see what role, if any, accountants should play in the reporting of such information.

In November 1994, the Special Committee issued its comprehensive report, *Improving Business Reporting--A Customer Focus: Meeting the Information Needs of Investors and Creditors*, containing recommendations the committee developed in response to what it learned about users' information needs. It plans a program of follow-up to make

sure that the recommendations receive the attention they need from standard-setters and regulators.

27. 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.

28. Q. **How might accounting rules change?**

A. Over the long-term there may be significant changes in the financial statement model. For example, some people believe that companies, and particularly financial institutions, should make wider use of market- value information in the financial statements.

29. Q. **What was the AICPA's position on the FASB's proposal to require reporting an expense on the granting of stock options?**

A. The AICPA's Accounting Standards Executive Committee (AcSEC) carefully studied the issue and concluded that, while it might be

theoretically sound to include such an expense when stock options are granted, measuring the expense would be too subjective to be reported in financial statements.

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 initiatives 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.

30. Q. **What is the profession doing to improve the financial reporting system in the United States?**

A. In *Meeting the Financial Reporting Needs of the Future: A Public Commitment From the Accounting Profession* (June 1993), the AICPA outlined five principal goals that have been reflected in its reform initiatives over the past two years:

- 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.

31. 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. Nineteen recommendations were addressed to the AICPA; 15 recommendations have been implemented,

two are in process, and two will not be implemented. Of the 14 addressed to others, two that relate to liability legislation are in the process of being implemented. Some of the recommendations completed by the AICPA are:

- We developed a proposed new disciplinary system that is included in the Domenici/Dodd bill, S. 240 (Private Securities Litigation Reform Act of 1995).
- The Special Committee on Financial Reporting has completed its work.
- A Statement of Position on the disclosure of risks and uncertainties has been issued.

REGULATION OF THE PROFESSION

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.

32. Q. What is the AICPA's position on "non-CPAs" having ownership positions in CPA firms?

A. After careful analysis and extensive discussion, the governing Council of the AICPA overwhelmingly voted in May 1994 to allow limited non-CPA ownership in accounting firms, but only under provisions intended to ensure the integrity and objectivity of the profession.

The Council action, in effect, formalizes what practitioners had already acknowledged in their practices for quite some time now: in a rapidly changing business climate, the scope of the profession has become much broader. To attract and retain the best and the brightest professionals from other disciplines, who are not CPAs, and to serve clients better, CPA firms need to offer equity interest to highly qualified and talented individuals.

The circumstances under which non-CPA ownership would be permitted include:

Two-thirds (66 2/3 percent) of the firm's owners in terms of financial interest and voting rights must be CPAs; the non-CPA owner must be actively engaged in providing services to the firm's clients as his or her principal occupation; ownership by investors or commercial enterprises not actively engaged as firm members in providing services to clients as their principal occupation continues to be prohibited, as is the free

transferability of ownership interests -- ownership interests may only be transferred to the firm or other qualified owners; and a CPA must have ultimate responsibility for all the services provided by the firm and each business unit performing financial statement attest, compilation and other engagements governed by the profession's standards.

Furthermore, a non-CPA could not assume ultimate responsibility for any financial statement, attest, or compilation engagement; non-CPA owners must have at least a bachelor's degree and, beginning in the year 2010, must complete 150 semester hours of education at an accredited institution; non- CPA owners would be permitted to use the title principal, owner, officer, member or shareholder, or any other title permitted by state law, but not hold themselves out to be CPAs. Finally, non-CPA owners will have to complete the same work-related CPE requirements as if they were AICPA members and abide by the *AICPA Code of Professional Conduct*.

33. Q. **The AICPA already permits non-CPA ownership of CPA firms. Why is it then supporting the Florida Board of Accountancy's opposition to American Express Tax & Business Services (formerly known as IDS) Inc.'s ownership of a CPA firm?**

A. The AICPA Council passed a resolution permitting limited ownership of CPA firms by non-CPAs, but under certain stringent and clearly defined conditions -- and IDS meets none of these conditions. Significantly, the Council permits non-CPA ownership only where, among other things, 66 2/3 percent of the ownership in terms of voting rights and financial interests belong to CPAs practicing in the firm, and where the non-CPAs are actively engaged as a firm member in providing services to firm clients as their principal occupation. Ownership by investors or corporations is otherwise prohibited.

The conditions placed on non-CPAs ownership by Council are intended to ensure the integrity and objectivity of the profession, and to allay any public concern that non-CPA ownership would compromise the professionalism and trust enjoyed by CPAs.

