

# Organization and Development of Arthur Andersen & Co.'s Public Review Board—The Minow Years, 1974–1983

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**SYNOPSIS:** This is a study of the first nine years of Arthur Andersen & Co.'s Public Review Board (PRB), from 1974 to 1983, coinciding with the term of its first chairman, Newton N. Minow. The PRB was a unique experiment, as the Andersen firm established it as an independent board composed of distinguished public servants who were to review the firm's policies and make visits to the firm's offices around the world and then render annual reports on their assessment of the quality of the firm's work in carrying out its professional practice, in auditing, tax, and administrative services. The PRB's annual reports were to be published. The paper concludes with a discussion of some lessons that might be learned from the PRB experience in today's debates over the regulation of audit firms and the management of audit quality.

**Data Availability:** PRB annual reports are held by the AICPA Library.

**Keywords:** Arthur Andersen; Public Review Board; auditor independence.

## I. INTRODUCTION

Since its formation in 2002 and increasingly in recent years, the Public Company Accounting Oversight Board (PCAOB) has been criticized for a lack of public transparency in its deliberations, findings, and recommendations. In addition, in the 2010s, the major audit firms created independent advisory boards and, in some cases, added nonexecutive independent directors to their boards. To date, none of these firms have publicly disclosed the results of the deliberations of these bodies. By contrast, in 1974, the audit firm of Arthur Andersen & Co. (AA&Co.) formed an independent Public Review Board (PRB) whose published annual reports on its examination of the entire scope of the firm's professional services practice, including its findings and recommendations, provided the public with an unprecedented level of transparency into the quality of a major audit firm's professional practice. It is the aim of this article to discuss the work of the PRB during its most productive period, from its founding in 1974 to 1983. Our motivation for pursuing this inquiry is to examine whether the PRB experiment, which remains unique in the profession, provides insight into current issues in audit regulation and the management of audit quality.

### Inception of the Public Review Board

Harvey Kapnick was at the helm of AA&Co. in 1974, and he believed that his firm needed to demonstrate that self-regulation by a Big 8 firm could work, thus countering claims that government regulation was necessary. He was also stung that two partners and an employee of the firm were criminally indicted by a federal grand jury in December 1972

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because of the collapse of Four Seasons Nursing Centers of America, one of its audit clients (Lubasch 1972), and he wanted to assure clients that the firm's probity was not in question. Kapnick was also sensitive to the increasing public demand for more information on the affairs of public companies. He regarded the public accounting profession as a public trust and believed that the audit firms themselves should also become more transparent.<sup>1</sup> Primarily for these reasons, he announced in June 1974 the formation of an independent Public Review Board, whose role would be to review and assess the entirety of Arthur Andersen's professional operations and to make recommendations for improvements that would be in the public interest (Arthur Andersen & Co. 1974a). Never before—and never since—has an audit firm established an oversight body with such broad authority and responsibilities, and whose reports were to be published.

Kapnick announced that Newton N. Minow would chair the Board, and Minow remained as chairman for nine years, until 1983.<sup>2</sup> The PRB continued in operation until 1997 and rendered 23 annual reports, all of which were published by Arthur Andersen.

## II. PURPOSE AND ORGANIZATION OF DISCUSSION

Arthur Andersen's strategy to avoid additional regulation of its practice was overwhelmed by the proliferation of litigation against auditors and the threat of Congressional action, which eventually resulted in its decision to join the profession in the creation of the AICPA's Securities and Exchange Commission Practice Section (SEC-PS) and its independent oversight body, the Public Oversight Board (POB), in late 1977.

The period of Minow's chairmanship covered a crucial time in the development of self-regulation of the accounting profession, as well as in the development of Arthur Andersen's practice. In this paper, we focus on that period alone, which will enable us to discuss at some length the work and implications of the PRB's findings during that important time.

First, we provide background information on the firm of Arthur Andersen and on the conditions that existed in the early 1970s that led to the development of the firm's strategy to avoid additional regulation. Next, we discuss the formation of the PRB, including its objectives, structure, and membership. We then discuss the salient points raised by the PRB during its review of the firm's professional practice that were covered in its reports, with particular emphasis on those contained in the reports from 1975 to 1983. Finally, we assess the PRB's performance in achieving its original objectives and discuss how the PRB experience might inform today's policy makers on current issues related to oversight of audit firms by the PCAOB and the management of audit quality by those firms.

The research for this paper has been informed not only by a reading of the PRB's annual reports and Arthur Andersen's own annual reports, but also by interviews with a law firm partner who attended the PRB's meetings and drafted its reports, with an Andersen senior partner who worked closely with the Board, with the Andersen CEO who succeeded Kapnick, and with several others. Of the 15 members who served terms on the PRB from 1974 to 1997, only Newton Minow is living, and he also was interviewed.<sup>3</sup>

## III. EVOLUTION OF THE PUBLIC REVIEW BOARD IN ITS EARLY YEARS

### Arthur Andersen & Co.—The Firm

Arthur E. Andersen initially built the firm in the United States by opening new offices with firm personnel to service existing clients or to exploit growth opportunities. As it became necessary to provide service to U.S. clients in other countries, he initiated affiliation agreements with other firms having operations in those countries. Upon Andersen's death in 1947, Leonard Spacek aggressively and effectively led the firm through an unprecedented period of growth until his retirement in 1973. In the 1950s, because of his concern over the quality of service being provided through the affiliation arrangements, the firm began to establish its own offices outside the U.S. by using a strategy of building "each practice with nationals rather than expatriates" (Arthur Andersen & Co. 1988, 100–101).

<sup>1</sup> Interview with Newton N. Minow, December 8, 2020.

<sup>2</sup> "Chairman" is used instead of "chair," because that was the usage during the period of our study.

<sup>3</sup> In November 2020, Rice University's ethics compliance administrator officially advised that the research interviews that Stephen Zeff conducts are exempt from institutional review.

In 1975, the firm had 103 offices located in 34 countries, with over 10,000 professional personnel, of whom some 900 were partners (Public Review Board (PRB) 1975, 2). It had the largest number of New York Stock Exchange-listed clients among the Big 8 firms, but it was a distant second to Price Waterhouse & Co. in the total sales revenue of its New York Stock Exchange-listed clients (Subcommittee on Reports, Accounting and Management of the Committee on Government Operations, U.S. Senate 1976, 421–425). The firm's executive office was in Chicago.

### The “One-Firm Concept”

Arthur Andersen first instituted policies providing that, after internal debate and agreement, the firm would speak “with one voice” on accounting issues, would recruit directly from college campuses, and would invest substantial resources in the formal training of its personnel (Arthur Andersen & Co. 1988, 35). Building on these policies, Spacek led the firm during its initial international expansion, using a strategy that became known as the “One-Firm Concept.” This strategy, as summarized by the firm (Arthur Andersen & Co. 1974b, 80), consisted of a commitment by all partners to “speak with one voice on matters involving important professional opinions.” The development of this “one voice” often involved intense internal debate in which partners were encouraged to participate. To implement this strategy successfully, the firm exercised centralized control over worldwide policies and procedures for personnel, recruiting, and training. The firm emphasized regular systematic communication of policies and procedures and of positions taken, and it maintained a worldwide Subject File that compiled the collective experience of the firm in a cross-indexed format that was available in all offices.

