## Public Oversight Board

# Annual Report 1978-79

Public Oversight Board
SEC Practice Section
Division for CPA Firms
American Institute of Certified Public Accountants

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# Public Oversight Board

SEC PRACTICE SECTION

American Institute of Certified Public Accountants

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Executive Director


March 31, 1979

To Member Firms of the SEC Practice Section,
The Securities and Exchange Commission and
Other Interested Persons

Attached hereto is the first annual report of the Public Oversight Board covering its activities from the first meeting in March 1978 through March 31, 1979. Since this is the Board's first annual report, it reviews and comments on the purpose and structure of the SEC Practice Section of which the Board is a part, in addition to reporting on the organization and activities of the Board itself.

The Board's first year was devoted principally to (1) organizing, defining its role and recruiting its staff, (2) advising on policy matters during the development of the Section's peer review program, (3) monitoring initial peer reviews, (4) studying the question of the scope of services provided by CPA firms and preparing and publishing a report containing recommendations on the subject, and (5) considering the question of what action should be taken by the Section in the event of an alleged or possible audit failure involving one of its member firms.

In the course of this work a number of formal Board meetings were held, and the Board or one or more of its members or staff met on numerous occasions with the Executive Committee and various officers and staff members of the Section. The Board also held a two-day public hearing on the scope of services question and received written comments from a substantial number of firms and individuals interested in the matter. On two occasions members of the Board testified before a Congressional subcommittee. In addition, members of the Board and its staff held two meetings with Chairman Williams, Commissioner Pollack, Chief Accountant Sampson and various members of the staff of the Securities and Exchange Commission, and members of the Board's staff held numerous conferences with members of the Commission's staff. As part of the Board's oversight program, a member of the Board attended the exit conference for each 1978 peer review involving a major firm.

Based upon experience to date, the Board has concluded that its own organization and authority are sufficient to enable it to carry out its oversight role and effectively contribute to and assist the profession in instituting and maintaining a vigorous and exacting self-regulatory system. The Board also has concluded that a well-considered structure for self-regulation of accounting firms has been initiated by the accounting profession. Perhaps the most important element of that structure, the mandatory peer review program, is in place and has started to function effectively. The Board recognizes, of course, that as experience is gained some procedures may be modified and improved. Moreover, the Board believes that the Section is in the process of dealing effectively with other major issues, including the scope of services issue and the question of the Section's role with respect to alleged or possible audit failures.

The Board believes that, due to the substantial progress to date, the strong commitment of the profession and the encouragement and support of the Securities and Exchange Commission, the Section's program of self-regulation will be effective. Moreover, the Board believes that, as a matter of principle, self-regulation is preferable to additional governmental regulation and that every effort should be made to assure the success of the Section's program.

PUBLIC OVERSIGHT BOARD

John J. McCloy
Chairman

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# Public Oversight Board

SEC PRACTICE SECTION

American Institute of Certified Public Accountants

ANNUAL REPORT
1978 - 1979

This is the first annual report of the Public Oversight Board ("Board") covering its activities from the first meeting in March 1978 through March 31, 1979. Since this is the Board's first annual report, it reviews and comments on the purpose and structure of the Section of which the Board is a part, in addition to reporting on the organization and activities of the Board itself.

## I. THE SEC PRACTICE SECTION OF THE DIVISION FOR CPA FIRMS

### A. Organization

During the last three years, some members of Congress and the Securities and Exchange Commission ("SEC") have expressed concern regarding the accountability of publicly owned corporations and their auditors. Attention has been focused on the manner in which the accounting profession is regulated and disciplined. In response, the Council of the American Institute of Certified Public Accountants ("Institute") took the initiative in September 1977 by establishing the Division for CPA Firms ("Division"), comprised of an SEC Practice Section ("Section") and a Private Companies Practice Section, to implement a program of voluntary self-regulation and self-disciplining of the profession by establishing requirements for practice by member firms and by creating the authority to impose sanctions for failure to comply with such requirements. Some members of Congress expressed doubt regarding the efficacy of the profession's program of self-regulation and on June 16, 1978, Congressman Moss introduced legislation1/ to create a regulatory organization for accountants patterned after the National Association of Securities Dealers, Inc. However,

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1/ HR 13175, A Bill to Establish a National Organization of Securities and Exchange Commission Accountancy, 95th Congress, 2nd Sess.

the SEC, in its 1978 Report to Congress2/ ("SEC 1978 Report to Congress") concluded that progress during the preceding year had been "sufficient to merit continued opportunity for the profession to pursue its efforts at self-regulation" and that the SEC would not recommend the adoption of legislation "to supersede or control self-regulation of accountants at this time."

