

Sent via e-mail to: comments@pcaobus.org

February 14, 2005

Public Company Accounting Oversight Board (PCAOB)
Attention: Office of the Secretary
1666 K Street, N.W.
Washington DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 017, Proposed Ethics and Independence Rules
Concerning Independence, Tax Service, and Contingent Fees

Dear PCAOB Board Members:

In conjunction with the Board's stated desire to move aggressively to protect the investing public, I respectfully submit the following thesis which contains comments and supporting business cases offered for the Board's consideration. The purpose of the comments are to: (1) answer specific comment requests in the PCAOB document on proposed ethics and independence rules and suggest ways in which the proposed and current PCAOB professional standards and ethics rules should be modified to further the profession; (2) suggest the PCAOB consider a proven set of professional standards and ethics laws in statutes and rules as a model; and (3) provide information on current Section 404 compliance work by Big Four Firms that may need additional PCAOB rulemaking.

Concerns for the profession of Accounting have been expressed in various journals and periodicals. The PCAOB's own cursory investigation into Big Four Firms found concerns about accounting and auditing and in quality control. Ethical lapses in Big Four Firms are becoming more apparent as the wave of investigations and prosecutions continues in companies they audited. The principles and practices of accounting and auditing in conjunction with professional ethics should be clearly defined and effectively expounded in PCAOB rules to more effectively regulate the activities of the profession.

I am a former corporate information officer of a public company and retired Professional Engineer with an EMBA from the Weatherhead School of Management at Case Western Reserve University. My past work has involved working with CEOs, CFOs, Controllers, Accounting Professionals, Internal Audit, Legal, and others in process redesign and controls remediation, often involving whole organizations and business systems, saving significant sums and resulting in positive impacts. In companies, I have served as functional head or in interim leadership roles. I have over 30 years of progressive business experience in all functions of manufacturing, distribution, construction, and in a variety of industries. We specialize in business change management and knowledge transfer in company and functional reengineering, process improvement and design, with better controls, all focused on results.

It is encouraging to see the PCAOB address these important issues to restore the stature of the Auditing and Accounting profession. Please contact me by email at deshleman@expertprocess.com or by phone at 704-892-6112 for any further discussion.

Sincerely,

[Signed]

David R. Eshleman
President

Proposed Ethics and Independence Rules

PCAOB Rulemaking Docket Matter No. 017

By David R. Eshleman, President, Expert Process Solutions LLC

February 10, 2005

BACKGROUND AND INTRODUCTION

In conjunction with the Board's stated desire to move aggressively to protect the investing public, the following comments and supporting business cases are offered for the Board's consideration. The purposes of the comments are to: (1) answer specific comment requests in the PCAOB document on proposed ethics and independence rules and suggest ways in which the proposed and current PCAOB professional standards and ethics rules should be modified to further the profession; (2) suggest the PCAOB consider a proven set of professional standards and ethics rules in statutes and rules as a model; and (3) provide information on current Section 404 compliance work by Big Four Firms that may need additional PCAOB rulemaking.

The consulting practices Big Four audit and accounting firms have subordinated the practice of Auditing. These practices have also taken a heavy toll on investors, both in fees and poor results. Thankfully, the PCAOB is acting quickly to restore confidence of accounting professionals in the ethical practice most already hold dear, the investing public, and the many workers who suffered the loss of their 401K and retirement security. In the recent PCAOB performance review of Big Four Firms and in the press, serious concerns are being raised about the efficacy of these firms. Past involvements in costly and unprofitable Y2K projects and in the recent confusion and excess cost accelerated filers have invested in the effort to become §404 compliant are significant issues. The Board should act quickly to define legitimate practice elements that constitute the standard practice of accounting along with the independence rules and restrict audit firms from doing any consulting.

A model exists in law for regulating professional standards and adherence to a code of ethics. The statutes regulating the practice of Professional Engineering and the rules of professional conduct are a body of model legislation found in varying degrees in every state. In North Carolina, for example, model legislation for the profession of engineering was enacted in 1951 with the original legislation governing the profession of engineering and establishing the Board of Registration dating from 1921. These laws and rules have been successful over many years in protecting the "life, health, property and welfare of the public and to establish and maintain a high standard of integrity, skills, and practice in the professions of engineering."¹ This is a worthy standard. Add "investing" in front of "public" and change "engineering" to "public accounting and auditing" and this becomes reality to the current situation.

The PCAOB should consider this proven model legislation as a basis in which to establish the foundation of professional standards and ethics for the individual and corporate practice of Public Accounting and Auditing. The references in the attached exhibit are from Statutes and Rules governing the practice of engineering in the State of North Carolina.