In addition, as noted by the PRB in its 1975 report, all partners in the firm participated in its worldwide earnings, without regard to local revenues or profits—a unique practice within the large firms (PRB 1975, 4).<sup>4</sup>

### Background to the Creation of the PRB

The late 1960s were

A period of widespread speculation in the securities markets . . . A new breed of promoters and managers took advantage of inadequacies in accounting principles to inflate reported earnings, to build conglomerates, and to promote real estate and franchising ventures. A flood of new securities issues was snapped up by investors in a fever of speculation. (Olson 1982, 2)

When this speculative bubble burst amid major business failures, investors brought a flood of class-action lawsuits against auditors, the press provided extensive coverage of these failures, and the SEC and the Congress began expressing increased concern regarding auditor performance. Voices were heard in Congress and elsewhere that perhaps there should be greater government regulation of the accounting profession (Olson 1982, 15). These trends continued and intensified during the 1970s, threatening the accounting profession's continued self-regulation and ultimately changing the profession (Zeff 2003; Jaenicke 1977; Olson 1982, 15–108).

Under the leadership of Leonard Spacek, AA&Co. broke with the established canons of professional firm behavior by publicly criticizing the AICPA's Accounting Principles Board, which at the time was the U.S. accounting standard setter, earning the firm a reputation as a “maverick” among the big audit firms (Louis 1970). Despite that reputation, AA&Co.'s worldwide operations expanded rapidly, initially to serve its newly multinational clients but increasingly to serve non-U.S. clients in their home countries. In 1970, Harvey Kapnick succeeded managing partner Walter Oliphant and adopted the titles of chairman and CEO, continuing and expanding upon Spacek's style as an aggressive and outspoken leader.

The formation of the PRB in 1974 was only one element of AA&Co.'s strategy to retain the power to regulate itself and to influence the development of standards for financial reporting and the form of regulation of the accounting profession. In addition to establishing the PRB, AA&Co. (Arthur Andersen & Co. 1988) was the first audit firm, beginning in 1973, to publish an annual report. From 1977 through 1980, these reports included a complete set of financial statements audited by Haskins & Sells (H&S). The firm voluntarily engaged H&S in 1976 to conduct a peer review of its audit practice.

To confirm its status as a truly international firm and to facilitate its worldwide operations, it incorporated under Swiss law in 1978 as a Société Coopérative (SC), with each national practice entity and each partner in those entities becoming members of the SC, and it moved the firm's world headquarters from Chicago to Geneva (Arthur Andersen & Co. 1988).

<sup>4</sup> In its 1975 report, the PRB noted that all partners participated in the earnings of the firm as a whole, not based on local office billings, and cited this as a key element in maintaining consistent quality (PRB 1975, 4). This practice was continued by the firm until a reorganization in 1989.

## Formation of the Public Review Board in 1974

The formal statement of “general purpose, organization and functions” of the PRB was published in the June 1974 issue of the firm’s monthly newsletter, *Executive News Briefs* (Arthur Andersen & Co. 1974a). It said:

One of the functions of the Board will be to review the general quality of the work of the firm in carrying out its professional practice. As part of this function, the members of the Board will review firm policies, standards and procedures with respect to the firm’s professional practice, including auditing and financial reporting, and will make comments and suggestions to the management of the firm as to improvements that in its judgment should be considered. However, the Board will have no responsibility for making or implementing policies or procedures of the firm.

The PRB’s aim was stated as follows: “This Board should bring an outside, independent viewpoint to the professional practice of the firm in its service to clients, investors and others who have an interest in the public responsibilities of the firm as independent accountants and auditors.”

The statement also stipulated that the scope of the PRB’s review “includes the manner in which the firm is managed and financed, the scope of its practice and how the quality of its work is controlled.” Scope of practice was a major issue in the profession in the 1970s, especially as regards the nature and extent of management consulting services rendered to audit clients. The PRB was given substantial authority to set the scope of its activities and to gain access to the firm’s personnel and resources. The statement specified that the members of the PRB “will have access to all information in the firm that is necessary to accomplish their objectives.” This access included the authority to “visit any of the offices and talk to any of the personnel” and to be “furnished with whatever staff assistance they consider to be necessary.”

Importantly, the statement required that the PRB would “make whatever proposals for improving the quality of the firm’s professional performance that it believes to be appropriate” and that these recommendations would be transmitted directly to the chairman of AA&Co. Further, the PRB was charged with rendering an annual report that would be published by the firm. This provision for public disclosure provided an important degree of both responsibility and authority to the PRB. It was also the first occasion that an audit firm elected to make such disclosures public. Speaking in 1976, Kapnick noted that clients could not directly observe the firm’s management and control processes and stated that the requirement for public reporting by the PRB had been intended to provide clients with assurance that “the policies that we say we are following are actually being followed” (Kapnick 1976, 160).

The PRB members were to be appointed by the firm’s chairman and approved by its board of directors for two-year terms, subject to renewal for further two-year terms. They “will consist of individuals who have not been members or employees of the firm” and “will be consultants rather than employees of the firm. They will be persons of outstanding reputation in business, public service, education or the professions.” They should meet at least quarterly and “are expected to require about fifteen to twenty days of work during each year... and a few days more on the part of the chairman.” A November 1975 press interview with Chairman Minow reported that the PRB “met as a group six times, totaling 10 days. In all, Mr. Minow logged 311 hours in his work as chairman, he said. [Another PRB member] said he put 45 days into the panel’s activities. The panel members are paid \$20,000 a year [equivalent to about \$105,000 in 2022 dollars]” (Andrews 1975).

## The Members of the PRB: 1974–1983

### Initial Members

Harvey Kapnick, who led AA&Co. as the dominating chairman and chief executive until he was ousted by the partners in October 1979, selected the members of the PRB. He wanted Board members who were “heavyweights,” distinguished public figures drawn from the private sector, but mostly having occupied important positions in government. Newton N. Minow, the first chairman, was the managing partner in the Chicago-based law firm of Sidley & Austin and had chaired the Federal Communications Commission. The other four members were as follows:

- William L. Cary, a Columbia University law professor and former SEC chairman
- James Don Edwards, a University of Georgia accounting professor and a recent president of the American Accounting Association
- George W. Romney, a former chief executive of American Motors Corporation who had served three terms as Governor of the State of Michigan and was Secretary of Housing and Urban Development
- Randolph W. Thrower, a partner in the Atlanta law firm of Sutherland, Asbill & Brennan and a former Commissioner of Internal Revenue.

Edwards was the only CPA on the Board, but his research and teaching were in financial reporting, not in auditing.