Prior to September 1977, the Institute, which is a professional association with some 144,000 individual CPA members, was not structured to regulate the activities of CPA firms. The Division now provides the organizational structure for regulating the activities of member firms. The creation of the Division has been the subject of litigation; recently, however, a court rejected the challenge by certain individual members to the procedures by which the Division was established.3/ As of March 31, 1979, 550 firms were members of the Section and 1,484 firms were members of the Private Companies Practice Section (517 firms were members of both Sections). While the membership requirements and program of the Section are designed specifically for CPA firms that audit companies whose securities are required to be registered under Section 12 of the Securities Exchange Act of 1934 ("SEC clients"), 340 member firms have no SEC clients.

Some concern had been expressed in the SEC 1978 Report to Congress (p. 18) as to the ability of the Institute to regulate CPA firms effectively, since membership in the Section is not mandatory. As indicated in the discussion of the peer review program (pages 13 and 14), a very high percentage of SEC reporting companies are audited by members of the Section, and the Section is studying methods for encouraging nonmember firms to join the Section. It is expected that the importance of membership in the Section will cause issuers, lenders and others who employ auditors or rely on audited financial statements of SEC clients to view less favorably CPA firms that do not participate in the programs of the Section.

Nevertheless, the Board shares the SEC's and the profession's concerns about the number of firms that audit SEC clients which are not members of the Section and believes that the Section should make every effort to increase the membership to provide the greatest possible coverage.

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2/ The Accounting Profession and the Commission's Oversight Role, 95th Cong., 2d Sess., (Comm. Print. 1978),p. 44.

3/ In Re Alam, 180 N.Y.L.J., August 2, 1978, p. 6, col. 3 (Sup. Ct. N.Y. Co., August 1, 1978).

B. Objectives of the Section

The structure and functions of the Section are set forth in its Organization Document, a copy of which, as amended and in effect at March 31, 1979 but excluding appendices, is attached as Exhibit I to this report.

Two key objectives of the Section are to (1) improve the quality of accounting and auditing practice by CPA firms through the establishment of practice requirements for member firms and (2) establish and maintain an effective system of self-regulation of member firms by means of mandatory triennial peer reviews of a firm's accounting and auditing practice, required maintenance of an appropriate system of quality control, and the imposition of sanctions for failure to meet membership requirements.

C. Structure of the Section

The Section is governed by an Executive Committee with the assistance of a Peer Review Committee and such other committees, subcommittees, and task forces as are considered necessary. The Executive Committee is responsible for (1) establishment of general policies and the oversight of Section activities, (2) amendment of membership requirements as necessary, (3) determination of sanctions to be imposed on member firms either on its own initiative or based upon recommendations of the Peer Review Committee, and (4) action to be taken upon complaints received with respect to member firms.

A substantial majority of the members of the Executive Committee are representatives of firms that audit 30 or more SEC clients. Representative Moss, SEC Chairman Williams and spokesmen of some smaller firms have expressed concern that the Section might be too heavily dominated by representatives of the larger firms. The present provisions of the Organization Document reflect some modifications in composition, voting, and quorum requirements made in response to these concerns.4/ The Board, in exercising its oversight responsibilities, will be mindful of the concern that has been expressed in this regard.

The Peer Review Committee is responsible for (1) establishment of standards for performing and reporting

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4/ See Organization Document, VI.2.(c). Membership on the Executive Committee includes 16 individuals from firms that audit 30 or more SEC clients and 5 individuals from other firms.

on peer reviews, (2) administration of the program of peer reviews for member firms and the maintenance of appropriate records of peer reviews, and (3) recommendations of sanctions and other disciplinary actions to the Executive Committee.

