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Parliament of Australia

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Review of Independent Auditing by registered Company Auditors

A number of submissions on the JCPAA website concentrate on specific issues, such as the provision of non-assurance services to audit clients. While these issues may be relevant concerns for the JCPAA to consider, they do not always appear to have been placed in the broader context of the Committee's particular concern: "where the balance lies between the need for external controls through government regulation, and the freedom for industry to self-regulate".

I thought therefore it may be helpful to make a submission that attempts to identify the points at which decisions need to be made about regulation, thus offering a framework to assist the Committee in analyzing issues. In so doing, I have also identified a number of issues, examples and references from overseas. In selecting the examples and references, I have not attempted to present a particular point of view, nor have I made any attempt to present all possible models – rather I have simply tried to identify some credible alternatives of which I am aware to show the huge variations in approach that currently exist, and to point out possibilities for consideration by the JCPAA, particularly ones that may not have been noted in other submissions.

1. Framework

The points at which decisions need to be made about regulation can be thought of as follows:

1.1 Setting and administering entrance standards

- In Australia, to become registered as a company auditor with the government regulator (ASIC) one usually needs to first become a member of a peak professional body (the ICAA or CPAA).
- In the USA on the other hand, the process is essentially the reverse – to become a member of the peak professional body (the American Institute of CPAs) one needs to first be registered with the government regulator (the State Boards of Accountancy). Therefore, membership of the AICPA (or a state CPA Society) is not mandatory for licencing.
- In the UK, the 3 Institutes of Chartered Accountants (England & Wales, Scotland and Ireland), as well as being peak professional bodies, are "Recognised Supervisory Bodies" (permitted to register firms to carry out company audit work) and "Recognised Qualifying Bodies" (permitted to train individuals to carry out company audit work).

- In Ontario, Canada, the Institute of Chartered Accountants of Ontario is the single "qualifying body" to license auditors under the *Public Accountancy Act* (other provinces are similar I believe).
- Issues relevant to entrance standards include: undergraduate education, professional membership programs and examinations, practical experience (eg "competency" versus "hours based" models), registration mechanisms (eg delegating regulatory functions to professional bodies) and requirements for professional indemnity insurance.

1.2 Auditor appointment

- In Australia, while the auditor is ostensibly appointed by shareholders, this process has been criticized as being open to excessive influence by management.
- In some European countries, eg Germany, the legislative framework provides for companies to have a two-tier board structure in which a supervisory (shareholder/governance) board, as opposed to the management board, deals with auditor related matters amongst other things.
- Other mechanisms that have been proposed include: appointment by the Auditor-General or by ASIC, and greater involvement of a (compulsory) audit committee.
- Other issues include: compulsory rotation, either of audit firms or of audit partners and staff.

1.3 Setting ethical (in particular independence) standards

- In Australia, ethical standards (the Code of Professional Conduct) are set by the National Councils of The Institute of Chartered Accountants in Australia (ICAA) and CPA Australia (CPAA).
- In the USA, the Securities and Exchange Commission (SEC) sets the primary independence rules for auditors. Also, some State Boards of Accountancy have some ethical requirements, and the AICPA has a Code of Professional Conduct.
- In the UK, an Ethics Standards Board has been created (but is not yet fully operative) to approve ethical standards drafted collectively by the peak professional bodies. The ESB is part of, and members are appointed by, the Accountancy Foundation. The peak professional bodies in the UK fund the Accountancy Foundation but do not appoint its members. Members are appointed by the National Association of Pension Funds, Bank of England, The Audit Commission, National Consumer Council, Trades Union Congress, Confederation of British Industry, Central Bank of Ireland and London Stock Exchange.
- Structural issues re ethical standards include:
 - who has final authority to issue standards,
 - who appoints the members of that body,

- how transparent is the process (eg, are meetings open to the public and are all agenda papers available on the WWW),
 - who funds it,
 - to what extent do standards deviate from international standards, and
 - to what extent should the legislature or a regulator issue directives that may go beyond current standards on a specific matter.
- All the main technical issues (eg the provision of non-assurance services to audit clients) are appear likely to be canvassed in other submissions.

