FINANCIAL EXECUTIVES INSTITUTE

July 28, 2000

Mr. David B. Pearson
Staff Director
Panel on Audit Effectiveness
c/o The Public Oversight Board
One Station Place
Stamford, CT 06902

Dear Mr. Pearson:

The Committee on Corporate Reporting of the Financial Executives Institute (CCR) appreciates the opportunity to comment on the Exposure Draft of the Report and Recommendations of the Panel on Audit Effectiveness. CCR represents the dual perspective of preparers whose financial statements are audited by independent auditors and executives who use and rely upon audited financial statements. We wholeheartedly agree that high-quality independent audits of the financial statements of both public and private enterprises are a cornerstone of sound and efficient capital markets. Issues that have a bearing on audit quality are regularly discussed by CCR, and we endorse all reasonable and effective measures that serve to protect and enhance the high caliber of audits provided by the public accounting profession today.

In our view, the Panel has not allowed sufficient time for interested parties to comment on the exposure draft. We can't help but think that the Panel will be deprived of useful feedback because some constituents found it impractical to fully study the report and share their views within the comment period. Nevertheless, we commend the Panel on the well thought-out scope of the project and the comprehensive nature of its recommendations. The Panel's findings that both the public accounting profession and the quality of its audits are fundamentally sound are certainly consistent with our views. However, with the recent attention and dialogue on issues such as earnings management, auditor independence, and high-profile cases of earnings restatements, we agree that it is an appropriate juncture at which to examine the external audit process from a broad perspective and consider potential improvements that would further strengthen it.

Overall, CCR supports most of the recommendations in the Exposure Draft. We strongly endorse the recommendations of the Panel aimed at enhancing the importance of the auditing function within the major accounting firms and the stature of the profession to talented and dedicated individuals who might consider making it their career choice. The

Panel's many excellent recommendations to improve the audit process will have limited effectiveness if the profession does not succeed at attracting and retaining the best and brightest people. While consulting services have been the primary growth engine for the major firms over the past decade, accounting and audit services remain a backbone of those firms' professional practices. We believe the major firms can do more to show the accounting and audit side of their businesses in that light. Several firms have recently announced plans to separate or divest their consulting practices. This may naturally lead to greater attribution of value to the audit function in the words and deeds of the firms' leadership. We believe the Panel's recommendations will reinforce and hasten that development.

Many other proposals by the Panel that deal specifically with the practice of auditing public companies are well conceived and certainly have the support of CCR. For example, the recommendations in paragraphs 2.171 through 2.173 that auditors be required to understand and be sensitive to analysts' reports and company communications with analysts are very appropriate. Since stock prices often are significantly affected by market reaction to analysts' views, it is advisable that auditors understand and consider financial factors of interest and importance to analysts. While the Panel's findings generally confirm the audit firms' current attention to analysts' reports and communications to varying degrees, we believe formal professional standards and internal firm guidelines will serve to elevate that attention and make it more consistent across the auditing profession.

We will focus the remainder of our letter on several key recommendations on which our views differ from those in the Exposure Draft or where we believe some modification of the recommendation is appropriate:

Forensic-Type Fieldwork Phase

CCR strongly opposes the recommendation in paragraph 3.47 of the Report that would require a forensic-type fieldwork phase in all audits. The goal of increasing the likelihood that outside auditors will detect fraudulent financial reporting or misappropriation of assets is a worthy one. In that respect, we take no issue with the recommendations that would serve to strengthen the process of risk assessment for fraud in the planning phase of an engagement and to train auditors to be more alert to the potential for fraud. However, we believe a mandatory forensic-type fieldwork phase creates the potential for many problems:

- Forcing the outside auditors to "presume the possibility of management (at various levels) dishonesty, including their involvement in collusion, the possible override of internal controls and falsification of documents" could have significant repercussions on the relationship between the auditors and their clients. With only rare exceptions, the relationship between an auditor and a client is based on mutual trust and honesty. That relationship is immediately altered when the auditors presume that the management and staff of the client may be dishonest. Going beyond the "healthy skepticism" auditors are required to employ today to a presumption of fraud will undoubtedly lead to a disruption of the free flow of information between client and auditor on some engagements, resulting in a reduction in the quality of those audits.

- A forensic-type fieldwork phase is simply not warranted on the great majority of audit engagements. Existing professional standards require the auditor to assess engagement risk, inherent risk, and control risk. The Panel has made various recommendations in Chapter 2 of its report aimed at strengthening the auditors' assessment of each of these types of risk, as well as the procedures they employ in response to their risk assessments. We believe that, where warranted, forensic-type audit procedures will derive from the proper completion of these risk assessments. Requiring them on all audits will override a proper cost-benefit analysis and result in additional audit fees which are not justified for most companies.