D. Membership Requirements

Each member firm is required to have a review at least once every three years of the manner in which it conducts its accounting and auditing practice in order to provide assurance that it has quality control policies and procedures which are appropriate for its practice and which comply with professional standards and with the Section's membership requirements. Other membership requirements relate to the professional qualifications of the members of the firm, continuing professional education, liability insurance coverage, dues, and administrative matters. The Section also imposes on its members, with respect to SEC clients, requirements related to audit partner rotation, concurring reviews, scope of management advisory services, and reporting to audit committees or boards of directors.

## II. PUBLIC OVERSIGHT BOARD

A stated objective of the Section is to "enhance the effectiveness of the section's regulatory system through the monitoring and evaluation activities of an independent oversight board composed of public members."

The responsibilities and functions of the Board, as set forth in the Organization Document, are to: (1) monitor and evaluate the regulatory and sanction activities of the Peer Review and Executive Committees of the Section; (2) determine that the Peer Review Committee is ascertaining that firms are taking appropriate action as a result of peer reviews; (3) conduct continuing oversight of all other activities of the Section; (4) make recommendations to the Executive Committee for improvements in the operations of the Section; and (5) publish an annual report and such other reports as may be deemed necessary with respect to its activities. The Organization Document requires the Section's Executive Committee and Peer Review Committee to consult from time to time with the Board, and members of the Board have the right to attend meetings of those committees.

During its initial meetings, the Board considered at length its oversight role contemplated by the Organization Document, as contrasted to an arrangement in which it would have authority to compel compliance with its views and to overrule Executive Committee decisions contrary thereto. The Board concluded that its oversight role should be preserved and that it should not have line or appellate review

authority. While there may be some advantages to being able to exercise line authority, the Board concluded that its ability to offer objective comment and criticism would be greater if it were not a formal part of the structure for planning and executing policy decisions of the Section. The Board also concluded that its ability to comment publicly on any matter regarding the accounting profession would provide sufficient power to discharge the Board's responsibilities. The SEC 1978 Report to Congress (p. 17) expressed concern that the Board did not have line authority. However, the report stated that the SEC was not prepared to conclude that the lack of line authority would necessarily be fatal to the Board's effectiveness. The Board's experience thus far indicates that line authority is not essential and that the Section is indeed responsive to the Board's recommendations.

The Organization Document provides that the Board shall consist of five members who "shall be drawn from among prominent individuals of high integrity and reputation, including, but not limited to, former public officials, lawyers, bankers, securities industry executives, educators, economists and business executives." Initial members of the Board, who were appointed by the Executive Committee of the Section with the approval of the Board of Directors of the Institute, are John J. McCloy, Chairman, Ray Garrett, Jr., Vice Chairman, and William L. Cary, John D. Harper and Arthur M. Wood. Mr. McCloy, The Assistant Secretary of War from 1941 to 1945, the United States Military Governor and High Commissioner for Germany from 1949 to 1952 and the Chairman of the Board of Directors of The Chase Manhattan Bank, N.A., from 1955 to 1960, is currently a member of the New York City law firm of Milbank, Tweed, Hadley & McCloy; Mr. Cary, Chairman of the SEC from 1961 to 1964, is the Dwight Professor of Law at Columbia University; Mr. Garrett, Chairman of the SEC from 1973 to 1975, is a member of the Chicago law firm of Gardner, Carton & Douglas; Mr. Harper is the former Chairman of the Board of Directors and Chief Executive Officer of Aluminum Company of America; and Mr. Wood is the former Chairman of the Board of Directors and Chief Executive Officer of Sears, Roebuck and Co.

One of the first actions of the Board was to review provisions of the Organization Document regarding its own existence. In order to provide a higher degree of independence from the Section and the Institute, the Board recommended a change in the Organization Document, which was enacted by the Institute, to provide that

> "Following its initial appointment, the Public Oversight Board shall, in consultation with and subject to the approval of the AICPA Board of Directors, appoint, remove, and set the terms and compensation of its members and select its chairman."