### ***Subsequent Changes in Membership***

In early 1977, William E. Simon, a former senior partner in the investment banking firm of Salomon Brothers and later Secretary of the Treasury, became the sixth member of the Board, staying only until 1980. In December 1977, Edward R. G. Heath, the former U.K. Prime Minister, joined the Board as its first non-U.S. member, shortly before William Cary resigned to become a member of the newly formed Public Oversight Board. In 1980, Thrower left the Board and was succeeded by Mortimer M. Caplin, a law professor at the University of Virginia who was a former Commissioner of Internal Revenue. Both Thrower and Caplin would have been useful in the Board's review of the firm's tax practice. In 1981, Elmer B. Staats, who had just retired after 15 years as Comptroller General of the United States and head of the General Accounting Office (today the Government Accountability Office), joined the Board, bringing the number of members again up to six.

## **IV. THE PRB'S REVIEWS OF THE FIRM'S PROFESSIONAL PRACTICE**

In 1973, AA&Co. became the first U.S. audit firm to publish an annual report, which it continued doing until the 1990s. The firm included the PRB's full annual report in the back of these annual reports from 1975 to 1979. It included only a summary of the PRB's annual report in the back of its annual reports for 1980 and 1981. From 1980 onward, the firm published the complete PRB annual reports as a separate document.<sup>5</sup> The first four of the PRB's annual reports ran between 18 and 26 pages, but from 1979 to 1983—following the Kapnick years—the length of its annual reports fluctuated between four and eight pages.

It is not known how widely AA&Co. circulated the PRB's annual reports. In a letter sent to Senator Lee Metcalf's subcommittee in January 1976, Harvey Kapnick said that the firm distributed its own annual report, which until 1979 also contained the PRB's report, to "our personnel, clients and others."<sup>6</sup> In his testimony to the Metcalf subcommittee's hearing on May 24, 1977, Kapnick said that the PRB's reports were "available to anyone upon request" (quoted in [Arthur Andersen & Co. 1977](#), 9). The authors believe that the PRB's reports were sent not only to the firm's personnel but also to the firm's clients, to the SEC, and eventually to the Public Oversight Board.<sup>7</sup>

In each of its reports, the PRB described the nature and scope of its activities related to its review of the firm's professional practice and reported its observations and recommendations resulting from those activities. When the Board felt it had sufficient basis to do so, it would express opinions on the design of the firm's quality control procedures and whether those controls were operating as intended.<sup>8</sup> In no case did the PRB indicate that any of these observations or recommendations were of such significance that they were serious deficiencies.

### **Limitations on the PRB's Review of Professional Practice**

The PRB's mandate from the firm included a charge to review the firm's professional practice. In its first annual report, issued in 1975, the PRB described the daunting assignment it faced. Observing that "the core of the audit process is judgment," the Board cited the difficulty of assessing the quality of professional judgments where those performing the assessment are not all accountants. Further, the Board indicated that the large size, breadth, and scope of the firm's worldwide practice was a major factor adding to the complexity of its assignment ([PRB 1975](#), 6).

After stating that the most important determinants of the quality of performance are factors that are "attributable to the people who do the work—their intelligence, technical skills, professional education, experience, intuitions, persistence, carefulness, ability to organize, administer and delegate, and ultimately their character and integrity," the Board concluded that it would be impossible for them or any other group of outsiders to draw conclusions about the "professional abilities of all, or even most, of the firm's professional personnel."

In light of these inherent limitations, the Board stated that "we have focused our attention on the process by which [audit] judgment is exercised" ([PRB 1975](#), 6). It added:

For example, we have attempted to understand and analyze the manner in which the auditor conducts his work and arrives at an opinion with respect to a client's financial statements, and the manner in which the firm attempts to monitor and control its audit practice. ([PRB 1975](#), 6)

<sup>5</sup> A complete set of the PRB's annual reports is held by the AICPA Library at The University of Mississippi.

<sup>6</sup> Letter dated January 7, 1976, included in [Subcommittee on Reports, Accounting and Management of the Committee on Government Operations, U.S. Senate \(1976, 196–197\)](#).

<sup>7</sup> In the 1970s, the academic coauthor of this paper asked to be placed on the mailing list to receive the PRB's reports, and he possesses a complete set of the reports from 1975 to 1997.

<sup>8</sup> As an example, see page 6 of the 1975 PRB report for a discussion of the PRB's logic in establishing the scope of its review of the firm's professional practice and its expression of a positive opinion on the design of controls over the quality of the audit practice.

The PRB further noted that two aspects of this approach consisted of seeking “to determine how the firm’s policies and system of quality control and internal review of its engagements are *supposed* to work” and “judging whether those policies and systems made sense” and observing and testing the system of quality control “in an attempt to see if it was actually functioning as intended” (PRB 1975, 6; emphasis in original).

As mentioned above, only one of the members of the PRB was an accountant, and that member was an academic in accounting, not auditing. Upon his appointment as PRB chairman, Newt Minow spent a week on an audit at one of AA&Co.’s client companies to find out what an audit was like.<sup>9</sup> This was a sensible decision for the chairman to make, and the other members of the Board might well have done likewise, but there is no record that they did.

Whereas the PRB members met as a group on a regular basis and made individual visits to the firm’s offices around the world, they were serving only part-time. AA&Co. arranged with Newt Minow’s law firm, Sidley & Austin, to appoint one of its young partners, R. Eden Martin, to attend all the Board’s meetings, write the minutes, and draft the PRB’s annual reports in consultation with Minow. AA&Co. made available, on a part-time basis, William D. Hall and Robert Mednick,<sup>10</sup> two executive office partners, to consult with and support the Board in its fact-finding inquiries and development of findings and recommendations.

Clearly, the composition of the Board, the lack of a dedicated full-time staff with accounting and auditing expertise (which could have been requested under its charter), and the limited amount of time that its members devoted to the PRB’s activities can be taken as an indication that the original intent of the firm when instructing the PRB to “review” the firm’s professional practice was not that the Board conduct a review sufficient in scope and expertise to develop *independent professional opinions* on the quality of the practice. Further, the firm already had in place an extensive internal review program that included the review and evaluation of individual audits by experienced AA&Co. personnel. In 1977, 1980, and 1983, this internal program was supplemented by independent peer reviews performed by H&S and its successor in name, Deloitte Haskins & Sells (DH&S). These peer reviews were designed and conducted in a manner that resulted in an independent professional opinion on the firm’s quality controls related to its audit practice.

### Reliance on the Internal Inspection Program

From the inception of its activities, the PRB expended significant effort in reviewing the scope, conduct, and results of the firm’s internal review program.<sup>11</sup> This effort included visits by individual members of the Board to offices where the review was in process. The Board members’ tasks during the visits were as follows:

During these visits, we examined the reports prepared or in process with respect to engagements selected by the reviewing partners. In addition, we discussed the reviewing partners’ findings and our own questions with the reviewing partners, Office Managing Partners, and engagement personnel. We also examined selected audit reports, audit working papers, file memoranda and correspondence, and other documentary material. (PRB 1975, 9)

In later years, the Board delegated these review activities to Don Edwards, the PRB member with accounting knowledge.<sup>12</sup>

During their office visits, the PRB members did not attempt to observe the conduct of one or more audit engagements. Even if they had, their lack of auditing knowledge and judgment would likely have precluded their being able to judge the quality of the conduct of those audits. When the PRB members were assembled at their next meeting, they had to formulate their recommendations based on the members’ notes on what they had learned from the local office partners during their one-on-one and group meetings. As far as we are aware, the Board members did not prepare memos summarizing their findings following their office visits for circulation to the other members.