1.4 Setting technical standards

- In Australia, auditing standards are issued by the National Councils of the ICAA and CPAA. (They are developed by the Auditing and Assurance Standards Board of the Australian Accounting Research Foundation (AARF) who submit draft standards to the ICAA and CPAA for approval. All members of the AuASB are appointed by, and AARF is funded by, the ICAA and CPAA.)
- In the UK, auditing standards are set by the Auditing Practices Board (APB). The APB is part of, and members are appointed by, the Accountancy Foundation (see above).
- In both Australia and the UK (as well as many other countries) International Standards on Auditing (ISAs) form the basis of national standards (although differences do exist). The USA and Canada, while they have been closely involved in the development of ISAs, have been less likely to use ISAs as basis for their own standards in the past. However, both now have strategic plans for greater harmonization and convergence.
- The European Commission is currently considering a proposal to adopt (as opposed to adapt) ISAs for all statutory audits by 2005. The proposal (known as “ISA+”) would result in all countries having an ISA audit report, but with local add-ons to pick up any national statutory, regulatory or professional requirements. The proposal is supported by the Federation of European Securities Exchanges.
- The International Organisation of Securities Commissions is currently considering endorsing ISAs.
- Structural issues are the same as for ethical standards (above).
- There is a large number technical issues, ones that are topical at the moment include:
 - the auditor’s responsibility with respect to fraud (eg should the auditor be responsible for detecting large frauds that are not material to the overall financial position of the company),
 - documentation and record retention (eg should an electronic set of working papers be lodged with the regulator when the audit report is signed),
 - the nature of testing and risk assessment (eg can the auditor rely on a review of internal control without detailed testing of final balances),

- the going concern assumption (eg, does a clean audit report mean that the entity will continue in operation for the next, say, 12 months),
- the “true and fair override” (ie does compliance with accounting standards always yield the “right” result),
- reporting illegal acts (eg should the auditor report, perhaps to ASIC, a suspicion that an entity may be trading while insolvent), and
- communication (eg, do users understand the standard audit report, and should it be supplemented by answering questions at the AGM).

1.5 Requirement to comply with technical and ethical standards

- In Australia, mandatory compliance with technical and ethical standards is a membership requirement of the ICAA and CPAA. It is implicit in this that members are required to keep their knowledge of auditing and ethical developments up to date. Member are required to undertake continuing professional education, although there is no requirement that this include audit or ethics related matters.
- In the USA, because the primary independence rules are set by the SEC, they have direct regulatory force.
- In Canada, the profession’s technical and ethical standards have legislative backing.

1.6 Monitoring compliance with technical and ethical standards

- In Australia, the main mechanisms to monitoring auditors’ compliance with standards are:
 - the quality review programs of the ICAA and CPAA; and
 - the various accounts review programs of ASIC, the Australian Stock Exchange (ASX) and the ICAA, which indirectly monitor auditors by monitoring companies’ compliance with accounting standards.
- In the USA: “Accounting firms that audit publicly traded companies must undergo triennial mandatory peer review. The peer review process focuses on the audit firm's quality control system for its accounting and auditing practice, including documentation of the system and compliance by firm personnel. There are at least two criticisms of the current peer review system. First, the audit environment for publicly traded companies is dominated by only eight firms that audit 80% of the publicly traded companies. These firms typically peer review each other. The peer review process may be inherently compromised because there is a limited pool of peer review firms. Firms may hesitate to report quality control violations on the very firm that may be conducting their firm's peer review, believing that criticism invites criticism. Second, peer review of these audit firms is only required on a triennial basis and it should be more frequent. Peer reviews of accounting firms auditing publicly traded companies should be conducted annually to

ensure that quality control standards are continually met.”¹

- Until recently, the peer review system in the USA was overseen by a Public Oversight Board, which was created to monitor and comment on matters that affect public confidence in the integrity of the audit process. As noted, Section 3 below, the POB decided earlier this year to terminate its existence.
- In the UK, the 3 Institutes of Chartered Accountants (England & Wales, Scotland and Ireland) have a legislative requirement to monitor the work of registered auditors, and publish annual reports to the Department of Trade and Industry which include extensive summaries of outcomes. Each Institute has a registration committee that is responsible for registering and then monitoring auditors, and together the Institutes have formed a Joint Monitoring Unit (JMU). The JMU employs inspectors to perform desktop reviews of auditing firms’ annual returns and to then carry out visits on a selection of firms. Criteria for selecting firms for a visit include possible concerns identified in the annual return, level of involvement with listed companies (greater emphasis is put on monitoring those firms where there is greater public interest) and complaints received.
- Lord Sharman, former chairman of KPMG International, has recently said in relation to the UK system “There are others who also join me in considering that the quality control reports carried out by the joint monitoring unit on those firms that audit public companies should be made public. Just as the independent Ofsted body makes its reports on schools available on the Internet, so should the performance of audit firms be made publicly available. The future requirement is for tough, visible, independent regulation.”²
- Structural issues include:
 - whether a system for monitoring compliance has statutory backing,
 - whether it has a separate governing or oversight board/committee,
 - how that board/committee is constituted (eg, who appoints members, the independence of members etc),
 - whether the system has an educational focus or an enforcement/disciplinary focus,
 - whether the process is transparent, eg what details are available about the outcomes of the process, and are reports on individual firms published, and
 - who funds it.
- Technical issues include:
 - whether there is a system of annual returns and what is the content of those returns,
 - frequency of desktop reviews and of physical visits,