Thereafter, the Board adopted bylaws establishing staggered three-year terms for its members, with the initial terms expiring on December 31, 1978 for Messrs. Cary and Garrett, on December 31, 1979 for Messrs. Harper and Wood and on December 31, 1980 for Mr. McCloy. The Board's initial Chairman was selected by the Executive Committee, but future Chairmen are to be selected by the Board. In May 1978, the Board designated Mr. Garrett as Vice Chairman, and in December 1978, Messrs. Cary and Garrett were elected to new three-year terms expiring on December 31, 1981. Annual compensation for Board members is: Chairman, $50,000; Vice Chairman, $40,000; and members, $30,000. The Institute indemnifies Board members against losses and expenses incurred by them in connection with litigation related to their official activities. Each member of the Board is authorized to use assistance available in his office or law firm in connection with the work of the Board. Mr. McCloy has designated Richard A. Stark, a partner in the New York City law firm of Milbank, Tweed, Hadley & McCloy, as his assistant and Mr. Garrett has designated Charles R. Manzoni, Jr., a partner in the Chicago law firm of Gardner, Carton & Douglas, as his assistant. Mr. Stark serves as Secretary of the Board and, prior to the employment of full-time staff, performed general administrative tasks for the Board.

The Board has employed a full-time Executive Director and full-time Technical Director and plans to obtain additional staff as needed. Offices for the Board's administrative staff have been established at 1270 Avenue of the Americas, New York, New York 10020. Louis W. Matusiak, formerly a partner of Alexander Grant & Company, has been Executive Director since May 1978. Saul Beldock, formerly a partner of S. D. Leidesdorf & Co. and Ernst & Ernst, was a consultant and later Technical Director until he resigned in January 1979 for personal reasons. Stuart Newman, formerly a manager with Touche Ross & Co., was appointed Technical Director in February 1979. Messrs. Matusiak, Beldock and Newman established procedures for monitoring peer reviews, which the Board approved, and carried out the monitoring of 1978 peer reviews as discussed elsewhere in this annual report (see pages 14-16).

Three recently retired partners of CPA firms (see page 15), each of whom had extensive experience in his former firm's quality control and internal inspection program, assisted the Board's staff in its monitoring of 1978 reviews. It is contemplated that they and several other recently retired partners will be employed on a part-time basis to assist in the task of monitoring peer reviews in future years.

During its first year of operation, the Board held 16 regular meetings and 3 telephone conference meetings.

The Board also conducted public hearings in Chicago on August 17 and 18, 1978, regarding the scope of services issue discussed elsewhere in this report (see pages 16-21). Representatives of the Board attended nearly all meetings of the Executive Committee and Peer Review Committee of the Section during the last year and met numerous times with members of those committees and certain of the Commissioners and staff of the SEC. Messrs. McCloy and Garrett offered testimony to the Moss Subcommittee hearings on January 30, 1978 and four Board members offered additional testimony to that subcommittee on July 28, 1978. Board members also participated directly in the Board's oversight of the peer review program by attending selected exit conferences between the reviewers and top management of the reviewed firms.

## III. PEER REVIEW PROGRAM

### A. Objectives

The centerpiece of the Institute's program for voluntary self-regulation is the peer review program. As noted above, each member firm of the Section is required to comply with the Institute's professional standards and to have a peer review at least once every three years of its quality control policies and procedures as they relate to its accounting and auditing practice. The objectives of a peer review are to determine whether a reviewed firm's system of quality control for its accounting and auditing practice is appropriately comprehensive and suitably designed for the firm, whether its quality control policies and procedures are adequately documented and communicated to professional personnel, and whether they are being complied with so as to provide the firm with reasonable assurance of conforming with professional standards and the membership requirements of the Section. Such determination is accomplished by (1) study and evaluation of a reviewed firm's prescribed quality control policies and procedures; (2) testing for compliance with such quality control policies and procedures at each organizational or functional level within the firm by inspection of selected engagement working paper files and reports and other documents; and (3) testing for compliance with other membership requirements of the Section.

### B. Peer Review Committee

The peer review program is administered by the Peer Review Committee, which consists of 15 individuals appointed from member firms by the Executive Committee. Almost all of these Committee members are from large national firms. The Board is aware that concerns have been expressed about a major representation from the larger firms and, in exercising its oversight responsibilities, will be mindful of this concern.