Hence, the PRB developed impressions based mostly on conversations with local office partners about the quality of the firm’s practice in the three divisions. To be sure, it made several useful recommendations for reform, and the firm apparently took remedial action in most instances. However, in view of the resources made available to the Board, it could not possibly have performed an in-depth review of the quality of the firm’s practice. When H&S carried out its peer review in 1977, it provided a significant in-depth complement to the Board’s work.

<sup>9</sup> Interview with Newton N. Minow, December 8, 2020.

<sup>10</sup> Mednick became chairman of the firm’s Committee on Professional Standards in 1980, upon the retirement of Hall, who had been chairman of that committee. As chairmen, Hall and Mednick had substantial roles in interacting with the PRB.

<sup>11</sup> It should be recognized that, until 1978, these reviews were focused primarily on reviews by partners of audit work papers and related auditor reports on selected audit engagements. In 1979 and later, in response to the release of the AICPA’s *Statement on Auditing Standards* (SAS) No. 4 and to the recommendation of the PRB, the scope of these reviews was expanded to include reviews of the elements of an audit firm’s system of quality control, as set forth in SAS 4 (Public Review Board (PRB) 1977, 11; Public Review Board (PRB) 1978, 10).

<sup>12</sup> Interview with Newton N. Minow, February 26, 2021.

Generally, the PRB's visits were scheduled to coincide with the conclusion of the firm's own internal practice review or, beginning in 1977, with H&S's peer-review procedures at the selected offices. The PRB members generally did not look at work papers, but relied on the inspectors to raise issues. Any technical expertise was supplied by engagement personnel or by internal or peer-inspection personnel.<sup>13</sup>

### Reliance on Peer Reviews

In 1976, the firm voluntarily engaged H&S to perform an independent peer review of its audit practice, and it received and published the results of that review in 1977. Peer reviews were also conducted by DH&S in 1980 and 1983 under the new standards for required triennial peer reviews under the SEC Practice Section of the AICPA (see below). The Board was careful in its reports to describe its involvement in these reviews, which generally consisted of some members of the PRB meeting with the relevant DH&S personnel during the planning and reporting phases of the reviews and during office visits. The Board also expressed its satisfaction with, and reliance on, the results of these peer reviews.

## V. THE PRB'S REVIEWS OF INDEPENDENCE AND NONAUDIT SERVICES

Beginning with its first report in 1975, the Board consistently concluded that the nature of nonaudit services performed by the firm, and not the level of fees for these services, should be the primary consideration in evaluating the firm's independence. It concurred with the firm's assertion that the type of administrative services (AS) work allowed by the firm's policy should not impair the independence, real or perceived, of its audit practice.<sup>14</sup> In its 1979 report, the PRB discussed and reconfirmed this conclusion, while acknowledging that the actual or perceived independence of the firm and its personnel were questions of fact that were outside the capabilities and scope of its activities. It also referred to the SEC's recently released *Accounting Series Release (ASR) No. 264 (Securities and Exchange Commission (SEC) 1979)*, which discussed the issues that audit committees should consider when assessing the independence of its audit firm. In the light of the matters discussed in this release, the PRB recommended that the interaction between the firm's audit and AS personnel involved in the decision to perform nonaudit services for an audit client should be carefully and fully documented (*Public Review Board (PRB) 1979*, 30–32).

The PRB reported increasing pressure to expand the scope of the firm's practice in other countries, where a broader scope of practice was being followed by competitors. The Board offered advice that, where a potential engagement would compromise the independence of the firm as auditors, it should choose either to retain the audit and decline the project or to accept the project and resign from the audit. It concluded, "Our advice is to incur competitive disadvantage where necessary in order to preserve and protect the independence of firm auditors" (*PRB 1979*, 32).

The PRB's 1979 report ended with a postscript dated October 18, 1979 that noted briefly that Harvey Kapnick had resigned as chairman of the firm (*PRB 1979*, 36). The events surrounding Kapnick's resignation, as described in candid fashion by the firm in its 1988 history of the firm, were precipitated by Kapnick's proposal to "spin off" the consulting practice into a separate firm as a solution to the increasing controversy over the effect of nonaudit services on auditor independence. This proposal, which had not been discussed with the PRB<sup>15</sup> or communicated to the partners in general, was presented to the 1979 partners' meeting by Kapnick. Open opposition at the meeting resulted in the proposal not being acted on. The controversy over both the necessity for, and the manner of presentation of, the proposal continued after the meeting and rapidly led to Kapnick's resignation as chairman and chief executive officer and, shortly thereafter, his resignation from the firm (*Arthur Andersen & Co. 1988*, 150–151).<sup>16</sup>

## VI. THE PRB'S EVALUATION OF FINANCIAL INTEGRITY AND LITIGATION

One of the Board's significant concerns in each year related to the financial ability of the firm to withstand the effects of litigation brought against it and to cope with the loss of its major clients. To address these issues, the PRB reviewed the financial statements of the firm and discussed them with financial management and internal audit personnel of the firm, as well as with H&S in those years in which they were audited. In each year through 1979, the Board reported that the firm was adequately capitalized to withstand known litigation against the firm, after consideration of available insurance, and to maintain a high level of performance. In 1975, the PRB reported that "No one client or

<sup>13</sup> Interview with Robert Mednick, January 11, 2021.

<sup>14</sup> Until 1980, the firm referred to management services as administrative services.

<sup>15</sup> Interviews with Newton N. Minow and R. Eden Martin, December 8 and 16, 2020, respectively.

<sup>16</sup> Interview with Duane R. Kullberg, February 5, 2021.

affiliated group of clients accounts for more than a small percentage of the firm's billings" (PRB 1975, 4). This issue was not addressed in subsequent reports.

The PRB also monitored the number and nature of legal cases brought against the firm and reported on developments and outcomes of the more significant cases. During the period of our study, the PRB generally expressed a view that the number and type of cases were like those against other large firms, that they did not indicate systemic deficiencies in audit procedure or policies, and that the firm had not experienced significant adverse outcomes from litigation. The tone of the PRB's discussion of litigation began to change beginning with its 1982 report, in which it stated there had been an "enormous change" in the amount of litigation in U.S. society in general and against professionals in particular (Public Review Board (PRB) 1982, 4). Although not reporting on specific cases in its 1983 report, the PRB devoted a substantial portion of its 6½-page report to a discussion of litigation trends and possible legislative solutions for reducing the level and potential effect of litigation. It suggested pursuing restrictions on the use of the RICO statute and the application of the doctrine of comparative negligence to professional malpractice cases (Public Review Board (PRB) 1983, 6–7).<sup>17</sup>

In 1982 and 1983, the Board also addressed the growing view within the profession that litigation was, at least partially, a result of a misunderstanding of the limitations of an audit on the part of the public (particularly by juries)—the "expectation gap" between what an audit could reasonably accomplish and what was expected by the public, particularly in the detection of material financial statement fraud (PRB 1982, 4; PRB 1983, 6–7).