¹ Testimony of New York State Education Department (NYSED) and The State Board for Public Accountancy before the Higher Education Committee, New York State Senate concerning The Purpose and Mission of 21st Century Accounting Firms and the Independence of Certified Public Accountants in the Post-ENRON Era, February 2002, <http://www.op.nysed.gov/cpasenatetestimony0202.htm>

² See article at <http://www.timesonline.co.uk/printFriendly/0,,1-189-297712,00.html> referred to at <http://www.accountancyage.com/News/1129129>. See also <http://www.accountancyage.com/News/1129226>.

- whether reviews look at systems or client files, and if client files, how those files are selected,
- how frequently are firms reviewed and how are they selected,
- who performs review visits (inspectors employed full-time for that purpose or peer firms), and
- if reviews are performed by peer firms, how are those reviewing firm assigned.

1.7 Complaints, investigation & discipline

- In Australia, as in many other jurisdictions, there is a mix of professional and government mechanisms to address complaints, investigation & discipline.
- In the UK, an Investigation and Disciplinary Board (IDB) has been created, but is not yet fully operative. The IDB is part of, and members are appointed by, the Accountancy Foundation (see above). The focus of the IDB will be on cases of public concern; other cases will continue to be dealt with by individual accountancy bodies.
- The Institutes in England & Wales and Scotland also have a Reviewer of Complaints or Independent Examiner respectively, whose responsibilities include the review of complaints against the Institute itself or in relation to its handling of a complaint against a registered auditor.
- Structural issues are similar to those for monitoring mechanisms in Section 1.6 above.

2. Scope of regulation

The comments in Section 1 above are mainly in relation to financial statement auditing.

2.1 Other services

- Auditing firms are also often involved in a growing variety of other services. Examples of some common services can be categorised as follows:

	Annual financial statements	Other financial information	Other
Assurance services	Annual audit Half-year review	Special purpose reports (eg the “audit” of sensitive account balances for a prospective purchaser) Reports on	Assurance about the effectiveness of internal controls Assurance about environmental reports

		prospective financial information (eg prospectuses)	
Other services	<p>“Compilation” (ie financial statement preparation from books and records)</p> <p>Assistance with compilation (eg performing complex tax calculations)</p> <p>Valuation of assets and liabilities for inclusion in the financial statements</p>	<p>Maintaining books and records</p> <p>“Agreed-upon procedures”</p> <p>Tax return preparation</p> <p>Tax planning</p> <p>Financial planning</p> <p>Forensic services (eg fraud investigation)</p>	<p>Systems design</p> <p>Systems implementation</p> <p>Management advisory (consulting) services</p>

- In Australia, all services provided by members of the ICAA and CPAA are covered by the general ethical standards. Some services have specific technical standards, which vary in their degree of detailed coverage.
- In the USA some states are considering broadening regulation of services provided by CPA firms, eg “In 2000, Senator LaValle held a highly productive roundtable forum on the scope of practice of public accountancy. At that forum, participants from several accounting firms, the New York State Society of CPAs, the State Board for Public Accountancy, and the SED reached a consensus that CPAs should be regulated for all professional services rendered, no matter where employed.”

2.2 Other factors

- There are many other factors that affect corporate collapses that could be regulated in one way or another, but which I have not attempted to cover in this submission. They include: corporate governance processes including the possibility of mandating an audit committee function and an internal audit function, the content of and the process for setting accounting standards, the adequacy and reliability of disclosures about risks faced by companies and their systems for managing those risks.

3. US testimony

I have extracted below (Section 3.1) key points from testimony by Charles Bowsher³ who, from 1981 to 1996 was the Comptroller General of the United States and from late 1999 to 2002 was the chairman of the US Public Oversight Board (POB). The full text of Mr Bowsher’s testimony is included at Section 3.2.