- A mandatory forensic-type fieldwork phase for all audits could very well result in the detection of some instances of fraudulent financial reporting or misappropriation of assets that otherwise may have gone undiscovered by the normal audit process. On the other hand, there would certainly be cases of fraud that slip through these fieldwork procedures and come to light later. Adoption of this recommendation could lead the investing public to hold external auditors to a higher standard of responsibility for fraud detection than exists today and one that, as a practical matter, is not attainable. Confidence in a particular firm or the auditing profession as a whole could be even more adversely affected than it is today when the business media reports a case of fraud that the auditors did not catch.

We believe the current standards continue to provide the most appropriate model with respect to the outside auditors' role in the detection of fraud.

<u>Retrospective Audit Procedures and "Continuous Auditing" Techniques</u>

In addition to the forensic-type fieldwork phase, the Panel also recommends in separate sections of paragraph 3.47 the establishment of standards for retrospective audit procedures that look back on previously audited balances and "continuous auditing" techniques that could serve to better weave interim period review procedures into the full-year audit. In our view, these recommendations will result in expanded audit effort and incremental audit fees that are not warranted for most companies. Even though under certain circumstances continuous auditing techniques can be beneficial as high risk exposures are identified during the year, the use of these types of auditing procedures should be based on the risk assessments prepared by the auditor in the planning phase of the engagement.

<u>Non-Audit Services</u>

CCR is pleased that the Panel's report did not recommend an exclusionary rule prohibiting a firm from providing non-audit or non-tax services to its public audit clients. While we are sensitive to the independence issues that have been raised in that regard, factors such as a firm's expertise in a particular area or its knowledge of the client's operations often make it the best and most cost-effective choice for a consulting engagement.

Boards of directors and audit committees currently have a responsibility to oversee the independence of their companies' outside auditors. We believe that many, if not most, audit committees already monitor non-audit services provided by the outside auditors. We would fully support a recommendation that would require audit committees to review and discuss non-audit services and document conclusions in their minutes with respect to the independence considerations. However, we believe the Panel's recommendation in paragraph 5.29 that audit committees pre-approve non-audit services exceeding a specified threshold is too stringent and not practical in many situations. For example, in some cases, it may be prudent for management to proceed with engaging a firm for non-audit services in between regularly scheduled meetings of the audit committee. In addition to this risk of needless delay in the progress of important work, a pre-approval requirement could create an unfair, unwarranted, and uneconomic disincentive to using the audit firm even where it might be the preferable choice.

We believe that audit committees should establish guidelines for management to follow in deciding on whether to engage the audit firm for non-audit services. These guidelines could be formulated from the factors that the Panel outlined in its recommendation to the Independence Standards Board in paragraph 5.28. Acting within the guidelines and subject to the ultimate monitoring responsibilities of the audit committee, we believe managements could be reasonably relied upon to make appropriate decisions on non-audit services. Audit committees would be free to require pre-approval or establish dollar thresholds to guide their subsequent review of non-audit services where they deem it necessary to the conduct of their duties.

<u>Use of Internal Auditors</u>

In paragraph 2.192 of the report, the Panel recommends that the Auditing Standards Board (ASB) establish more definitive criteria and requirements for the testing of work performed by internal audit. In paragraph 2.193, the Panel recommends that the audit firms, in their internal interoffice reviews of selected engagements, consider whether audit teams may be using the work of internal audit excessively. We recognize that the outside auditors must consider many factors (e.g., the perceived strength of the client's staff or the risk assessment for a particular audit area) in determining the extent to which they may rely on the work of internal audit. Some companies choose to prohibit or limit the involvement of the internal audit staff in the external audit. Reasons for this may range from desiring the most objective view possible in the conduct of the audit to ensuring that the scope and procedures set by the outside auditors are fully responsive to audit risk and professional standards. While we believe the outside auditors will always have to exercise considerable judgment in determining their reliance on internal audit, we would favor a supplemental recommendation that the ASB provide more specific guidance not just on the extent to which internal audit work should be tested, but on the degree to which internal audit may assist in the overall scope of the audit.

Revenue Recognition

CCR does not agree with the Panel's recommendation in paragraph 2.137 that the Financial Accounting Standards Board (FASB) add a revenue recognition project to its agenda. We believe it is much more practical and appropriate to funnel revenue recognition issues to the Emerging Issues Task Force (EITF) for consideration and immediate guidance. Revenue recognition questions that grow out of newly developing technology and service businesses are precisely the types of issues that the EITF was created to address. We believe they will do a capable job of providing appropriate guidance in that regard.

CCR again commends the Panel for its excellent work on this project and appreciates the opportunity to share its views. This response was developed by Robert Peebles of CSX Corporation. Should you have any questions, please feel free to contact him at (804) 782-6770.

Sincerely,

Philip D. Ameen

Philip D. Ameen
Chair, Committee on Corporate Reporting
Financial Executives Institute