Concerns for the profession of Accounting have been expressed in various journals and periodicals. The article "Fuzzy Numbers," the October 4, 2004, Business Week Cover Story² caused Colleen Cunningham, President of Financial Executives International (FEI), a COSO organization, to wonder in her editorial reply, if the author couldn't have quoted at least one righteous Accounting Executive from among her organization's many members and companies. In her own Editorial Page in the current issue of FEI *Financial Executive*, entitled "The Value of Values,"³ she relates an issue that caused her to resign her position at one of the "Firms." This came about because of her concern for ethics on an audit engagement and the lack of concern for the issue on the part of the senior partner, only later to have to testify on the matter before the SEC. Ethical lapses in Big Four Firms are becoming more apparent as the wave of investigations and prosecutions continues. Professional ethics should be clearly and effectively expounded in Board Rule definitions.

In our reviews of company performance in one area of our expertise, business processes, we found poor performance relative to effective and efficient operations, especially in Supply Chain. Management needs to check that controls are in place to make sure their objectives are communicated throughout the organization and that these controls regulate the execution of the strategies of the CEO and his or her team. This element of "the framework" analysis required by the SEC and in PCAOB Rules on §404, Auditing Standard #2, (AS-2) for Management's Assessment has not been effectively implemented in public companies that have Big Four Audit Firms. We have found a notable absence of understanding concerning Management's Assessment. How can performance results for management and investors be accurately achieved, when analysis of controls over effectiveness and efficiency of operations, required by COSO/AS-2⁴ is ignored as a control objective?

Section 1. COMMENTS ON PCAOB PROPOSED RULES

RULE 3502. RESPONSIBILITY NOT TO CAUSE VIOLATIONS.

A person associated with a registered public accounting firm shall not cause that registered public accounting firm to violate the Act, the Rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under the Act, or professional standards, due to an act or omission the person knew or should have known would contribute to such violation.⁵

COMMENT: Audit firms should not be allowed to perform any consulting services. A firm's judgment could be impaired if the dollar amount of the consulting work is sizable compared to audit services. An individual engagement may not appear to an outsider to be large in revenue compared to audit services, but within a firm may actually involve a number of smaller engagements that, over a short period of time, could amount to a sizeable sum. A partner in the same firm could pressure an auditor to forego certain judgments in audit because it may be perceived as creating a potential business loss for the entire firm's book of other business at that client. Even with non-audit clients, the outside work could be of such magnitude that the audit firm views auditing as less attractive to the partnership as a whole, diminishing the quality of the auditing function.

The Board should at the very least define every specific practice element to restrict non-attest consulting work so as not to diminish or subordinate audit. This rule should apply to both attest and non-attest clients.

Similar to a *conflict of interest*, the size of any potential non-audit service or services could be argued to alter a firm's judgment. In this case, a potential conflict of interest may be with a firm's own sizeable services offered to an audit client. This view is strikingly similar to the underlying wording in PCAOB **Rule 3500T, Interim Ethics Standards**; which includes "...AICPA's Code of Professional Conduct Rule 102, and interpretations and rulings thereunder..."⁶ The AICPA conflict of interest rules and interpretations included in the PCAOB's current ethics standards are:

.01 **Rule 102—Integrity and objectivity.** In the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts *or subordinate his or her judgment to others*. [As adopted January 12, 1988.] (emphasis added)

Interpretations under Rule 102 —Integrity and Objectivity .03 102-2—Conflicts of interest. *A conflict of interest may occur if a member performs a professional service for a client or employer and the member or his or her firm has a relationship with another person, entity, product, or service that could, in the member's professional judgment, be viewed by the client, employer, or other appropriate parties as impairing the member's objectivity.* If the member believes that the professional service can be performed with objectivity, and the relationship is disclosed to and consent is obtained from such client, employer, or other appropriate parties, *the rule shall not operate to prohibit the performance of the professional service (emphasis added).*⁷

If the interpretation of the rule is to prevent subordination of judgment, what does "*the rule shall not operate to prohibit the performance of the professional service*" mean? If a larger client project could subordinate the judgment of the auditor, is this excused by the interpretation? If, an unambiguous reading of the rule and interpretations leads one to question the ethics, shouldn't the PCAOB act to rectify this by clearly defining the practice of accounting in law?

An example could even arise if several sizable projects were being performed at a non-audit client in which an audit committee board member served on the board of another of the firm's audit clients. Could a situation arise in the Audit Firm's office discussions where an auditor would be asked to forego an adverse opinion because of offending the board member that served on the two companies?

For this and other reasons, all consulting work should be totally disallowed for Registered Firms. This rule should apply for any attest or non-attest client consulting work. The over arching principle is ...**auditors "should not only be independent in fact; they should avoid situations that may lead outsiders to doubt their independence."**⁸ To avoid the appearance of impropriety, the PCAOB should, at the very least, define the specific attest and non-attest services permitted for both attest and non-attest clients. Any practice should be disallowed that could be of a size that the overall independence and integrity of public Audit Firms might be called into question. It is not prudent for Audit Firms to consult.