## VII. RECOMMENDATIONS FOR IMPROVEMENTS IN PROFESSIONAL PRACTICE INCLUDED IN THE PRB'S REPORTS FROM 1975 TO 1978

In addition to describing the scope of its activities and offering general conclusions on the quality of AA&Co.'s practice, each of the PRB's annual reports from 1975 through 1978 included a number of recommendations for improvements in the firm's professional practice. These recommendations are discussed below. As discussed later, beginning in 1979, the PRB reports contained no specific recommendations related to the firm's professional practice.

### Financial Integrity

Early in the PRB's 1975 report, it noted that AA&Co. had been the first audit firm to publish selected financial information about itself and that, upon the Board's recommendation (apparently made orally), the firm began to present *full* financial statements in its 1975 annual report (PRB 1975, 4–5).<sup>18</sup> The PRB strongly recommended that, notwithstanding concerns expressed by the firm regarding confidentiality of client information, the firm arrange for the audit of its own financial statements because "the financial integrity of a major accountancy firm" is in the public interest (PRB 1975, 5). AA&Co. implemented this recommendation, and H&S audited its financial statements for the years 1977–1980.

### Audit Practice

#### *Involvement of Financial Analysts to Improve the Usefulness of Clients' Financial Statements*

The PRB adopted the view expressed in the report by the AICPA's Trueblood Study Group on the Objectives of Financial Statements, issued in 1973, that "the basic objective of financial statements is to provide information useful for making economic decisions" (Study Group on the Objectives of Financial Statements 1973). This was not a widely accepted view within the accounting profession at the time (Armstrong 1977). "Usefulness in this regard," the PRB added, "should be determined from the vantage point of those who have invested or extended credit, or who are in a position to invest or extend credit" (PRB 1975, 10). The PRB noted that, because of changing conditions, "information that was once irrelevant may become highly important to the users of financial statements. Furthermore, financial statements may be technically in accordance with generally accepted accounting principles and yet fail to disclose underlying economic weakness or business difficulty—as is sometimes alleged in lawsuits brought against accounting firms in recent years" (PRB 1975, 10).

In light of these concerns, the PRB recommended that AA&Co. engage a firm of financial analysts to review and comment on a sample of client financial statements, either before or after issuance, with a view to improving their usefulness (PRB 1975, 10). This was an inspired suggestion, because audit engagement partners seldom, if ever, had any

<sup>17</sup> RICO refers to the Racketeer Influenced and Corrupt Organizations Act, passed by Congress in 1970.

<sup>18</sup> In 1981, the firm discontinued publication of its financial statements in its annual report.



meaningful contact with third-party users of financial statements. Further, as the PRB pointed out, generally accepted accounting principles at that time gave comparatively little guidance on fairness of disclosure.

Chairman Minow recalls that Don Edwards and William Cary were the sources of this suggestion.<sup>19</sup> Edwards had served as a member of the Trueblood Study Group and would have been exposed to the views of C. Reed Parker, the lone Study Group member who was a financial analyst. It was Parker who persuaded the Study Group to embrace a recommendation that the financial statements should enable users to predict future cash flows, which the FASB and all other national and international standard setters eventually adopted in their conceptual frameworks (Zeff 2016, 150–151). This PRB recommendation stood out because it could have had a direct impact on the quality of clients' financial reporting by improving disclosures and potentially improving auditors' ability to evaluate the materiality of those disclosures.

AA&Co. responded to the recommendation by engaging the Chicago-based investment research firm of Duff and Phelps, Inc., whose executive vice president was Reed Parker, to write a 178-page report entitled *A Management Guide to Better Financial Reporting: Ideas for Strengthening Reports to Shareholders and the Financial Analyst's Perspective on Financial Reporting Practices*, which AA&Co. published in September 1976 (Duff and Phelps, Inc. 1976). The firm distributed copies of the report to all partners and staff. This publication, which included a lengthy critical analysis of the financial reporting by 329 companies drawn from 37 industrial sectors, not limited to AA&Co. clients, was a unique and valuable—yet largely overlooked—contribution to the accounting literature.

But there is no evidence that the firm implemented the operational part of the PRB's recommendation, namely, that it obtain advice from financial analysts on the usefulness to investors of a sample of their clients' financial reports either before or after their release. That this recommendation did not lead to a change in audit methodology or in auditor training was a missed opportunity.

### ***Increased Partner Involvement in the Auditing Engagement***

In 1975, the PRB observed that, in practice, the role of the engagement partner in audits varied from office to office and from partner to partner and was, at times, too limited, particularly in the planning phase of audits (PRB 1975, 10). The PRB thus recommended that the firm “give serious consideration to enlarging the extent and depth of involvement and participation of the partners at all steps of the auditing engagement” (PRB 1975, 10). In 1976, the Board reported observing improvement in partner participation and favorably noted that policy had been revised to emphasize partner involvement in all phases of audits, but said that further improvement was possible (Public Review Board (PRB) 1976, 3–4, 14). In 1977, the PRB commented on AA&Co.'s further strengthening of policies regarding partner involvement (PRB 1977, 14).

### ***Obtaining a Second Partner's Formal Approval prior to Release of Auditors' Reports***

In partial response to a recommendation by the PRB in 1975 that the letter of transmittal to the client should disclose the names of both the engagement and reviewing partners (PRB 1975, 11), the firm revised its policy to clarify the scope of the second partner review and to require that the second partner “must be satisfied that any disagreements on substantive matters have been satisfactorily resolved before the report is issued” (PRB 1976, 14). This revision to policy to require a second partner to concur with the issuance of an audit report prior to issuance represented a substantial increase in the second partner's responsibility.

### ***Understanding and Documenting Internal Controls and the Linkage to Audit Scope***

The PRB, although acknowledging the firm's recent development of a “transaction flow” approach to assessing and testing a client's accounting procedures and internal controls, nonetheless recommended that “further improvement is also possible in the areas of documenting evaluations of internal control and of electronic data processing reviews in setting the scope of audit tests” (PRB 1976, 4). In its 1977 report, the PRB noted that H&S had reported the same issue in its peer review and added a recommendation that this analysis should be updated each year and thoroughly documented (PRB 1977, 11–12). Also in 1977, the PRB recommended that the firm provide guidance “in assuring the right balance of both judgment and statistical sampling” and that its continuing education program “should be reviewed to determine whether audit personnel are being given sufficient training in sampling theory and techniques” (both in PRB 1977, 12).

### ***Implications of the Foreign Corrupt Practices Act***

Several of the PRB's recommendations were motivated by the need for clients to comply with the accounting provisions of the Foreign Corrupt Practices Act (FCPA). At the time of its passage in 1977, it was believed that the law would be vigorously enforced. The PRB (1978, 11) said, “We suggest that the firm consider requiring that senior audit and administrative

<sup>19</sup> Interview with Newton N. Minow, December 8, 2020.

services personnel assigned to each audit jointly discuss and reach conclusions (which would be documented) as to the adequacy of client internal controls before any final decisions as to audit ‘scopes’ are made and before any firm opinion or report on internal controls is rendered.” The PRB also argued that partners—whether in audit, tax, or administrative services—impress their clients’ audit committees and boards of directors with their increased responsibilities under the Act.