IDS, a division of American Express, purchased an accounting practice in Florida and employed the CPA who owned that practice. It offers to perform non-attest services to clients and wants to be able to hold its employee out as a CPA while performing those services. This violates the Florida Board of Accountancy's statute that CPAs who hold themselves out to the public as CPAs do so only through a firm that is owned by CPAs and are licensed by the state board. The percentage of

non-CPA ownership is not at issue here. The Board's position therefore is fully consistent with the recent AICPA Council resolution, and is legally and constitutionally justified.

Firm-licensure and CPA shareholder rules are for, and in, the public interest, and this deserves the AICPA's support.

34. Q. Why aren't CPAs regulated?

A. CPAs are regulated, by the state and federal governments, 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 Professional Conduct*, educational standards and peer review, the regulation picture is complete.

And regulation of the profession is continually monitored and updated to reflect changing times and conditions. For example, 32 jurisdictions have now passed a requirement that individuals must have 150 semester hours of education, including a baccalaureate degree, prior to certification.

35. 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 practices 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.

36. 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 airline flights, virtually all 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 as those that did have a review.

37. 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 to assure themselves of the quality of their practices, 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.

38. **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.

39. **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 April 30, 1995, that committee has considered more than 640 cases.

As of June 30, 1994, in 60 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 89 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. The Institute's Ethics Division administers the Joint Ethics Enforcement Program (JEEP), investigates complaints or other information regarding potential disciplinary matters and presents formal charges of violations of

applicable rules of the Code of Professional Conduct to the Joint Trial Board, either on its own behalf or jointly with state societies participating in JEEP.

40. 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.

41. 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.

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

A. The process is credible because of the close oversight of an independent body, the Public Oversight Board, and the SEC's involvement as well. 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.

43. 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 within five days, 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.

44. 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.

45. 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, it is more difficult for companies -- particularly smaller ones -- to have access to cost-effective consulting services.

46. 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 the 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.

LEGISLATIVE REFORM

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:

47. 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. CPAs who knowingly commit fraud should be punished; those who are negligent should pay for their negligence. But a legal system based on joint and several liability that permits coercive settlements and names accountants as defendants solely because they have "deep pockets" is not working. We are willing to pay our fair share, but not for the mistakes of others.

That's why the AICPA seeks replacement of joint and several liability with proportionate liability, except in cases when fraud is knowingly committed.

Under the concept of joint and several liability, each defendant is liable for the entire amount of the plaintiffs' loss, regardless of his or her degree of responsibility. Proportionate liability would help to restore

balance and equity in the liability system by discouraging capricious lawsuits and giving blameless defendants the incentive to prove their innocence rather than settle.

Several bills to reform the nation's securities litigation system have been introduced in the 104th Congress in both the House of Representatives and the Senate. The House approved H.R. 1058, the Securities Litigation Reform Act, by a whopping 325-99 margin in March 1995. Before the July 4th recess, the Senate passed by a 70-29 margin S.240, an amended version of the legislation introduced by Senators Pete Domenici (R-NM) and Christopher Dodd (D-CT), and sent it to a House-Senate conference committee.

48. Q. Why should partners of accounting firms be let off the hook when it comes to liability?

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, CPA firms were given 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.

We feel accountants should be treated like anyone else in business. Why should an innocent partner's personal assets, such as his house, etc., be at risk because of what a corporation does -- especially if that person has had nothing to do with a particular audit?

49. 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.

50. Q. **If CPAs are so innocent of wrongdoing, then why do they often settle out of court rather than defend themselves in a trial?**

A. Even in meritless cases, the cost of defense and the exposure to disproportionate liability could bankrupt even the largest firms. As a result, settlement at times is economical, even when the allegations are unwarranted.

51. **Q. Does this litigation have any effect on people or companies that rely on accounting services?**

A. Unfortunately, it does. Increasingly, CPA firms of all size are limiting the industries they serve and the services they offer. In a 1994 survey of small business owners across the country, the AICPA's Private Companies Practice Section (PCPS) found that during the past five years, more than half (55%) of the respondents said that their overall liability exposure had increased and 65% said that their liability-related costs had risen *[American Institute of CPAs' Private Companies Practice Section, July 1994]*.

52. **Q. Isn't the financial burden of litigation against CPA firms relatively minor compared to the annual revenues these firms earn?**

A. No, litigation costs are a significant part of firms' revenues. Indeed, litigation against CPA firms has grown exponentially in the last few years. In 1993 alone, the accounting industry and its liability insurers paid out more than $1 billion in awards, settlements, and defense costs

(19.4% of accounting and auditing revenues), compared to $783 million (14.3% of revenues) in 1992. Total damage claims now approach $30 billion *[Press release issued by the six largest accounting firms, June 1994]*.