RULE 3520. AUDITOR INDEPENDENCE, ppA-4 Subpart 1 – Independence

A registered public accounting firm must be independent of its audit client throughout the audit and professional engagement period. ⁹ Independence Rules of the PCAOB are found in **Rule 3600T, Interim Independence Standards**, which states that "...a registered public accounting firm, and its associated persons, shall comply with independence standards...as described in the AICPA's Code of Professional Conduct Rule 101, and interpretations and rulings thereunder..." ¹⁰

The AICPA's Code of Professional Conduct "Rule 101 – Independence" and "**Interpretations of Rule, 101-3 Performance of nonattest services**" states that "before a member or his or her firm ("member") performs nonattest services ...for an attest client, the member should determine that the requirements described in this interpretation have been met..." ¹¹ The following section is from the table of interpretations in the AICPA code regulating non-attest services registered firms can offer:

Specific Examples of Nonattest Services

The examples in the following table identify the effect that performance of certain nonattest services for an attest client can have on a member's independence.... Below is a section of a table entitled, "**Impact on Independence of Performance of Nonattest Services**" ¹²

<u>Type of Nonattest Service</u>	<u>Independence Would Not Be Impaired</u>	<u>Independence Would Be Impaired</u>
Information systems – design, installation or integration	<ul style="list-style-type: none">• Install or integrate a client's financial information system that was not designed or developed by the member (e.g., an off-the-shelf accounting package).• Assist in setting up the client's chart of accounts and financial statement format with respect to the client's financial information system.• Design, develop, install, or integrate a client's information system that is unrelated to the client's financial statements or accounting records.• Provide training and instruction to client employees on an information and control system.	<ul style="list-style-type: none">• Design or develop a client's financial information system.• Make other than insignificant modifications to source code underlying a client's existing financial information system.• Supervise client personnel in the daily operation of a client's information system.• Operate a client's local area network (LAN) system

COMMENT: INDEPENDENCE ISSUES WITH INFORMATION SYSTEMS CONSULTING

The previous comments on Rule 3502 illustrated the "subordination" of audit to other services of a greater magnitude in a registered Firm that would impair its judgment in audit. Whatever the PCAOB decides on independence rules, one such practice has nearly destroyed auditor independence due to other practices of a Firm. Accounting and audit firms should be prohibited from information systems consulting, which is a practice requiring the knowledge and principles of engineering. **The PCAOB should immediately act to prohibit both Auditing and Accounting Firms from offering to perform or performing information systems consulting.**

In the Table above from the AICPA Ethics and Standards Rules, the listing of any of the above Independence and Practice Areas specifically indicates "Information systems – design, installation or integration" as a service that may be offered by a member or Firm for both attest and non-attest clients and not impair independence. Most of "information systems design, installation or integration" services are outside the knowledge and principles associated with the practice of accounting. The only area of education and skill that is within the practice of accounting is "Assist in setting up the client's chart of accounts and financial statement format with respect to the client's financial information system." ¹³

The practice of systems design, installation, and integration services is well defined in engineering science. These services require the knowledge of the principles and practices of engineering. The regulation of the engineering profession starts with a national testing program that defines the "final Exam" for engineers seeking Professional Engineering registration. The National Council of Examiners for Engineering and land Surveying or NCEES (<http://www.ncees.org/>) provides Principles and Practice Exams¹⁴ to test academic knowledge and understanding gained in engineering practice. The Professional Engineering exams created by NCEES for state

boards of engineering registration cover a comprehensive range of subjects in engineering. The NCEES website lists specifications for the Principles and Practice exams.

The practice areas of Electrical and Computer Engineering and Industrial Engineering below define in detail these areas of practice found in the AICPA non-attest services table segment “Information systems – design, installation or integration” category.

Electrical and Computer Practice Areas for Professional Engineers

General Computer Systems: Interpretation of Codes and Standards (IEEE and ISO Standards), Microprocessor Systems; **Hardware:** Systems and Architecture; **Software:** System Software, Development/Applications (Computer Control and Monitoring, Software Lifecycle, Fault Tolerance, Modeling and Simulation, Human Interface Requirements, Software Design Methods and Documentation (Structured Programming, Top Down or Bottom Up Programming, Successive Refinement, Programming Specifications, Program Testing, Structure Diagrams, Recursion, Object Oriented Design, Data Structures); **Networks:** Protocols, Computer Networks.¹⁵