### ***Expansion of Scope of the Firm’s Audit Review Program***

The PRB observed that:

The firm’s internal audit review program focuses primarily upon working papers and auditors’ reports of particular engagements and, accordingly, is not designed to determine in any systematic way whether other elements of quality control identified in Statement of *[sic]* Auditing Standards No. 4 (including such matters as independence, acceptance and continuance of clients, assignment of personnel, hiring and advancement, and professional development) are being fully satisfied. (PRB 1977, 11)

*Statement on Auditing Standards No. 4*, “Quality Control Considerations for a Firm of Independent Auditors,” was issued in December 1974, and it is curious that the firm had not yet heeded its recommended major expansion of the working paper review, especially as an AA&Co. partner signed the unanimous opinion issued by the AICPA’s Auditing Standards Executive Committee. The firm responded in 1978 that it now complied fully with the PRB’s expectation (PRB 1978, 17).

### **Tax Practice**

#### ***Revising Roles within the Tax Practice***

The PRB made several recommendations that encouraged the firm to critically review the appropriateness of the partner-manager-staff organization structure in its tax division with the aim of achieving more extensive involvement by partners in all stages of the tax engagements and to involve newer staff more quickly in noncompliance work (PRB 1975, 19). The firm responded “by developing uniform written programs for tax work and standardized working papers which call for greater partner participation” (PRB 1976, 14).

#### ***International Tax Practice***

Whereas the PRB’s 1975 report dealt with tax practice in the continental United States, its 1976 report focused on the non-U.S. tax practice of the firm and commented that the diversity of tax regimes made it more important that a worldwide standard of service be established through policy, oversight, and training (PRB 1976, 7). The firm replied that it had taken steps to achieve common standards of quality across the firm (PRB 1977, 15).

### **Administrative Services Practice**

#### ***Scope of Administrative Services***

In 1975, the PRB commented on the “scope of services” issue, which was then a subject of controversy inside and outside the profession because of its possible impact on a “firm’s independence in carrying out its principal mission, i.e., auditing” (PRB 1975, 20).<sup>20</sup> It observed that AA&Co. “has carefully avoided expanding [its administrative services] in many directions which might adversely affect the independence of its auditing function . . . . The firm’s concentration is on major systems and related work. Furthermore, there is no executive search program” (PRB 1975, 21). The PRB’s conclusion was “that there is no present cause for genuine concern that the firm’s practice impinges on management decision making or otherwise jeopardizes the independent performance of its auditing responsibilities” (PRB 1975, 21).

### **Training and Professional Development Program**

This was an area of inquiry where the PRB recommended to the firm that the Board conduct “a more exhaustive, in-depth review” (PRB 1976, 9). The PRB added, “Accordingly, the firm arranged for three groups of academic experts to review the three divisions of the training program in the United States—audit, tax, and administrative services—and to report to us the results of their reviews and conclusions.” Overall, based on the reports of these experts and its own inquiries, the PRB concluded that the firm’s training and professional development in the audit area was “excellent” and that the quality of the tax and administrative services training appeared to be “very high” (PRB 1976, 111, 213).

<sup>20</sup> See AICPA (1974), Public Oversight Board (POB) (1979a), and Olson (1982, 15–32).

**Attention to the “Why” as well as to the “How”**

A PRB suggestion that likely originated with Don Edwards, the accounting academic on the Board, was that, when training new audit staff personnel, “we think somewhat more attention could be given to the reasons why financial statements are important to their users and why audits are required, why certain audit steps are necessary, or why they are performed in a particular manner” (PRB 1976, 11). The PRB reported that this suggestion “was received unenthusiastically by those in charge of audit training,” who stated that this training program should continue to concentrate on immediate needs (PRB 1977, 15–16).

**VIII. CREATION OF THE AICPA'S PUBLIC OVERSIGHT BOARD**

Ultimately, AA&Co.'s strategy to lead the profession in demonstrating that an audit firm could successfully regulate itself, restore public confidence in its work, and avoid additional regulatory oversight was overwhelmed by continuing audit failures and criticism of the profession that culminated in Congressional investigations in the House (Moss subcommittee) and the Senate (Metcalf subcommittee).

In response to the threat of additional legislation arising from these investigations, in September 1977, the AICPA established the SEC-PS as one of the two sections of the new Division for CPA Firms and created the independent POB to monitor and oversee the activities of the SEC-PS. These activities included mandatory triennial peer reviews of all the audit firms that were Section members.

We have been unable, in our search for documentation and our interviews and correspondence, to identify contemporary evidence that the AICPA used the PRB reports or experience as a model for the formation of the POB. Yet we believe it is plausible to infer that Arthur Andersen's experience with the PRB played a role. Wallace E. Olson, the full-time president of the AICPA, noted that George R. Catlett played a “key role in negotiations regarding the division for SEC Practice” (Olson 1982, 133). Catlett was chairman of Arthur Andersen's Committee on Accounting Principles and Auditing Procedures and was the principal liaison between the firm and the PRB until his retirement in 1980. It is worth noting that William Cary, an original member of the PRB, was selected as one of the five charter members of the POB.

A review of the organizational document for the SEC-PS indicates a high degree of similarity in the composition, responsibilities, and authority of the POB and Arthur Andersen's PRB. Specifically, the members of the POB were to be “prominent individuals of high integrity and reputation,” the POB was required to publish an annual report, and the POB was charged with monitoring and evaluating the “regulatory and sanction activities of the Peer Review and Executive Committee of the [SEC-PS]” (Public Oversight Board (POB) 1979b, 4). Significantly, the POB, as with the PRB, was authorized to engage staff to assist in its activities, but, unlike the PRB, the POB did create a permanent staff of its own (Public Oversight Board 1979b, 6).

**IX. CHANGE IN FOCUS OF THE PRB'S ANNUAL REPORTS AFTER 1978**

Beginning with the PRB's 1979 annual report, its reports became much more abbreviated. As noted above, the four reports for 1975–1978 spanned 18–26 pages, whereas the five from 1979–1983 ran to between 4 and 8, a significant reduction in length. Whereas the PRB's reports from 1975 to 1978 were laden with recommendations for improvements in quality control, those from 1979 to 1983 were composed mostly of observations and conclusions, with very few explicit recommendations.

To some extent, this change in emphasis and reduction in detail may have been because the PRB believed that it had already covered most of the ground requiring its critical analysis with a view to making recommendations.<sup>21</sup>

The developments in the accounting profession and at the SEC relating to oversight and governance of public company auditors also influenced the PRB's thinking about its future role. In the introduction to its 1979 report, the PRB signaled this change in focus with the following statement:

The more we have learned about the technical aspects of the firm's practice, the more it is apparent that the most difficult issues that face the firm and the accounting profession are not technical accounting and auditing issues confronted by the firm's professionals. Instead, the overriding issues are whether an accounting firm (and the accounting profession) can govern itself so as to assure that high ethical and professional standards are followed and whether uniform accounting and auditing standards can be developed and maintained by the profession without additional government legislation or regulation . . .