³ Source: http://www.senate.gov/~banking/02_03hr/031902/bowsher.htm

In January this year, the POB decided to terminate its existence, and Mr Bowsher's testimony gives the reasons behind that momentous decision (which I have not tried to summarise).

There has been a plethora of Enron-inspired commentary about auditor regulation. I have chosen to include this particular testimony in my submission because of its singular nature despite which, to my knowledge, it has not received any coverage in Australia.

3.1 Extract of key points of testimony by Charles Bowsher

“Mr. Chairman, the current system of self-regulation of the accounting profession has significant problems.

First, the funding of the POB is subject to control by the firms through the SECPS (the SEC Practice Section of the AICPA). In the past – as noted above – the SECPS has cut off that funding in an effort to restrict POB activities ... 4

Second, the disciplinary system is not timely or effective ...

Another problem is that monitoring of firms' accounting and auditing practices by the peer review process has come to be viewed as ineffective, and has been described as "clubby" and "back-scratching" ...

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

... the Public Oversight Board strongly believes that a new regulatory structure for the accounting profession is essential. However, we believe that to be effective, it must be totally independent of the accounting profession and it must be based on the foundation of congressional action creating a statutory self-regulatory organization.

The Board recommends that Congress create a new Independent Institute of Accountancy – the IIA – and center all regulation under its auspices. ...

Important functions of the Institute would include:

- The IIA would exercise oversight for all standard setting for accounting, auditing, and independence ...
- Firm-on-firm peer review would be discontinued for firms that audit more than 100 public corporations each year. In its place, IIA employees would conduct thorough and comprehensive yearly reviews ...
- An Office of Enforcement and Discipline within the IIA would have full authority to investigate allegations of wrongdoing by public accounting firms

⁴ Lord Sharman, in the UK context, has also noted the need to “eradicate any notion that he who pays the piper calls the tune” saying “it was no longer acceptable for the key regulatory body to be funded by the very firms it sought to regulate” (see references per footnote 2).

and their personnel ...

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

3.2 Full text of testimony by Charles Bowsher

“U.S. Senate Committee on Banking, Housing, and Urban Affairs

Hearing on "Accounting and Investor Protection Issues Raised
by Enron and Other Public Companies."

Prepared Statement of Mr. Charles A. Bowsher
Chairman, Public Oversight Board
Former Comptroller General of the United States
9:30 a.m., Tuesday, March 19, 2002 - Dirksen 538

Thank you Mr. Chairman. My name is Charles Bowsher and since late 1999, I have been chairman of the Public Oversight Board, which was created in 1977 to oversee the voluntary self-regulatory program of the accounting profession. I am pleased to be here today to discuss our observations about recent problems in regulation of the accounting profession, to offer our recommendations for reform, and to discuss the decision of the POB in January to terminate its existence as of March 31 of this year.

I am joined today by Aulana L. Peters, a member of the POB, a retired partner in the law firm of Gibson, Dunn & Crutcher and a former commissioner of the Securities and Exchange Commission, and by Alan B. Levenson, a senior partner at Fulbright & Jaworski, who is counsel to the POB and former director of the SEC’s Division of Corporation Finance.

The accounting world as it exists today is the outgrowth of a long series of steps taken by Congress, the securities industry, and the major accounting firms over many years since the bleak days of the 1929 stock market crash and the Great Depression that followed in the 1930s.

After the market crash in 1929, Congress enacted a series of reforms that laid the foundation for the system we know today. Chief among them was the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934, which included the creation of the Securities and Exchange Commission; the requirement that corporations that sell stock to the public register with the SEC; and that public companies undergo an annual independent audit of their financial statements. The system created in the early 1930’s survived for more than 40 years with only minor adjustments.

In the 1970s, however, it was revealed in hearings before the late Senator Frank Church’s Subcommittee on Multinational Corporations that some companies had paid bribes to foreign officials to win business and that these payments had been kept secret from auditors and the public. In the aftermath of these revelations, Congress – under the leadership of this

committee – passed the Foreign Corrupt Practices Act in 1977 to make clear that bribery of foreign officials by American firms is unacceptable.

Another event affecting the accounting profession in the 1970s was the bankruptcy of the Penn Central Railroad – the largest bankruptcy since the 1930s and the Enron failure of its day.

In the wake of the "sensitive payments" scandal, the Penn Central collapse, and audit failures, the late Senator Lee Metcalf of Montana in 1977 chaired a series of hearings to determine whether new federal regulation of the accounting profession might be appropriate. In response to these hearings, and as an alternative to legislation, the American Institute of Certified Public Accountants (AICPA), in consultation with the SEC and with the support of the nation's leading accounting firms, created a self-regulatory framework for the profession. To enhance the quality of audits of financial statements of public corporations, peer review was instituted as the cornerstone of the self-regulatory program.