Industrial Engineering Practice Area for Professional Engineers

Systems Analysis and Design: Analysis and Design Processes, i.e. System analysis and design tools (e.g., input/output analysis, affinity diagrams, Pareto charts) and Value analysis and engineering (e.g., projected cost flow, projected value stream analysis); Costing and Performance Measurement, i.e. Cost accounting (e.g., product and process costing, standard costs, activity-based costing) and Performance measures and applications (e.g., leading and lagging measures, metrics); **Logistics:** Production Planning and Control, i.e. Forecasting methods (e.g., exponential smoothing, seasonal methods), Aggregate planning, Traditional strategies (e.g., MRP, MRP II, JIT), Lean manufacturing, Scheduling, Inventory control; Distribution and Storage/Warehousing Methods, i.e. Direct shipment, warehousing, cross-docking, Transshipment, and Routing; **Work Design:** Methods to Measure Work, Motion study, Operations process charts, Predetermined time systems, Work sampling, Methods Design and Analysis; **Quality Engineering:** Quality Control, i.e. Control charts, Acceptance sampling, Process capability analysis, Design for quality, Total Quality Management, Kaizen, ISO, Reliability and Maintainability.¹⁶

The services of “information systems design, installation or integration” are clearly designated above as principles and practices of scientific analysis, computing and engineering, not accounting. There is longstanding evidence in the evolution of computing to support this. Early in 1970, IBM introduced the System/370 series of mainframes. IBM branch offices that sold and supported computers and applications had “Systems Engineers” to assist clients with installing and integrating accounting applications. This was a longstanding practice and job description within IBM, dating from the 1960s. IBM provided up to two years of training in the science of computing, business applications and software, including the practice areas described in the above paragraphs. About this time, colleges and universities also began establishing computer science departments to teach and develop these same practices and advance the scientific and engineering basis for computing.

During Y2K, there was a significant departure from proven information system and technology practices by the Big Eight and other large accounting and consulting firms. Before Y2K, these firms had inroads to the executive suite through their audit practices. With this access, these firms began convincing C-level executives that their boards wanted only firms of their size to perform the Y2K remediation, and SAP was the best way to do it. Much of the Y2K work was secured this way, forgoing a disciplined due diligence process and the scientific and engineering insight of the last 30 years. The accounting and audit firms sold huge projects without real knowledge of the principles, practices, and application of science in computing or capabilities to perform in accordance with the established practices of industrial, electrical and computer engineering. One national IT advisory group estimated that the business cost of Y2K was \$40 billion without measurable economic benefit.

In the course of securing millions of dollars of consulting services and enriching the partnership, the large accounting and consulting firms subordinated the practice of auditing, diminishing the quality and accuracy of this valuable service in larger public companies. As the Y2K process unfolded, the quality of Internal Controls suffered as well. Years of internal IT controls specific to a particular business to maintain the effectiveness and efficiency of operation, along with competitive capabilities, were done away with in the rush to secure billions in consulting revenues and implement “modern” Enterprise Resource Planning (ERP) systems. The impact of subordination of audit practices to IT consulting and ensuing implementations within client companies is now history; the PCAOB should act decisively to prevent this from occurring ever again.

The PCAOB should act decisively in rules to prohibit Accounting and Audit Firms from the practice of any consulting in information systems – design, installation or integration, including restricting business application advice to accounting and finance. Operations application consulting should be disallowed.

COMMENT/BUSINESS CASE: FAILURE TO IDENTIFY INEFFECTIVE INTERNAL CONTROL

Further example of the violation of the independence rule has been the dilution of the value of accounting practices and controls in large public firms to adequately inform management of the results of their actions. Ineffective controls defeat the objectives of management in operational effectiveness and efficiency. Nowhere is this more obvious than in the outsourcing of millions of jobs that have value to American manufacturing and distribution businesses. In many cases, the return to shareholders has been minimal for these vogue programs. In outsourcing, a management team may have a goal to eliminate unions and reduce cost. Company accounting and not-so-independent auditors may justify management's goal in internal allocations of costs that show manufacturing labor as overly costly to the business, when in fact a total and/or lifecycle costing approach may show otherwise.

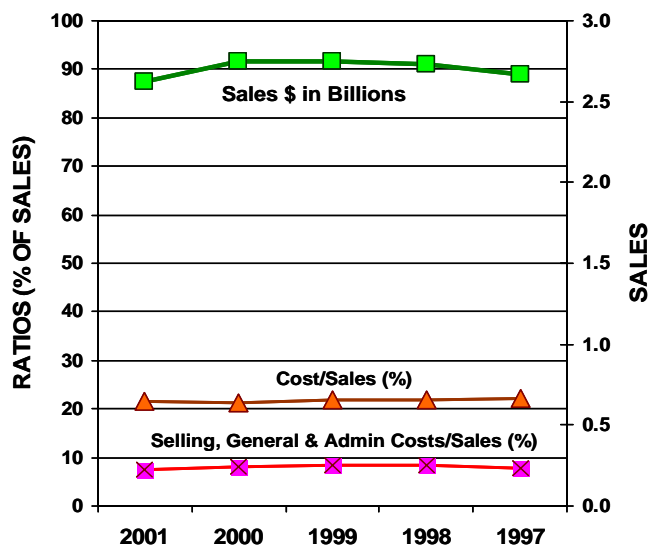
Consider the following public company's performance data. In this manufacturing company example, the CEO rolled out an outsourcing strategy. The results of this program are shown below. The source of information is the company's 10K filings from 1997 to 2001.