The fundamental question is whether an international, private firm of professionals can be relied upon to act in the public interest, even though in doing so it must occasionally take positions contrary to the interests of its clients, partners or employees.

<sup>21</sup> Interviews with Newton N. Minow and R. Eden Martin, December 8 and 16, 2020, respectively.

In our report this year, we deal somewhat less with the details of what we have done in the course of the last year and focus instead on an analysis of this crucially important question. (PRB 1979, 29–30)

In 1980, the PRB noted the recent formation of a quality control review panel by the SEC-PS and expressed concern regarding the increasing number of oversight bodies (Public Review Board (PRB) 1980, 5).

In its 1982 report, the PRB said that it had “decided to reexamine our role for essentially two reasons” (PRB 1982, 1). First, it observed that current conditions in the profession were much different from those that led to its creation in 1974, specifically citing the creation of the SEC-PS and the POB, as well as the mandate that all firms belonging to the Division for CPA Firms (which included the SEC-PS) undergo triennial peer reviews. Second, the Board said:

As we became more and more familiar with Arthur Andersen’s operations through our periodic reviews and visits, the original focus of our purpose and function had become less clear. Initially, our review of Arthur Andersen’s organization and internal policies had been intended to enable us to assess whether possible changes in organization or policies might improve the quality of professional service and thus benefit the public. As we came to know more of the professional personnel, situations arose in which we were invited to offer advice and express judgments as to internal matters which, though important to the partners, would have little or no impact on the performance of high quality service or the public interest. (PRB 1982, 1–2)

The PRB then said, following discussions it held with the firm’s management and individual partners, “The judgment which we have heard has been that the Board continues to serve an important function and should be continued” (PRB 1982, 2). The Board specifically stated that matters related to internal management of the firm that had no public interest dimension would be communicated to management, or to the partners, as appropriate, and it confirmed that, where these matters might affect the quality of service, “we would continue to consider them and would include them in our reports to the partners and the public” (PRB 1982, 2).

Yet there were signs that the Board’s public profile as well as its status within the firm was in descent after Harvey Kapnick’s sudden departure as chairman and CEO in October 1979. In all his annual letters to the partners from 1974 to 1979, Kapnick discussed the work of the PRB or at least thanked them for their service. From 1980 to 1983, Kapnick’s successor as CEO, Duane Kullberg, never mentioned the Board in his own letters. Further, only a summarized version of the PRB’s 1980 and 1981 reports was included in the firm’s annual report to the worldwide organization. In 1982, the PRB’s report began to be published separately and was no longer included in the firm’s annual report, even as a summary.

Yet both Harvey Kapnick and Duane Kullberg, during their respective chairmanships, attended meetings of the PRB and otherwise consulted with its members, in particular with Minow, finding it to be a valuable sounding board for the discussion of policy matters.<sup>22</sup> It must have been refreshing to hear the views and reflections of nonaccountants of such high stature on matters that had been discussed only by the firm’s partners. This high value that the firm’s leadership placed on its conversations with the PRB members was probably the main reason why the firm wanted the PRB to continue its service.

## X. ASSESSING THE PUBLIC REVIEW BOARD’S PERFORMANCE AND IMPACT

Harvey Kapnick’s idea when he devised the PRB was to appoint an independent board whose annual reports would assure regulators and clients that the firm was taking its independence and quality control seriously. And, indeed, the Board was composed of leaders who had distinguished themselves in high-profile public service, academics, and corporate management. Their qualifications were primarily as users of financial information, regulators, or accounting academics and certainly not as accountants involved in the actual preparation of financial statements or as auditors of financial statements. This diversity provided an independent perspective that the firm did not possess internally and that could be expected to be trusted by the public. The contents of the Board’s annual reports went far beyond the information contained in transparency reports, annual reports, and other public communications being issued by audit firms today.

Although the members of the Board did not have the responsibilities or powers of partners in the firm, a close observer of the PRB identified one of its primary values as being its role in “tone-at-the-top temperature taking,” in a manner analogous to independent members of a board of directors. The PRB also gathered and evaluated feedback from the firm’s personnel during its numerous visits and incorporated this information into its public reports and communications with upper management of the firm. In performing this role, the Board—and especially Newt Minow—was

<sup>22</sup> Interview with Robert Mednick, January 11, 2021, and Duane R. Kullberg, February 5, 2021.



a valuable source of advice on policy to the leadership of the firm. In its public reports, the PRB also supported certain policy positions advocated by AA&Co. when it felt these were in the public interest. These matters included reforms related to accounting for the effects of inflation, improvements in accounting and reporting by governmental entities, and support for changes in the regulation of the audit firms. The value of the Board to AA&Co. as a source of independent perspective may be inferred from the fact that it continued in operation until 1997, well after the establishment of the SEC-PS and the POB.

The Board had neither the responsibility nor authority to require implementation of its recommendations. Nevertheless, from 1975 through 1978, the PRB made a number of recommendations for improvement, most of which were implemented by the firm. One exception was that, as suggested by the PRB, AA&Co. did retain a firm of investment advisors to help develop its perspective on user needs for financial statements, and this initiative did result in a useful published study, but the firm did not adopt the PRB's recommendation that it use these advisors to consult on specific client filings; nor did it incorporate these perspectives into the training of auditors, as the PRB had recommended.

The PRB also made recommendations principally centered on cross-training between practice disciplines and the expansion of audit training to include studies in the “why” of audit procedure. As regards the firm's audit practice, this recommendation was not implemented due to an unwillingness to modify the firm's apprenticeship approach to training, with its heavy emphasis on early indoctrination.

## XI. CURRENT ISSUES RELATED TO THE INDEPENDENT OVERSIGHT OF AUDIT FIRMS

In the United States, the period of self-regulation of auditors of public companies ended with the enactment of the Sarbanes-Oxley Act of 2002 (SOX), which, among other things, created the PCAOB with statutory power to oversee the auditors of the financial statements of companies whose securities are registered in the U.S. It is worth noting that the events that led to the enactment of SOX resulted in Andersen's withdrawal from public practice.

### Criticism of the PCAOB's Lack of Transparency and Diversity of Input

SOX, in establishing the PCAOB, specified certain limitations on its operations and activities that created a regulatory process that resembled, in terms of a lack of public transparency, the self-regulatory structure that it replaced. Specifically, SOX provided that “all documents and information prepared or received by or specifically for the Board, and deliberations of the Board and its employees and agents” in connection with either an inspection or an investigation are confidential and protected from discovery and are exempt from the Freedom of Information Act (SOX, paragraph 105(b)(5)(A)). The Act further provided an incentive for audit firms to address deficiencies in quality control by providing that, if corrected within 12 months of the date of an inspection report, those deficiencies would not be disclosed publicly. Increasing the public transparency of the PCAOB's inspection and enforcement activities would require amendments of SOX or, perhaps in some cases, new interpretations of the statute. The lack of transparency of the PCAOB, including the results of inspections, created by these provisions of the law has been the cause and focus of much criticism of the PCAOB since its creation, and it stands in strong contrast to the public transparency into the professional practice of AA&Co. provided by the PRB some three decades earlier.