To run the new self-regulatory programs, including peer review, the AICPA created the SEC Practice Section (SECPS), composed of firms that audit the financial statements of public corporations. And to oversee the programs of the SECPS, the independent Public Oversight Board (POB) was created in 1977. Its function is to protect the public interest. Specifically, the POB was created to monitor and comment on matters that affect public confidence in the integrity of the audit process.

I believe peer review – where one accounting firm hires another to review its operations and internal controls – resulted in major improvements. The recommendations that flowed from peer reviews in the early days led to substantive improvements in the quality controls at accounting firms, large and small.

However, even though the new self-regulatory programs were innovative for their time, they were created with some concern and caution.

John C. Burton, a distinguished professor of accounting at Columbia University and the chief accountant at the SEC when reforms were being made in 1977, warned in testimony before the House Interstate and Foreign Commerce Committee in 1978, that peer review "is likely to be seen as a process of mutual back scratching." He also warned that "it is highly doubtful that a part-time group [POB] can either in fact or perception" provide an effective substitute for statutory regulation.

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

Now, a quarter century after the reforms of the late 1970s, I believe events of recent months demonstrate that the warnings of Dr. Burton and Chairman Williams have come to pass. I've come to the conclusion that the voluntary self-regulatory program needs to be replaced because it has failed to keep pace with challenges faced by the profession. More troubling is the resistance of the profession's trade association, the AICPA, and several of the Big 5 firms to major reform.

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

In 1980, the SEC said in a report prepared for the Senate Committee on Governmental Affairs that the POB has an obligation to "serve as the conscience and critic of the self-regulatory effort." The POB's charter provides that the POB is "to represent the public interest on all matters that may affect public confidence in the integrity, reliability and credibility of the audit process."

Despite our attempts to serve the public interest and be the "conscience and critic," the POB has been impeded since I became chairman in its ability to oversee the profession. Three events are noteworthy in how the POB has been frustrated in its ability for effectively carry out its responsibilities to serve the public interest:

- On May 3, 2000, SECPS took the unprecedented step of notifying the POB that it would refuse to pay for special reviews of public accounting firms. The special reviews in question had been sought by the SEC to determine whether the firms had complied with SEC and professional independence standards. The decision of the SECPS to deny funding to the POB was a serious blow to the notion of independent oversight of the accounting profession. Melvin Laird, the former Congressman and Secretary of Defense and the longest-serving member of the POB, said that this was "the worst incident in my 17 years" on the POB.
- Following the decision to cut off funding of the POB's special reviews requested by the SEC, the largest accounting firms – the Big 5 – agreed with the SEC that the POB should instead conduct more limited independence reviews of the large firms. Despite this agreement, the next 21 months were marked by a series of delaying tactics. Because of this lack of progress, the POB, in the end, was unable to conduct the reviews.
- For years, the POB had carried out its oversight responsibilities under a set of bylaws adopted after it was created in 1977. The POB felt that a formal charter would improve the independence of the Board, and a charter was one of the primary recommendations in August 2000 of the Panel on Audit Effectiveness, which was created by the POB at the request of the SEC. However, objections from the AICPA and the Big 5 caused negotiations to drag on for more than a year. Ultimately, a new charter took effect in February 2001.

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

These three events and the frustration they created were among the factors that led the POB to decide, on January 20 of this year, to terminate its existence. But the precipitating event was the announcement by the Chairman of the SEC, Harvey Pitt, of a proposed new regulatory structure for the accounting profession. This plan was worked out in private talks

between the SEC and the AICPA and the Big 5 accounting firms with no input from the POB, which had repeatedly been assured that it would be consulted.

The new proposal effectively rendered the POB a "lame duck." The POB believed it could not oversee the activities of the accounting profession under the circumstances and that it would mislead the public to appear to do so. Furthermore, the POB was concerned that were it to continue in operation during an interim period before a new governance structure was in place, it would leave the impression that it approved of the Pitt proposal, which it did not. As "conscience and critic," the POB felt it had no choice but to disband. Only by so acting, we felt, could we protect the public interest. What the POB did was akin to what an auditor does when it believes it must resign from a client engagement because of a fundamental disagreement.