The Peer Review Committee, under the leadership of Donald L. Neebes, a partner of Ernst & Ernst, has, in less than a year, (a) established the basic framework for peer reviews that involved numerous protracted meetings within the profession and with the staff of the SEC and with the Board and (b) produced a manual setting forth standards and guidelines for performing and reporting on peer reviews and establishing the administrative framework within which peer reviews are to be conducted. The Board has been impressed with the magnitude of the undertaking and the quality of the initial effort. In order to test the effectiveness of these standards and guidelines, the Committee is studying the reviews that have been conducted to determine whether any revisions should be made.

The Committee also presented a two-day orientation session on peer reviews for member firms and reviewers. Future training programs are to be part of the Institute's continuing education program.

C. Selection of Reviewers

Under the program established by the Peer Review Committee and approved by the Executive Committee, a peer review may be conducted at the reviewed firm's option by another member firm selected by the reviewed firm or by a team appointed by the Peer Review Committee. The Committee is studying the possible use of review teams organized by state societies of CPAs and by associations of CPA firms.

In the initially proposed program, in addition to the review conducted either by members of a single firm or a team drawn from several firms, performance review panels were to be appointed by the Committee to determine whether the reviewers were qualified to conduct the particular review and whether the review was conducted in accordance with established standards. Performance review panels were to be appointed for firm-on-firm reviews and, on a test basis, for Committee-appointed team reviews. The Board expressed concern with the Committee's decision that a firm that opted for a firm-on-firm review was permitted to select the reviewing firm. The staff of the SEC and others expressed concern about the reliability of the firm-on-firm reviews, especially since the firm can select its own reviewer. With regard to firm-on-firm reviews, the Board and the SEC in its 1978 Report to Congress (p. 24) suggested that, in order to overcome the concern expressed above, the panel's responsibility be expanded in a substantive way to require an opinion as to the quality control system as it relates to the accounting and auditing practice of the reviewed firm. This suggestion was adopted by the Committee, and the panel's designation was changed from a performance review panel to a quality control review panel.

The Board is convinced that for medium and large firms the option to use a single firm, rather than an ad hoc team, is of great importance. There are several efficiencies derived from using the resources of a single firm as contrasted with the problems of assembling and coordinating a team of persons who have not previously worked together. Furthermore, while a firm can command the talents and expertise of its top specialists in the conduct of a peer review it has undertaken, such specialists may not be as readily available for team-conducted reviews. The Board was also impressed with the argument that firm-on-firm reviews provide the reviewed firm greater flexibility in negotiating the fee. Also, the addition of the quality control review panel was intended to deal with whatever weakness might appear to result from the reviewed firm's right of selection.

D. Peer Review Reports and Letters of Comment

Upon completion of the review, the reviewing firm or the review team, as the case may be, furnishes its report to the reviewed firm. Further, a letter of comment on matters that may require corrective action and suggestions for improvement in its quality control system may be issued. The reviewed firm has the responsibility to submit that report, the letter of comments, if any, and its response thereto, promptly to the Peer Review Committee. The report of the quality control review panel is submitted directly to the Peer Review Committee, which makes the report available to both the reviewed and reviewing firms.

The Peer Review Committee examines each report, letter of comments and the reviewed firm's response to determine whether further action is required, including whether it should recommend the imposition of sanctions to the Executive Committee.

E. Content of Public Files

During the development of the peer review program, the Peer Review Committee initially proposed, and the Executive Committee concurred, that only the reviewer's report be made public. In discussions between the Board and members of the Peer Review and Executive Committees, the Board expressed the view that there might be sufficient public interest in the letters of comment to warrant making them public. A similar view was expressed in the SEC 1978 Report to Congress (pp. 24-25). The Committee reconsidered its position and decided to make the comment letters and responses thereto public.

In addition, several other documents are placed in the public files: (1) the firm's membership application, which contains a profile of the firm's personnel and practice; (2) the review panel's report, where required; (3) any

sanctions imposed by the Executive Committee; and (4) notification of discontinuance of review, if applicable.

