Allies in Protecting Shareholder Interests

The Public Oversight Board, an independent body charged with overseeing and monitoring the quality control programs of public accounting firms that audit publicly held companies, suggests steps to improve the quality of financial reporting.

Why This Report is Being Issued

Since the Securities Acts of 1933 and 1934 established financial reporting requirements for most publicly held corporations, there have been periodic efforts to improve the usefulness of audited financial statements for shareholders and other external users of financial information. Currently, the Public Oversight Board (POB), an independent body charged with overseeing and monitoring the quality control programs of public accounting firms that audit publicly held companies, is taking steps to further improve the quality of financial reporting.

In 1994 the POB appointed an Advisory Panel on Auditor Independence[1] to assess criticisms about the professionalism of independent auditors and consider steps to better assure the integrity and objectivity of their judgments about the application of generally accepted accounting principles. Particular attention was directed to identifying steps to improve the quality of financial reporting.

In accepting the Panel's report, *Strengthening the Professionalism of the Independent Auditor*, the POB determined that issues raised by the Panel merit consideration by a broad audience of corporate directors, chief executives, and chief financial officers.

A major topic in the Panel's report deals with strengthening the relationship between the board of directors and the independent auditor to help directors meet their governance responsibilities and improve the quality of financial statements. Of the Panel's ten principal conclusions five are related to that topic.

Corporate financial reports require numerous judgments in applying generally accepted accounting principles to reflect the economic substance of transactions and events and to determine the underlying amounts reported in financial statements. Many respondents to the Panel's inquiries observed that corporate financial reports, while conforming to generally accepted accounting principles, do not always reflect the most appropriate or useful presentation allowed by those principles.

The central suggestion of the Panel is that corporate boards and audit committees should expect to receive and independent auditors should deliver forthright, candid, oral reports in a timely manner on the *quality*—not just acceptability—of a company's financial reporting. That quality assessment should be based on judgments about the appropriateness, aggressiveness or conservatism of selected or contemplated accounting principles and estimates and judgments about the clarity of disclosures.

By making that suggestion, the Panel's objective is not to narrow the range of acceptable accounting practices but to give directors a better basis for understanding and influencing corporate practices. The POB believes that if corporate directors and audit committees endorse the Panel's suggested practices and establish a supportive climate, the result will be a low-cost, non-regulatory step toward more credible financial reporting.

The Executive Committee of the SEC Practice Section[2], with the encouragement of the American Institute of Certified Public Accountants Board of Directors, has

An active and effective board of directors, responsible financial management, skeptical and independent auditors, and attentive regulatory authorities all have responsibilities to safeguard those who invest in public corporations. Effective corporate governance of the financial reporting process is an important tool for enabling companies and their auditors to fulfill those responsibilities.

Arthur Levitt
Chairman
Securities and Exchange Commission

[1] The Panel was chaired by Donald J. Kirk, corporate director and former Chairman of the Financial Accounting Standards Board. The other members were George D. Anderson, former Chairman of the AICPA, and Ralph S. Saul, corporate director and former Chairman and CEO of CIGNA Corporation. The Panel interviewed auditors, business executives, attorneys, academics and government officials and reviewed written submissions and other related reports and studies.

[2] The SEC Practice Section is an organization of over 1,250 CPA firms formed to improve the quality of practice of CPA firms that audit public companies.

pledged active support for the Panel's suggestions. Recognizing that implementation of the suggestions requires action by all participants in the corporate governance process, the Section has also pledged to help other groups address the recommendations directed to them. The POB welcomes that support, and looks for similar endorsements by those concerned with corporate governance.

The remainder of this report explains more fully the POB's call for action and the rationale for its recommendations to financial managements, independent auditors, and boards of directors and audit committees.

A Corporate Governance Approach to Improved Financial Reporting

The POB urges the board of directors to play an active role in the financial reporting process and for the auditing profession to look to the board of directors — the shareholders' representative — as its client. As the shareholders' representative, the board is accountable to them for monitoring the company's performance.