	<u>2001</u>	<u>1997</u>
Number of US Employees	7,000	12,000
Number of Foreign Employees	7,400	6,000
Total Employees	14,400	18,000
<hr/>		
Outsourcing Reduction in US Jobs 1997-2001	-42%	(5,000)
Foreign Employees – jobs gained	23%	
Total Jobs Lost/Gained	-3,600	

The job loss chart above indicates a 42% outsourcing job loss over a five year period. Over 5,000 jobs were permanently lost. In some cases foreign vendors replaced manufacturing jobs, which accounts for reduction in the "Total Employees" numbers. Did this produce financial benefit to the company? The following chart shows the financial results for this same period. Sales are flat, and cost and SG&A ratios are flat.

Why do the numbers show such poor results, even though American workers were replaced by cheaper Chinese labor? If a framework analysis like in COSO is correctly performed by this company, the real risks of this strategy are revealed:

- Overhead had been unfairly "allocated" to production workers on division P&Ls
- Labor cost for most products was less than 8% of the base product cost, while overhead was often well over 90% of the total cost.
- Company accountants calculated internal cost allocations monthly – these were not publicly reported, but were used for internal decision making by management.
- Outsourcing to China produced unwanted competition. Now knock-offs from China of key products are being showcased by key high-volume customers.
- The intelligence and skill base used to produce safe, useful and quality products is gone, decreasing the company's (and investor's) brand value.



Did the company's auditors alert the CEO, board and shareholders that a potential inaccurate picture created by overhead allocations presented a risk to the company and its investors? No – the question is, did the audit firm fail the independence test? Many companies have outsourced their workers. Have millions of jobs have been lost, even though external reporting is attested as accurate by the company's auditors, because end results have questionable value due the misapplication of internal accounting in allocations? If a Management's Assessment of Internal Controls over Financial Reporting had been performed in the Objective of Efficiency and Effectiveness of Operations, this oversight might have been discovered.

Were internal controls designed and in place? Did they govern the effectiveness and efficiency of operations? The audit firm should have at least recognized the lack of control that could undermine long term investor value. While this example is about good controls over performance and investors losing value when a skilled workforce is lost, it also unfairly caused loss to the workers and their families. True auditor independence should be well-defined by the PCAOB to help reveal questionable practices that may work against management's strategy to reduce overall costs.

Section 2. A MODEL LAW FOR PROFESSIONAL PRACTICE AND ETHICS

In statutory laws of the states, with NC as an example, both the engineer and the practice of engineering is defined corporately and individually on the qualifications of both education and experience. It governs what can and can't be done in work assignments with clients. It sets up a Board of Registration in the state to establish and maintain a code of professional practice and ethics. The Board of Registration has the authority to investigate and fine wrongdoers among individuals, professionals, and corporations for violations of both the Law and the Rules. Strong punishment and fines can be given by the board to unlicensed individuals that engage in the public practice of engineering and also for professionals that practice outside their area of expertise.

The NC statute is available as a download at: <http://www.ncbels.org/GS89C8-2000.pdf>.¹⁷

Statutory Requirements of Professional Practice – Significant Features of NC Law.

- 1. An Engineer is defined by knowledge, application, and experience:** An engineer is defined as “A person who, by reason of special knowledge and use of the mathematical, physical and engineering sciences and the principles and methods of engineering analysis and design, acquired by engineering education and engineering experience, is qualified to practice engineering.”¹⁸
- 2. The “practice” of engineering is defined:** A person practicing or offering to practice engineering in “...any branch of the profession of engineering; or who, ...in any other way represents ...to be a professional engineer, or through the use of some other title, ...licensed ...or able to perform, or who does perform any engineering service or work, ...or any other service ...recognized as engineering.”¹⁹
- 3. Unlawful to Practice without a License:** Any individual who practices engineering as defined above by offering services to the public at large (including public corporations) without a license to do so is in violation of state law. “Any person who shall practice, or offer to practice, engineering... without first being licensed... or any person, firm, partnership, organization, association, corporation, or other entity using or employing the words "engineer" or "engineering..." or have a “form of business or activity except as licensed...or **who shall practice or offer to practice when not qualified... shall be guilty of a Class 2 misdemeanor**. In no event shall there be representation of or holding out to the public of any engineering expertise by unlicensed persons...”²⁰ The board may prosecute any persons violating these provisions and the Attorney General of the State will be the legal advisor.
- 4. Establish and Enforce Rules of Professional Conduct:** The board defines rules that govern professional conduct and discipline of all licensed practitioners, which includes civil penalty, for violation of the Rules of Professional Conduct, professional incompetence, and other things. “Rules of Professional Conduct applicable to the practice of engineering... are construed to be a reasonable exercise of the police power vested in the Board... Every person licensed by the Board shall subscribe to and observe the adopted rules as the standard of professional conduct for the practice of engineering... and shall cooperate fully with the Board in the course of any investigation.”²¹
- 5. Conduct Investigations:** the Board can – “Any person may prefer charges of fraud, deceit, gross negligence, incompetence, misconduct, or violation of the rules of professional conduct, against any Board registrant. The charges shall be in writing and shall be sworn to by the person or persons making them and shall be filed with the Board.”²²
- 6. Licensure of Corporations and Business Firms; Responsible Charge...** A corporation or business firm may not engage in the practice of engineering... unless it is licensed by the Board... A corporation or business firm is subject to the same duties and responsibilities as an individual licensee. ...all engineering... work done by the corporation or business firm... [is required] to be performed by or under the responsible charge of individual registrants...”§ 89C-24. “...the Board may by regulation establish a reasonable limit on the number of unlicensed individuals which a licensee of the Board may directly or personally supervise at one time.”²³