53. Q. **What's so bad about suing auditors, especially if they've made egregious errors?**

A. Unfortunately, the current system makes it both easy and financially rewarding to file claims regardless of the merits of the case. Plaintiffs often seek to recoup losses from a poor investment decision by going after the most convenient "deep pocket" -- usually the auditor. In far too many cases, claims are filed with the sole intent of forcing defendants to settle.

54. Q. **Should states allow CPAs to organize in legal forms other than proprietorships and professional corporations (PCs) that often provide increased protection from litigation?**

A. Traditionally, accounting firms are required by state law to operate as sole proprietorships, partnerships or professional corporations. In 1992, the AICPA membership voted to change its rules to allow members to practice under any form of organization permitted by state law. This position was supported by the majority of state CPA societies.

Accordingly, many states are considering legislation to allow CPAs to practice in Limited Liability Companies (LLCs), Registered Limited Liability Partnerships (LLP) or general corporations, because their forms of practice provide common-sense advantages to practitioners.

For example, LLCs and general corporations often provide the benefits of increased protection from litigation. In addition, LLCs may limit tax liability, their members generally are not personally liable for the debts of the LLC and an LLC may enjoy more liability protection under state law than do professional corporations. In LLPs, innocent partners may have limited liability for acts and omissions of other partners. In short, organizing as an LLC, LLP or general corporation gives accounting firms the flexibility to deal with current litigation systems by protecting innocent partners and their families.

More than 40 jurisdictions now have LLC laws in place; approximately 20 have LLP laws in place. Some states have passed bills allowing CPAs to form general corporations and others do not have any prohibitions on CPA general corporations.

55. Q. **What is the AICPA doing to ease the effects on accountants of "workload compression," which forces CPAs to cram most of their work during the first three months of every year?**

A. Small business will gain greater tax flexibility under a bill introduced in early May 1995 by Congressman E. Clay Shaw (R-Fla.). This bill, H.R. 1661, will give back to partnerships and S corporations the right to have a tax year other than December 31, which they lost when Congress passed the Tax Reform Act of 1986. The 1986 tax law required all partnerships, S corporations, trusts and personal service corporations using fiscal years to adopt a calendar year for tax purposes. In effect, the law forced not only the preparation of all year-end tax returns into the first few months of the calendar year, but also the preparation of financial statements and audit reports, which creditors and shareholders need within 90 days of a business' year end. Small businesses are being deprived of the right to use a natural business year, and not being able to spread the workload over the entire year makes CPAs' lives miserable. H.R. 1661 will maintain a steady cash flow to the federal government by requiring quarterly estimated taxes on partnerships and S corporations. Businesses will be able to select the fiscal year-end most natural for their particular activities.

TAX ISSUES

During the tax season, the media begins to write more tax-oriented stories. Therefore, we can expect tax-related inquiries such as:

56. 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 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, we recognize that in this era of highly complex financial transactions it is often not possible to design a tax law in as simple a form as we would like. It is not clear to us that we will ever again see

a truly simple system (despite recent suggestions that we adopt a flat tax), but the AICPA will continue to push for a simpler system.

57. Q. **Regarding the proposed new tax rules in the so-called "Contract with America," what position does the AICPA take concerning the laws' complexity? Does it decrease or increase tax complexity?**

A. Overall, it would increase complexity, and much of our testimony has dealt with ways in which Congress could get the same approximate result in a manner that would allow easier compliance. For example, instead of indexing the cost of assets for inflation, allow larger capital gain deductions for longer-lived assets. Instead of a Family Tax Credit with complex phase outs, allow larger standard deductions or exemptions.

58. Q. **Flat tax proposals are being heard with more frequency. Does the AICPA have a position on them?**

A. This subject was debated during the early to mid-1980s, and we opposed a pure flat tax. However, there are likely to be several versions of a flat tax proposed this year, and we shall review them all carefully before coming to conclusions.

59. Q. **Given the obvious need to raise revenue, does the profession favor any kind of a value-added tax or other tax on consumption?**

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. Traditional VATs are either highly regressive (if they have only one rate) or require great complexity (multirates and exemptions from tax) to make them more fair. Other types of consumption taxes might provide a better solution, and the AICPA continues to study them.

60. 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, would improve the manner in which the federal government controls, records and reports its money.

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