That accountability is discharged, in part, by ensuring that shareholders receive relevant and reliable financial information about the company's performance and financial position. The board should expect

AUDIT COMMITTEES — A PIVOTAL ROLE, a Deloitte & Touche LLP publication, describes the pitfalls of a compliance-based approach to financial reporting and the benefits of a corporate governance approach.

The POB Advisory Panel is concerned, and Deloitte & Touche shares the concern, that if no action is taken to adjust the course of current trends, we are destined to an ever more highly regulated, compliance-based financial reporting environment in which professional judgment takes a back seat.

One need only look at our tax laws and regulations to see the results of a totally compliance-driven approach. It may appeal to some — an approach that enforces discipline and precision through a myriad of rules. Management and auditors alike would have rule books and checklists to counter the hindsight of litigators and regulators. Auditors would have clearer lines to draw in addressing new or changed accounting principles, thereby eliminating potential conflicts. There may even be a higher tolerance for financial reporting failures because people typically have lower expectations of an end product from a highly regulated process.

The regulated, compliance-based approach does, however, have a serious flaw — its focus is on the process rather than on the end product. Such a focus could result in less-relevant and less-reliable financial information that would be of limited use to all. And, it tends to force a one-size-fits-all solution to financial reporting, despite differing circumstances and audiences.

In contrast to a highly regulated, compliance-based approach, a corporate governance approach focuses on the needs of the users of the financial information and the quality of the end product. Professional judgment is its center-piece and its strength. It is also what gives this approach a fragile quality — dependent on the willingness of independent auditors and corporate management to discuss with audit committees and outside directors what is "most appropriate," rather than what is merely "acceptable." Responsibility and accountability are the foundation for this approach — rules and regulations only provide a framework for making the best professional judgments.

Corporate governance in the United States is not working the way it should. The problem is not the system of laws, regulations, and judicial decisions which are the framework of corporate governance. It is the failure by too many boards of directors to make the system work the way it should. This state of affairs suggests clearly to us that more effective corporate governance depends vitally on strengthening the role of the board of directors.

Martin Lipton
Partner, Wachtell, Lipton, Rosen & Katz

the auditor to assist it in meeting that responsibility to the shareholders, and the auditor should assume the obligation to do so. This requires what is referred to herein as a "corporate governance" approach to financial reporting in contrast to a rule-driven, compliance-based approach. By bringing the independent auditor into the mainstream of corporate governance, an auditor's professional services will add value and not be performed simply to meet a regulatory requirement.

The POB believes that present practices followed by well governed corporations foster an environment where the independent auditor, management, audit committees and boards of directors play interactive and timely roles in the financial reporting process. This is accomplished by both financial management and the external auditor discussing important financial reporting issues with the audit committee and, when needed, the board of directors in a timely manner. These existing practices need to be more widely adopted and, in the view of the POB, enhanced.

Responsibilities of Management

As partners in the financial reporting process, each with a unique and possibly different insight and perspective, management, the independent auditor, and the audit committee should exchange and understand each other's point of view in reaching decisions that affect shareholders' interests.

To accomplish this, financial management should assume an obligation to bring to the attention of both the independent auditor and audit committee the accounting implications of significant new transactions and policies while they are being contemplated, not after the fact or after financial information based on them has been released publicly. This is critical to an effective corporate governance approach to financial reporting.

> As a director, it's not the accounting issues that are brought to my attention that worry me. It's the ones that I am not aware of. Expert assistance is always obtainable. Clairvoyance is harder to come by.
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> **Paul Kolton**
> **Corporate Director**
> **Former CEO, American Stock Exchange**

Candid discussion between management and the auditors will often lead to complete agreement about the most appropriate practices to recommend to the audit committee, but will, in some cases, define differing views of management and the auditing firm. Differences of opinion are healthy because they alert the audit committee to the choices the corporation has and the merits of alternative courses of action. While management and the auditor will find their judgments questioned by the audit committee on occasion, that is a small price to pay for enhanced oversight of the financial reporting process.