COMMENT: The PCAOB should act to define Accounting and its principles and practices. An engineer is defined in statutes along with individual and corporate practices of engineering. This definition includes the acceptable span of control for management – “Responsible Charge” The PCAOB should define the principles and practice of the Accounting profession and its registered firms in particular. The Board should eliminate or at least restrict the consulting activities of these firms by strict definition of what practices are allowed. Clear definitions would put a boundary on what are the acceptable professional standards and regulate the practice of accounting based on the education, knowledge, experience and ability of individual and firms in the profession. The PCAOB independence and ethics rules should be explicitly defined so violators can be severely punished.

Rules of Professional Conduct – Significant features of NC Administrative Laws

The NC Administrative Rules are available as a download at: <http://www.ncbels.org/CHAPTER21.pdf>

- 1. Binding Upon All Professional Engineers and Engineering Businesses:** “In order to safeguard the life, health, property and welfare of the public and to establish and maintain a high standard of integrity, skills, and practice in the professions of engineering...” (a) All licensed persons must have knowledge and understanding of the rules of professional conduct.²⁴
 - 2. Perform Services Only in Areas of Competence, Education, and Experience:** Licensed engineers can perform services only in areas of competence and undertake engineering projects only when qualified by education or experience in the specific technical field... (1) If multiple disciplines are required, associates, consultants, or employees must be licensed and competent in each discipline.²⁵
 - 3. Subject Matter Experience and Responsible Charge:** A licensed engineer can not sign or seal any engineering plan or document without having education or experience in the subject matter, or if plans or documents are not prepared under the engineer’s direct supervisory control. “Direct supervisory control (responsible charge) requires a licensee or employee to carry out all client contacts, provide internal and external financial control, oversee employee training, and exercise control and supervision over all job requirements to include research, planning, design, field supervision and work product review...”²⁶
 - 4. Other Ethical Standards:** “A licensed engineer shall not attempt to injure, maliciously or falsely, directly or indirectly, the professional reputation, prospects, practice or employment of another engineer...”²⁷ “...solicit or accept work only on the basis of qualifications..., compete for employment on the basis of professional qualification and competence to perform the work... not falsify or permit misrepresentation of academic or professional qualifications... ..not misrepresent degree of responsibility in or for the subject matter of prior assignments.”²⁸
 - 5. Advertising:** “Brochures or other presentations incident to the solicitation of employment shall not misrepresent pertinent facts concerning employers, employees, associates, joint ventures, or past accomplishments with the intent and purpose of enhancing qualifications and work.”²⁹
- “The Licensee shall perform services in an ethical and lawful manner...”³⁰

COMMENT: The PCAOB should clearly define the discipline and practice of the accounting profession. The Engineer and the “practice” of engineering are defined in the statutes. This concept is further defined in the code of ethics in administrative rules to control the quality of the profession and further protect the public. An engineer can perform services only in areas of competence, education, and experience and undertake projects only when qualified by education or experience in the specific technical field involved. If multiple disciplines are required for an assignment or project, every individual must be licensed and competent in each discipline and the supervision must be licensed, qualified and involved. The purpose is to keep the quality of services high and to protect the public welfare.

Part 5 – Ethics Rule 3501³¹. Definitions of Terms Employed in Section 3, Part 5 of the Rules should be expanded to include all definitions relative to the practice of accounting. This should include disciplines as well as practices that Audit and Accounting Firms can be expected to perform. It would also permit the PCAOB to more closely regulate the profession to restore public confidence in the audit process.

