

## **POB Panel on Audit Effectiveness**

**Statement by James E. Copeland  
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Good morning, my name is Jim Copeland, and I am Chief Executive Officer of Deloitte & Touche. With me today is John Fogarty. John is one of the architects of our audit methodology and he will share some of his thoughts on risk-based auditing. Additionally, I may call on him to help me respond to any questions you may have.

I began my career with Deloitte & Touche some 32 years ago – as an auditor. I spent my early years on the audit staff and later served as the manager and then the partner on audits of public companies. I fully appreciate the important role the independent audit plays in our capital markets and the difficulty of the issues you are considering.

It is my hope and expectation that this external look at the audit model and our performance will benefit the profession, the regulators, and the investing public; I support your efforts and objectives. I believe that in time we all can benefit from the information gathered and the findings of this panel.

This current focus on audit effectiveness, it seems to me, has been prompted largely in reaction to a number of recent, highly-publicized cases of fraudulent financial reporting. Though these cases are few in numbers relative to the many annual audits of public companies, they do take their toll. They raise doubts in the minds of regulators and the public and have the potential to shake confidence in our capital markets. Consequently, we should do all that we reasonably can do to minimize their occurrence. As a profession, we have to accept that the credibility of our reports is essential to investor confidence.

In an environment in which concerns have been raised about public confidence in the effectiveness of audits, we should look beyond debates about whether the level of fraudulent financial reporting is, or is not, tolerable, or whether these incidences are, or are not, indicative of systemic weaknesses. Even if your study shows that the audit process is working within reasonable tolerances of performance, but the regulators or the investing public have doubts about the process, then we must look for ways to improve their confidence level.

You will no doubt receive numerous suggestions for possible changes to the audit process and its implementation. As I understand your process, you are devoting substantial time and resources to understand what today's risk-based audit approach is all about and how it is being executed. At the conclusion of your work, you will have a unique, independent perspective from which to make recommendations.

If your study finds shortcomings in the risk-based audit approach, your recommendations for improving timely detection of fraudulent financial reporting will be welcomed.

Even with improvements in the effectiveness of audits, however, it is inevitable that frauds will occur and escape timely detection. When those situations do occur, we can still focus on how investor confidence can be restored.

When fraudulent financial reporting is identified, the investing public learns for the first time that there is a problem. Over the following weeks and months and indeed years, they may or may not learn more about the magnitude of the problem and the periods affected.

What the public generally does not learn on a timely basis is why the problem occurred, why it was not detected earlier and what changes have been made to prevent similar occurrences in the future. Investors are left to wonder whether, or in what ways, the audit was faulty or whether there were other circumstances that allowed the fraud to go undetected. Investors are also left to wonder whether that same accounting firm approaches all audits of similar companies in the same manner, or whether this circumstance was an aberration that was not capable of detection through any reasonable audit procedures.

Perhaps we should look to the experience of the airline industry. When an airplane goes down, an investigation ensues and as a result of that investigation, findings are publicly reported. Based on those findings, the airlines take corrective action, which also is highly publicized. One objective of the disclosure of that corrective action is to bring closure – to give confidence to travelers that all reasonable efforts are being taken to assure their safety and that the same factors should not contribute to other accidents in the future. When losses from fraudulent financial reporting occur in the capital markets, largely for legal reasons, today's processes do not provide investors with timely closure and, accordingly, the opportunity to restore confidence is lost.

I believe that one area that should be given further consideration, by both the profession and the regulators, is improvement of the investigation process related to instances of alleged audit failures. We should explore ways to open up the process, provide better and more timely information to the public and make sure that the disciplinary process is sufficiently robust, including any attendant disclosures, to have a meaningful impact on individual professional responsibility. I worry that the individual responsibility of a professional is getting lost in this debate. There is a quotation that expresses my concern – "people want systems so perfect that they no longer have to be good." Perhaps a rigorous, public investigation process will restore the emphasis on personal professional responsibility. In order for the investigation and disclosure of findings to be sufficiently robust, there must be appropriate protections for all parties involved from the use of such findings of the investigation in private litigation. Without such protections, the ability of the parties to cooperate would be constrained and the process would not be as effective in restoring investor confidence.

Equally important, when an investigation indicates that the audit process and performance were appropriate in the circumstances that information must be reported to the public. Then investor confidence can be maintained while reinforcing that audits alone cannot guarantee the safety and profitability of investments.

As I stated earlier, I believe more study should be given to the investigation and disciplinary process. It would deal with the erosion of investor confidence when frauds

occur, regardless of other recommendations aimed at improving the timely detection of fraud.

We have a long and valued tradition in the audit practice of my firm. I am proud of the performance of my firm and its people in the conduct of our audit services. I believe that the quality and professionalism of our work is high, but there is always room for improvement. I would like to thank the Panel for this opportunity to share some thoughts on this important subject. I look forward to working with you further as you complete your information gathering and move into the recommendations phase of your work. After John's remarks, I would be pleased to respond to any questions you may have.