This report calls for the participants in the financial reporting process to take a logical and necessary next step to improve corporate governance and the quality of financial information provided to investors. The audit committee and board must insist upon, and financial management and the auditor must deliver, their candid views about the most appropriate accounting principles and estimates—not just their acceptability—and the clarity of the related disclosures of financial information that the company reports publicly.

Responsibilities of the Independent Auditor

The POB agrees with the Panel that it is essential for the auditing profession to bring greater clarity to the issue of who is their client. The board of directors, as the representative of the shareholders, should be the client, not corporate management. Corporate boards and audit committees should make this clear to auditors.

In *United States v. Arthur Young & Co.*, the Supreme Court of the United States concluded that the independent public accountant "owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust."

In most companies today, management selects or recommends auditors and changes in auditors, negotiates fees, selects accounting principles, makes estimates, prepares the financial statements, and monitors the audit. Clearly, a smooth working relationship between auditor and management is important, but there can be a downside. Too close a relationship can discourage the auditor from speaking up if the auditor questions the accounting principles selected, the clarity of disclosures, or the estimates and judgments made by management.

For years, auditing standards have required the auditor to judge whether the accounting principles selected by management are "appropriate in the circumstances." The standard to which the auditor has been held in making that judgment has been whether the selected principle falls within the range of acceptable practice. The POB endorses the Panel's suggestion that the auditor should now be held to a higher standard in communicating with management and the board of directors.

To accomplish this, the auditor should express his or her views about the appropriateness, not just the acceptability, of the accounting principles and financial disclosure practices used or proposed to be adopted by the company and, particularly, about the degree of aggressiveness or conservatism of its accounting principles and underlying estimates and the relevance and reliability of the resulting information for investment, credit, and similar decisions.

> Audit is about governance; it derives from the Latin word meaning "to hear," it is about upholding the integrity of financial reporting and business conduct, it is about seeking the truth. It is not about stifling the objectives of entities but constructively adding value to confidence in those entities...Audit is about judgment, which in the final analysis is personal; an expert view with personal accountability.
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> **The Audit Agenda**
> **The Auditing Practices Board**
> **United Kingdom**

These communications should be based on the auditor's independent evaluation of best financial reporting practices applicable to the company's environment. Such financial reporting practices should not be prescribed by new professional standards. Such standards, if they could be developed, would tend to result in boilerplate language, which would not be in the best interests of the auditor, management, or the board of directors.

Responsibilities of Boards of Directors and Audit Committees

Over the past decade, the influence of management on the corporate governance process has ebbed as boards of directors have assumed the long-acknowledged but only sometimes-practiced role as "the fulcrum of accountability" in the corporate governance system.

The trend in corporate governance is to hold the board more accountable to shareholders and management more accountable to the board. Increased oversight by directors and expansion of the role of auditors in helping the board exercise its responsibility will keep the management-auditor relationship in balance.

Boards of directors have a fiduciary responsibility to shareholders and others for reliable financial reports. To meet that responsibility they should be aware of the implications of alternative accounting principles for reporting significant transactions and events as well as the aggressiveness or conservatism of significant estimates. It is vital, therefore, that audit committees function effectively as the board's primary contact with both financial management and the independent auditor.

With the right atmosphere — the audit committee recognizing its responsibilities and auditors expanding theirs — the result will be a forthright interchange of professional views, thereby giving directors a better basis for influencing corporate reporting practices. In most situations where management and auditors differ on the appropriateness of accounting treatments, the audit committee can be a catalyst for all parties to thoroughly discuss and understand each other's rationale. Most often this should lead to agreement on what accounting treatment is most appropriate. However, if management and the auditor do not reach agreement the audit committee and the board need to be fully informed and reach a judgment about what accounting treatment is most appropriate for public reporting to investors and others.