Licensure of Corporations and Business Firms; Responsible Charge of individual registrants. Partner and management structure of Audit Firms, like Responsible Charge in the engineering laws, should also be regulated by

PCAOB. Disconnected partners that spend time with management and boards, leaving inexperienced associates to run an audit leads to quality and performance issues. Quality and performance issues have already been identified in the PCAOB's own preliminary investigation of the Big Four. Subject matter experience and Responsible Charge are linked in engineering rules: an engagement professional must have education or experience in the subject matter, and direct supervisory control of other professionals. "Direct supervisory control (Responsible Charge) requires a licensee or employee to carry out all client contacts, provide internal and external financial control, oversee employee training, and exercise control and supervision over all job requirements to include research, planning, design, field supervision and work product review..."³²

The PCAOB should define the concept of Responsible Charge for Auditors and their Firms to require all client contacts, including board member and senior management to be handled only by the audit professional in responsible charge of the audit. This individual would be defined as having the knowledge, competence and experience in accounting principles, audit rules and client operations.

Section 3. CURRENT PROBLEMS OF INDEPENDENCE AND CONCLUSIONS

SARBANES-OXLEY ACT, SECTION 404 – PROCESS COMPLIANCE: The practice of mapping and documenting processes is an industrial engineering practice. Accounting and Auditing Firms have been providing these services, often with inexperienced individuals. Indications in the financial press revealed that preparation of business process documentation required by public companies to meet PCAOB Auditing Standard #2 under Section 404 of the Sarbanes-Oxley Act has increased the cost of compliance dramatically for accelerated filers. Providing process mapping and documentation is yet another conflict of interest with independence and not within the practice of accounting. Accountants can also be licensed engineering professionals, and if so, their Firm must also be licensed in order to practice in this field. This individual must also have Responsible Charge in order to maintain the quality of the engagement. This is yet another practice element should be restricted by the PCAOB, both to audit or non-audit clients, to preserve the quality of the accounting and auditing profession and protect the investing public.

An equally troubling problem with "process consulting" is the potential loss of competitive advantage because the Audit and Accounting Firms are required by the PCAOB to audit and walkthrough business processes. These firms are required to learn a company's processes, which may be an important source of competitive advantage for that company. If this same firm is allowed to consult, audit firms could intentionally (to sell services) or unintentionally give away proprietary process information to a competitor of the firm they are auditing. In addition, potential control, significant, or material deficiencies might be flagged, with "suggestions for improvement" (allowed under AS-2) for which the Audit firm then gains significant fees to "remediate."

CEOs, Audit Committee members, and company internal audit employees have been heard to express the following concerns: "our auditor is telling us how to run our business and we must do what they tell us for compliance" and "we must spend extra time dealing with external audit personnel that don't understand our business or the compliance process" In the manufacturing and distribution businesses, overall process complexity is only understood by only a few. The accounting and finance function is only 6-8% of the total business processes of these companies. An Auditor must make a reasonable assumption about, or assessment of, over 90% of the business and system controls that are important for operations effectiveness and efficiency and financial reporting, but may be outside of their knowledge or experience.

Evidence of weaknesses in business processes over the last ten years can be found in assessing the quality of business processes in 7 Key or significant process areas found in most Fortune 1000 public companies. Three of these key processes are shown in the table below. The table below shows the relative efficiency and effectiveness of these processes and controls using current systems. These processes and their low operational effectiveness ratings are now a potential source of control, significant, or material deficiencies. Lack of knowledge and skills in Y2K in designing, implementing and integrating the ERP systems and controls that regulate these processes by the Big Eight accounting and consulting firms and their ERP recommendations has contributed to the inability of companies to significantly improve their performance. This table reflects the ineffective and inefficient business process and control activities in larger companies (mostly over \$200 million in revenues). Along with ineffectiveness in the other four significant processes (not shown), this situation causes higher overhead and working capital in these companies.

Table 1 – Key Business Processes, ratings and potential for control issues:

<u>Key Business Process</u>	<u>Operational Efficiency & Effectiveness Rating</u>	<u>Control/ Significant/ Material Weakness?</u>
Orders to Cash (including DC/FG Shipments)	50%	?
Procure to Pay	58%	?
Accounting and Financial Reporting	81%	No or ?

Evidence is emerging of the lack of process knowledge on the part of Big Four Audit and Accounting Firms with regard to process compliance in AS-2. Consider this recent report in CFO Magazine: "...Some finance executives are organizing peer groups to share experiences, compare notes on their auditors, and vent frustrations. One such group, in Silicon Valley, includes finance executives from about 30 technology companies who meet in informal sessions every other month. ...One common complaint is that auditors have inconsistent and evolving standards on what is required for a clean audit. ...Ed Pitts, director of internal audit at Foundry Networks, explains, "There is no precedence for [the regulation], so there is a lot of confusion about what is required." ...Members of the group say requirements vary not just from firm to firm, but from audit partner to audit partner. "The same firm is telling different companies different things," explains Pitts."³³ **The PCAOB should define then regulate practice elements and Responsible Charge to insure the quality of process and internal control audits defined in Auditing Standard #2.**

Accelerated filers are still looking to their Big Four Audit and Accounting Firms for "advice," some of which may violate rules of the PCAOB, (1) by using their Audit Firm's methods for Management's Assessment and (2) by failing to document and assess the internal controls over the objective of effectiveness and efficiency of operations. The COSO framework required for Management's Assessment and Auditing Standard Number 2 provide tools for a company to make sure they controls that carry out management's objectives for efficient and effective operations, accurate financial reporting, and compliance with laws and regulations. **PCAOB rulemaking should eliminate the practice of process mapping and "advice" giving by Audit Firms to preserve independence.** The businesses themselves should be responsible to improve their operations and automate accounting controls by using the COSO Framework "Evaluation Tools"³⁴ analysis and by following AS-2 without the "advice" of their auditor.