F. Confidentiality of Working Papers

The Board, as part of its oversight of the program, has complete and unrestricted access to all phases of the peer review process, including working papers of reviewers and review panels. The Board, through its staff, has examined working papers for all 1978 peer reviews and will examine working papers of future reviews on a selected basis. In firm-on-firm reviews, the working papers remain the property of the reviewing firm. The working papers of review teams and panels are placed in private files at the Institute. Thus, none of the reviewers' working papers becomes part of the Board's files. The Board's files consist of (1) working papers developed by the Board's staff in the performance of its own monitoring functions and (2) selected items from the Institute's public files such as reports, letters of comment, responses of the reviewed firms, and certain information about the firms obtained from membership records. In order to maintain confidentiality of client-related information, the Board's working papers do not contain any information that could be used directly or indirectly to identify specific client engagements of the reviewed firm or personnel associated with such engagements.

In the SEC 1978 Report to Congress (p. 23), concern was expressed regarding whether the SEC would have sufficient access to the peer review process to make an objective evaluation of its adequacy. All papers in the files of the Board pertaining to 1978 peer reviews have been made available to the staff of the SEC. Providing the SEC access to other papers, particularly those containing specific client data, could create complex legal and practical problems for the Section and member firms and clients. The staffs of the SEC and the Board are working to develop an arrangement that will accommodate the legitimate concerns of the profession and the needs of the SEC.

G. Exclusion of Engagements from Scope of Review

Under procedures established by the Peer Review Committee, a reviewed firm may exclude certain engagements from the scope of a peer review, for example, when the financial statements are the subject of litigation or regulatory investigation or when the client will not permit the working papers to be reviewed. If a request is made to exclude a specific audit engagement from review, the reviewer must evaluate and concur with the reasonableness of the explanation for exclusion. If an engagement is excluded, alternative procedures are to be used by the reviewers, such as review of other engagements in the same industry or a similar area of practice and review of other work of super-

visory personnel who participated in the excluded engagement. If the exclusion materially limits the overall scope of the review, the reviewers issue a modified report. This standard is in substantial agreement with the SEC 1978 Report to Congress (p. 25), which states that valid reasons may exist for certain limitations, but expresses the view that "the ultimate decision to exclude these engagements should rest with the reviewers, under Board oversight, and should depend on whether they are satisfied that the reviewed firm's personnel and the procedures utilized in those engagements can be adequately examined in other ways."

In its monitoring activities, the Board inquired whether there were any excluded engagements in the ten reviews conducted in 1978. It ascertained that two firms requested that a particular engagement be excluded; in one case, a nonpublic client did not grant permission, and in the second case, the client was under investigation by the SEC. In both cases, the reviewers concluded that the exclusion did not materially affect the scope of review and selected another engagement to obtain the desired coverage. The Board intends to continue to monitor this aspect in future peer reviews.

## H. Review of Audit Work Performed Outside of the United States

As pointed out in the SEC 1978 Report to Congress (pp. 25-26), subjecting audit work performed outside of the United States to the review process involves complex problems that will take time to resolve. Professional bodies and firms in the United States have significant limitations on their authority to impose review requirements on accounting firms in other countries. Indeed such "intrusion" is often resented and must be handled with care.

The Peer Review Committee is studying this matter. Meetings have been held with representatives of the professions in Canada, West Germany, France, The Netherlands and the United Kingdom to describe the peer review program and to ask for their cooperation in review of international engagements. The current discussions are limited in scope, pertaining only to the quality of accounting and auditing work, including independence considerations, as it relates to financial statements used in connection with the offer or sale of securities in the United States. The various organizations agreed to consider the matter and reconvene in June. The Board is monitoring the Committee's progress and will consider its conclusions before addressing this issue.

## I. Peer Review Schedule

The Peer Review Committee reports that as of March 31, 1979, 550 firms were members of the Section, 355 of which had tentatively selected their review year as follows:

| Year of Review | Number of Firms |
|---|---|
| 1978 (completed) | 10 |
| 1979 | 110 |
| 1980 | 235 |
| Undecided | 195 |
| | 550 |

Of the firms that have selected their review year, 136, or 38 percent, will have firm-on-firm reviews.