The independent auditor can add to the effectiveness of the full board in monitoring corporate performance on behalf of shareholders—without detracting from the roles of financial management and the audit committee—by occasional attendance at full board meetings when the audit committee reports on its activities. This may be particularly appropriate when there are independent directors who are not members of the audit committee. It should also help provide a basis for the board to recommend to the shareholders the appointment of the auditor or ratification of the board's selection of the auditor.

> Directors must not wait passively for a crisis before they intervene. Their job, even in the normal course of events, is an important one, and they must have the necessary power to do it. Power, as we have used the term, implies the time and knowledge, which not only contribute to power but also allow its intelligent applications.
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> **Jay W. Lorsch**
> **Professor**
> **Harvard Graduate School of Business Administration**

Legal Implications

Many legal actions against directors have alleged that the financial statements of their companies in some fashion misled investors. Some observers have suggested the recommendations calling for expanded discussions about the appropriateness of accounting principles, disclosures, and estimates will increase the exposure of board members to litigation.

The POB does not believe this will be a likely outcome. First, the procedures recommended will reduce the possibility that the financial statements are in fact misleading, thus reducing the danger of finding directors at fault. Second, the additional steps taken by board members should be persuasive in convincing courts and juries that the financial statements were prepared with care and that every measure was taken to avoid the statements being misleading. In time, as the increased care becomes apparent, plaintiffs' attorneys should be less willing to undertake the risks involved in making claims that financial statements were faulty.

Conclusion

In summary, three steps are needed to further improve the credibility of financial reporting. (1) The board of directors must recognize the primacy of its accountability to shareholders. (2) The auditor must look to the board of directors as the client. (3) The board, and its audit committee, must expect and the auditor must deliver candid communication about the quality of the company's financial reporting. Ways for audit committees to implement these suggestions are set forth below. Establishing a supportive climate for the resulting process to work effectively is a task for all directors.

What the Audit Committee Should Do

The POB **urges that audit committees take action** to ensure that their charter or terms of reference include or provide for the following:

- An instruction to the independent auditor that the **board of directors**, as the shareholders' representative, **is the auditor's client**.
- An expectation that financial management and the independent auditor perform a **timely analysis** of significant financial reporting issues and practices.
- An expectation that financial management and the independent auditor discuss with the audit committee their **qualitative judgments about the appropriateness, not just the acceptability, of accounting principles and financial disclosure practices** used or proposed to be adopted by the company and, particularly, about the degree of aggressiveness or conservatism of its accounting principles and underlying estimates.
- An opportunity for the independent auditor to be available to the full board of directors at least annually to help provide a basis for the board to recommend to shareholders the appointment of the auditor or ratification of the board's selection of the auditor.

The audit committee discussion with the independent auditor about the appropriateness of accounting principles and financial disclosure practices should generally include the following:

- the auditor's independent qualitative judgments about the appropriateness, not just the acceptability, of the accounting principles and the clarity of the financial disclosure practices used or proposed to be adopted by the company
- the auditor's views about whether management's choices of accounting principles are conservative, moderate, or extreme from the perspective of income, asset, and liability recognition, and whether those principles are common practices or are minority practices
- the auditor's reasoning in determining the appropriateness of changes in accounting principles and disclosure practices
- the auditor's reasoning in determining the appropriateness of the accounting principles and disclosure practices adopted by management for new transactions or events
- the auditor's reasoning in accepting or questioning significant estimates made by management
- the auditor's views about how the company's choices of accounting principles and disclosure practices may affect shareholders and public views and attitudes about the company.

Copies of the report of the Advisory Panel on Auditor Independence *Strengthening the Professionalism of the Independent Auditor*, or additional copies of this report, can be obtained by contacting the Public Oversight Board's offices.

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