CONCLUSIONS: The problem of mixing the practice of Auditing and other consulting services dilutes the practice of accounting and subordinates audit. "Information Systems – design, installation, or integration" services allowed by the AICPA's independence rules has caused great expense to large public companies with little return to investors because of lack of engineering, process and information systems knowledge, competence and education in the past by Big Eight accounting and consulting firms.

The internal controls that enable company management to assure the effectiveness and efficiency of their operations have also been diminished or overlooked by the consulting practices of the large accounting and consulting firms. Process documenting services for Section 404, like the Y2K practice, is yet another consulting service that Big Four firms are not qualified to perform that affects independence. Accounting and Auditing Firms should be prohibited by the PCAOB from providing information system or process consulting services to any attest or non-attest clients.

Internal accounting practices that allocate costs to justify certain management decisions should be evaluated by auditors to determine if a sufficient risk exists that might cause investor values to be damaged. The Board should consider ethics and independence rule definitions that compel the auditor to investigate all internal accounting practices.

Since the PCAOB rules demand independence – Auditors "should not only be independent in fact; they should avoid situations that may lead outsiders to doubt their independence."³⁵ The PCAOB should therefore define the practice of accounting, the professional services, restrict the services offered, and define the supervision of engagements and professional practice of auditing. The Board should consider using the state Engineering Statutes and Rules as a model for the accounting and auditing profession. The PCAOB should act to prevent Audit firms from offering to perform or performing any consulting services outside the practice of services specifically related to auditing. This prohibition from consulting should include any process documentation or other services related to Section 404 of the Sarbanes-Oxley Act. Audit and Accounting Firms should be restricted to auditing and accounting services.

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Footnotes

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4. Internal Control – Integrated Framework, Committee of Sponsoring Organizations of the Treadway Commission, July 1994 (two volumes) and Auditing Standard #2 – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements, PCAOB, September 8, 2004
5. PCAOB Release 2004-015, December 14, 2004, Page A–1–Rule, SECTION 3. PROFESSIONAL STANDARDS
6. AICPA Professional Standards, ET §§ 102 and 191 (AICPA 2002)
7. Public Company Accounting Oversight Board Bylaws and Rules – Rules – Professional Standards As of December 3, 2004, page 41; and SECTION 3. PROFESSIONAL STANDARDS page 38
8. PCAOB Release 2004-015, December 14, 2004, Page 2-5, Section I. Background, page 3
9. PCAOB Release 2004-015, December 14, 2004, Page A–1–Rule, SECTION 3. PROFESSIONAL STANDARDS
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14. <http://www.ncees.org/>
15. PE Electrical and Computer Exam http://www.ncees.org/exams/professional/pe_electrical_exams.php
National Council of Examiners for Engineering and Land Surveying
16. Industrial Engineering Exam http://www.ncees.org/exams/professional/pe_industrial_exam_specs.pdf
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17. General Statutes of North Carolina Chapter 89C, <http://www.ncbels.org/GS89C8-2000.pdf>
18. Chapter 89C of the General Statutes, Engineering and Land Surveying, § 89C 3. Definitions
19. *ibid*
20. *ibid*, § 89C-23
21. *ibid*, § 89C 20
22. *ibid*, § 89C 22
23. *ibid*, § 89C-25.1
24. Board Rules, North Carolina Administrative Code, Board of Examiners For Engineers and Surveyors, Title 21, Chapter 56 (<http://www.ncbels.org/CHAPTER21.pdf>), 21-56.070
25. *ibid*, 21-56.070 (2)
26. *ibid*, 21-56.070 (3)
27. *ibid*, 21-56.070 (4)
28. *ibid*, 21-56.070.
29. *ibid*, 21-56.070 (f)
30. *ibid*, 21-56.070 (g)
31. PCAOB Release 2004-015, December 14, 2004, Page A–1–Rule, SECTION 3. PROFESSIONAL STANDARDS
32. NC Administrative Code, Title 21, Chapter 46, 21-56.070 (3)
33. “Sarbox Support Groups,” *CFO Magazine*, November 2004, Page 21
34. Internal Control – Integrated Framework, Evaluation Tools, Committee of Sponsoring Organizations of the Treadway Commission, July 1994 (two volumes)
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