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## Ethics Forum: Committee Proffers Suggestions For The Future Of California's Professional Accountants

Recommendations For Change In The Financial Reporting Process, Published Financial Statements, And The Conduct Of Audits

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In recent times, financial reporting has faced a crisis in credibility. Problems involving financial executives and accountants have appeared too often on the evening news, and the fallout in the public's perception of the financial reporting community has been profound. Confidence in financial reports and the work of auditors has been shaken. This has consequences for the future of the accounting profession, its status, its reputation for integrity and its attractiveness as a career for both current and prospective accountants.

To address this crisis in credibility, the Board of Directors of the California Society of Certified Public Accountants (CalCPA) assembled a committee to recommend changes that could be made in California to improve financial reports and the process involved in preparing and auditing those reports. To that end, in June 2003, the Committee on the Future of California's Professional Accountants – group of California civic, business and professional leaders – was assembled to prepare a report with recommendations for change. The report represents the collective recommendations of the committee and does not necessarily represent the views of the CalCPA or the view of each individual member on each issue.

The committee has prepared a report that recommends actions to improve:

- (1) the financial reporting process,
- (2) published financial statements, and
- (3) the conduct of audits.

These recommendations apply to the conduct of professional accountants and auditors and the financial statements with which they are associated for both Securities and Exchange Commission (SEC) registrants, nonpublic companies and organizations with substantial outside capital or public trust. It is expected that those companies would engage a CPA firm to conduct an audit of their financial statements. Some of the recommendations also may be of interest to accountants employed by or serving companies and organizations that do not prepare audited financial statements.

The federal securities laws have changed in response to recent problems created through the passage of the Sarbanes Oxley Act, along with other related changes. Those changes apply only to public entities subject to the federal securities laws, however. The report addresses all entities with substantial outside capital or public trust. Some of the recommendations in the report are to broaden the reach of some provisions of the federal securities laws to other entities to which they do not currently apply. Other recommendations go beyond what is currently included in those federal laws and would apply to all companies, including those subject to the federal securities legislation.

The committee believes that adopting these recommendations will help to restore confidence in published financial statements, the financial reporting process and the work of independent auditors. The committee believes that leaders of the accounting profession must clearly communicate to California's professional accountants their duty to the public trust and the types of behavior that will not be tolerated.

**Financial Reporting Process:** To improve the financial reporting process, the committee recommends that each company identify a Chief Accounting Officer (CAO) who is an actively licensed CPA (or similar) and subject to continuing education requirements. Moreover, the committee recommend that the California State Board of Accountancy and other equivalent state boards should consider expanding the requirements of licensure to include CPAs involved in the financial reporting process and that the American Institute of Certified Public Accountants and Financial Executives Institute should consider developing an additional certification for CAOs of public companies. The committee also recommends that companies and organizations with substantial outside capital or public trust should establish an independent audit committee; the report also recommends enhancing the audit committee's independence and competence. Companies also should be encouraged to develop an internal audit function and the audit committee should meet regularly with both the internal and the external auditors.

**Published Financial Statements:** To improve published financial statements, the committee recommends that companies should choose accounting policies that best reflect the underlying economics of the events and transactions, and that additional disclosures should be made about accounting policy choices and the consequences of those choices. Additional disclosure about accounting estimates that have a material effect on the financial statements is also suggested. The committee recommends that audited, nonpublic companies with substantial outside capital or public trust be encouraged to provide disclosures like the Management Discussion and Analysis (MD&A) disclosures currently required by public companies.

**Audits:** To improve audits, the committee recommends creating two separate audit reports. One report would opine on the financial statements of companies that are governed by and follow the requirements of Sarbanes Oxley (SOX) and non-public companies that elect to follow the SOX. The other report would opine on those non-public companies that choose not to follow SOX. Auditors should be required to report on internal controls for audited, nonpublic companies. We also recommend annual evaluation of executive compensation (including retirement plans), the code of ethics, and the financial reporting process at the audited company, including the corporate culture, the audit committee and the CAO and staff.

The Committee on the Future of California's Professional Accountants believes that the changes suggested in the report – and adherence to the principles embodied in this report by both SEC registrants and nonpublic companies and organizations with substantial outside capital or public trust – will improve the financial reporting process, published financial statements and the conduct of audits. ■

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### **Committee On The Future Of California's Professional Accountants**

- John M. Lacey, Chair, Professor of Accountancy and Ernst & Young Research Fellow, California State University, Long Beach
- Joseph Berenato, Chairman and CEO, Ducommun Incorporated
- John A. Dodsworth, CEO, CAMICO Mutual Ins. Co.
- William W. Holder, Ernst & Young Professor of Accounting, Leventhal School of Accounting, University of Southern California
- Michael Josephson, Founder and President, Michael and Edna Josephson Institute of Ethics
- Ira Landis, Adjunct Professor, West LA College and Pepperdine University Former President, California Board of Accountancy
- Kenneth Leventhal, Retired Chairman, Kenneth Leventhal and Company

- Roger Molvar, Retired Chief Executive Officer, IndyMac Bank
  - Harold Williams, Chairman, SEC, 1977-81, Counsel, Skadden, Arps, Slate, Meagher & Flom LLP
- Summary Of Committee Recommendations Financial Reporting Process
- Companies employ a Chief Accounting Officer (CAO) who is an actively licensed CPA (or similar), subject to continuing education requirements.
    - California Board of Accountancy and the National Association of State Boards of Accountancy (NASB) expand the requirements of “active” licensure to company-employed CPAs involved in the financial reporting process.
      - AICPA and FEI develop an additional certification for CAOs of SEC registrants.
      - Companies establish an independent audit committee that meets frequently with the internal and the external auditors.
      - Companies develop an internal audit function.

#### Published Financial Statements

- Companies choose accounting policies that best reflect the underlying economics of the events and transactions and additional disclosures should be made about accounting policy choices and the consequences of those choices.
  - Companies provide additional disclosure about accounting estimates that have a material effect on the financial statements.
    - All companies provide Management Discussion & Analysis (MD&A) disclosures.

#### Conduct Of Audits

- Auditors adopt two separate audit reports, one for companies that follow the Sarbanes-Oxley Act (SOX) and a second for those that do not.
  - Auditors report on internal controls for all companies. Auditors evaluate annually (a) executive compensation and retirement programs; (b) codes of ethics; and (c) financial reporting processes at the company, including corporate culture, the audit committee and the CAO and staff.