Attached to my testimony, Mr. Chairman, are copies of the letters I sent as chairman to Mr. Pitt on January 21 and January 31, 2002, detailing the POB's decision to terminate. These letters are attached as Appendices A and B. I would also ask that a letter to the SEC dated March 5, 2002, urging that an independent person be named to conduct the independence reviews which the POB was unable to complete, be made a part of the record.

Mr. Chairman, the current system of self-regulation of the accounting profession has significant problems.

First, the funding of the POB is subject to control by the firms through the SECPS. In the past – as noted above – the SECPS has cut off that funding in an effort to restrict POB activities. In addition, the AICPA and SECPS insisted on a cap on POB funding when the new charter was created.

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

Another problem is that monitoring of firms' accounting and auditing practices by the peer review process has come to be viewed as ineffective, and has been described as "clubby" and "back-scratching". The peer review team does not examine the work of audits that are under investigation or in litigation, and public peer review reports are not informative.

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

Mr. Chairman, the Public Oversight Board strongly believes that a new regulatory structure for the accounting profession is essential. However, we believe that to be effective, it must be

totally independent of the accounting profession and it must be based on the foundation of congressional action creating a statutory self-regulatory organization.

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

The SEC would have oversight of the IIA, and the SEC's Office of the Chief Accountant would be the liaison to the IIA. Attached as Appendix C is a chart showing the organization of the IIA.

Important functions of the Institute would include:

- The IIA would exercise oversight for all standard setting for accounting, auditing, and independence, and their interpretation. Accounting standards are just as important as auditing and independence standards. For this reason, the POB believes the Financial Accounting Standards Board must be brought under the umbrella of the IIA, which would take responsibility for its oversight and funding.
- Firm-on-firm peer review would be discontinued for firms that audit more than 100 public corporations each year. In its place, IIA employees would conduct thorough and comprehensive yearly reviews of the annual internal inspections of such firms. Unlike peer review, no activities of a firm would be off limits to Institute reviewers and the process would produce detailed public reports. For firms that audit less than 100 public corporations yearly, reviews would be performed by other firms selected by the IIA. Their reports would be addressed to the IIA as the client of the reviewer. In addition to the reviews, IIA employees would conduct special reviews, when warranted. Similar to those the SEC originally asked the POB to undertake, these reviews could take a systemic, in-depth look at a firm's systems, policies, procedures, and operations. If necessary, such special reviews would delve into questions affecting the firm's compliance with applicable professional standards. As with the yearly reviews, reports of these special reviews would be public.
- An Office of Enforcement and Discipline within the IIA would have full authority to investigate allegations of wrongdoing by public accounting firms and their personnel. The POB recommends giving the IIA the privilege of confidentiality as well as the power of subpoena to compel testimony and produce documents. Cases of alleged misconduct would be brought before IIA hearing examiners. When warranted, these examiners would recommend to the IIA board the imposition of sanctions, ranging from fines to expulsion from the profession. Cases could be referred to the Justice Department for possible prosecution, or to the SEC, state boards of accountancy, or other agencies, as appropriate.
- Funding would be provided through fees imposed on public corporations in

amounts sufficient to cover the costs of the Institute. The POB strongly believes that the funding mechanism must be beyond the reach of the profession to prevent it from withholding necessary funds, as it did in May of 2000.

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

Beyond these functions, the POB recommends that:

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

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

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

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

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

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

- Auditors should be rotated every seven years. As a corollary, public corporations would be prohibited from firing auditors during their term of service unless such action is determined by the audit committee to be in the best interest of shareholders, with prompt notice to the IIA and the SEC. Such

action would be required to be publicly disclosed by corporations in current reports and proxy statements filed with the SEC.

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

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

A decade ago this committee was in the forefront of enacting major reforms for the banking industry – reforms that were widely opposed by the banks and their lobbyists. Opponents then predicted gloom and doom for the industry should the proposed reforms be enacted. In reality, the reforms contained in the Federal Deposit Insurance Corporation Improvement Act of 1991 repaired flaws in regulation of the nation's banking industry. More important, they significantly strengthened the industry.

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

the POB believes it is time to resist the continuation of the status quo and move ahead with fundamental change.

Mr. Chairman, you recently made the point that recent events have had a "critical impact on the national confidence in the financial markets" and that the time has come to "focus on the protection of investors and the efficient functioning of our capital markets." I could not agree more. That is why I believe it is time to resist continuation of the status quo and move ahead with fundamental change.

Mr. Chairman, this concludes my prepared testimony. I would be happy to answer any questions you may have."

I hope that the above information will be of some assistance to the Committee.

Yours sincerely,

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