As discussed previously, another key benefit of the PRB and, subsequently, the POB was the perspective provided by a diverse, highly qualified group of individuals who were independent and, for the most part, not accountants. As provided in SOX, the PCAOB formed in 2004 a Standing Advisory Group (SAG) and, somewhat later in 2010, an Investors Advisory Group (IAG). Both of these advisory groups consisted of a diverse mix of highly qualified individuals who met frequently and in public to advise the PCAOB. Neither group has met since 2018, although the PCAOB has announced the formation of a replacement group for the SAG. The appearance of a reduction in independent input to the PCAOB's deliberations caused by the suspension of the activities of these advisory groups has drawn substantial public criticism.<sup>23</sup>

### Transparency and Independent Reporting by Audit Firms

An important aspect of Arthur Andersen's strategy in 1974 was that, by openly providing information on the firm to the public, the public would be reassured about the firm's quality of practice, financial stability, and orientation

<sup>23</sup> A discussion of many of these most recent criticisms, including the suspension of the SAG and IAG, can be found in a letter written by several former members of the IAG to Gary Gensler, Chairman of the SEC, dated April 19, 2021, which can be accessed at <https://consumerfed.org/wp-content/uploads/2021/04/PCAOB-IAG-Letter.pdf>

toward the public interest. As noted previously, this information was provided by the firm through a combination of its own voluntary reports and those of the PRB. After the formation of the POB, some transparency was also provided through its annual reports and in the peer-review reports that were made available to the public. Notably, no other audit firm followed AA&Co.'s example of voluntary transparency.

Currently, in the United States, all of the four largest audit firms and many others now produce reports on audit quality that are generally referred to as transparency reports.<sup>24</sup> In some other countries, these reports are mandatory, and their minimum contents are specified by statute or rule.<sup>25</sup> In no case does the extent and nature of disclosure in these reports reach the level exhibited by the PRB's reports. The PRB's reports included feedback from the various parts of Arthur Andersen's practice, observations on litigation, organization, competitive pressures, and the firm's business model that, today, would be considered highly confidential to an audit firm. Although it is likely that disclosure of this type of information would be useful to the public in assessing the risks to the quality of an audit firm's work, it is unlikely, because of the fear of litigation, that such a step would be undertaken voluntarily by any audit firm.

### Independent Oversight as an Element of a Firm's Quality Controls

In 2013, Deloitte & Touche LLP (the U.S. audit component of Deloitte) voluntarily formed an Audit Quality Advisory Council (AQAC), consisting of five independent members with diverse backgrounds, to advise the firm on matters related to audit quality.<sup>26</sup> Arthur Andersen's experience with its PRB was considered when making the decision to form the AQAC.<sup>27</sup> Much later, in 2019 and 2020, three of the other large U.S. audit firms (Ernst & Young, PricewaterhouseCoopers, and Grant Thornton) formed similar advisory councils. In addition, two firms (PricewaterhouseCoopers and KPMG) added independent directors to their board of partners. These actions have been publicly disclosed by the firms. However, these disclosures have been limited in nature and do not include specific information on the nature of the relationship between those persons and the firm (e.g., indemnities and legal duties and obligations). Those disclosures indicate that these advisory councils are more limited in their objectives and mission than those of the PRB. Specifically, none of the advisory councils discloses a responsibility, or a capability, to review the firm's professional practice, and none of these advisory bodies have published reports of their activities and related observations.<sup>28</sup>

To the extent that independent members of a governing board or an independent advisory group come to be considered as elements of a firm's system of quality management, their activities might be subjected to inspection and evaluation. In December 2020, the International Auditing and Assurance Standards Board (IAASB) issued its *International Standard on Quality Management 1 (ISQM 1)*, which created a comprehensive set of standards governing an audit firm's system of quality management. In December 2019, the PCAOB issued a concept release, "Potential Approach to Revisions to PCAOB Quality Control Standards," which commented on potential differences in how the PCAOB might approach specific issues and the proposed *ISQM 1*. One such comment noted that some firms had adopted various forms of independent oversight and that the PCAOB was considering whether its standards should be revised to address these forms of independent oversight and their effect on a firm's system of quality control. That comment also noted that the role of independent oversight in a firm's system of quality management would depend on the level of authority, responsibility, and influence exercised by the independent parties (such as the firms' advisory councils). The PCAOB has not yet moved beyond its concept release to revise its quality control standards, but could decide to adopt more prescriptive standards than the international standard. For example, the PCAOB could require an audit firm to create independent oversight within the firm, either through independent directors or an advisory council, or both. It could also require independent reporting either to the PCAOB or to the general public. Structuring these advisory councils in a manner that would allow them to function as elements of a firm's system of quality control would require a substantial increase in their responsibilities, duties, and time commitments. The substantial increase in litigation and aversion to discovery in the years since the formation of the PRB would likely create time demands and liability exposure that would represent major barriers to recruiting qualified persons to perform these duties.

<sup>24</sup> As an example, see a recent edition of the Deloitte U.S. Audit Quality Report, available online.

<sup>25</sup> For example, see the EU requirements at: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0537&from=EN>

<sup>26</sup> The practitioner coauthor of this paper has been a member of the AQAC since its formation.

<sup>27</sup> This is based on an e-mail communication dated June 11, 2021, with Charles A. Horstmann, a former Arthur Andersen partner who was, at the time, a Deloitte partner, and a telephone conversation on June 11, 2021, with Robert J. Kueppers, who was at the time the Deloitte partner in charge of its SEC practice. Both took part in the discussions involved in the establishment of the AQAC. Also, Robert Mednick has confirmed by e-mail on June 21, 2021, that he shared with Deloitte his experience with the PRB at the time of the formation of the AQAC.

<sup>28</sup> As an example of the disclosures related to its advisory council made by one firm in its annual audit quality report, see pages 23 and 27 of the 2021 Deloitte U.S. Audit Quality Report at <https://www2.deloitte.com/us/en/pages/regulatory/audit-quality.html>

More than 45 years since Arthur Andersen & Co. launched its Public Review Board, with authority to review the entire range of the firm's professional operations and to make its findings and recommendations public in independent annual reports, the users of financial statements are still struggling to obtain a regulatory model that provides that level of transparency.

## XII. INTERVIEWS

The authors conducted the following interviews, via Zoom or conference call:

| Interviewee           | Date of Interview                       | Relation to PRB               |
|-----------------------|---|-------------------------------|
| Charles A. Bowsher    | February 26, 2021                       | AA&Co. partner                |
| Douglas R. Carmichael | May 6, 2021                             | AICPA Vice President-Auditing |
| Duane R. Kullberg     | February 5, 2021                        | AA&Co. CEO                    |
| R. Eden Martin        | December 16, 2020                       | Partner, Sidley & Austin      |
| Robert Mednick        | January 11, 2021                        | AA&Co. senior partner         |
| Newton N. Minow       | December 8, 2020, and February 26, 2021 | PRB chairman                  |
| Manuel Soto           | November 10, 2020                       | AA&Co. partner in Madrid      |

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