Because member firms vary widely in size and in the nature of their practice, it is helpful to evaluate the schedule of peer reviews in terms of its coverage of SEC clients. The following schedule, based on data derived from "Who Audits America"5/ has been furnished by the Peer Review Committee:

| Year of Review | Number of SEC Clients | Percent |
|---|---|---|
| 1978 | 2,210 | 31% |
| 1979 | 1,820 | 25 |
| 1980 | 3,010 | 42 |
| Undecided | 155 | 2 |
| | 7,195 | 100% |

Of the 3,010 SEC clients whose auditors will be covered by peer reviews in 1980, 2,300 are clients of firms that were reviewed in 1977, prior to the establishment of the Section. Thus, member firms that audit 63 percent of SEC clients were reviewed during 1977 and 1978 and member firms that audit 88 percent will be reviewed by the end of 1979.

The Peer Review Committee reports that approximately 99% of the U.S. companies listed on the New York Stock Exchange and more than 93% of the U.S. companies

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5/ 2nd edition (Menlo Park, California: Data Financial Press, May 1978).

listed on the American Stock Exchange are audited by members of the Section.6/ The Board is informed that the Section intends to make every effort to include in its membership all firms that audit SEC clients. Letters have been sent to all CPA firms that are not members of the Section and are believed to have one or more SEC clients. It is expected that as the Section becomes more established more firms will join.

Although the vast number of CPA firms that serve as auditors of companies whose securities are listed on the major stock exchanges are members of the Section, a large number of firms that practice before the SEC are not. While only 550 CPA firms are members of the Section, the staff of the SEC reports that there are approximately 1,200 CPA firms that audit the 9,700 companies required to file financial statements with the SEC under various sections of the Securities Act of 1933 or the Securities Exchange Act of

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6/ Information on extent of coverage of listed companies by members of the Section:

| | NYSE | ASE |
|---|---|---|
| Listed companies whose auditors are members of the Section | 1,509 | 880 |
| Listed companies whose auditors are not members of the Section | 11 | 64 |
| | 1,520 | 944 |
| Listed foreign companies | 30 | 64 |
| Other* | 1 | 8 |
| Total number of listed companies** | 1,551 | 1,016 |

* One company listed on the American Stock Exchange is shown by Moody's as not having an auditor; in other cases, no record of the company can be located in reference sources currently available.

** Based on "mid-1977" listing supplied by the New York Stock Exchange and February 28, 1979 listing supplied by the American Stock Exchange.

1934. Some of the difference is accounted for by the variations in the definitions of an "SEC client" used in accumulating these data.

Whatever the correct number of nonmember firms may be, the Board shares the profession's and the SEC's concern about firms that audit publicly held companies that are not members of the Section.

J. 1978 Peer Reviews

Peer reviews of ten firms, which among them audit over 2,200 SEC clients, were conducted in 1978. Six reviews were conducted by committee-appointed review teams and four were conducted by individual firms; three firm-on-firm reviews were reviews of "Big Eight" firms and the other a review of a single-office, three-partner firm with no SEC clients.

Unqualified reports were issued in nine of the ten reviews. The qualified report resulted not from a deficiency in the firm's quality control system but from a failure by the reviewed firm to comply with the Section's membership requirement relating to liability insurance coverage; the firm subsequently obtained the required amount of insurance coverage.

The Board's staff questioned the appropriateness of the application of reporting standards to one review and requested the Peer Review Committee to investigate. The Committee had not concluded its consideration of this matter as of the date of this report. In addition, the Board's oversight program includes monitoring reviews commenced but discontinued prior to completion. Two such cases occurred in 1978 and the Peer Review Committee is reviewing both cases to ascertain whether the discontinuances were justified.

K. The Board's Monitoring of the Peer Review Program

In order to ascertain whether the Section's quality control compliance reviews are conducted and reported upon according to the "Standards for Performing and Reporting on Quality Control Compliance Reviews" as promulgated in the manual published by the Peer Review Committee, and whether the reports and letters of comments are consistent with the findings of the reviewers, the Board instructed its staff to prepare and implement an appropriate monitoring program. The Board's oversight and monitoring program consists of (1) postreview of working papers prepared by reviewers, including panels, (2) observation of reviews in process with emphasis on attendance at exit conferences, and (3) other selected procedures. The selection of specific peer reviews and the number of each type of review to be covered in the Board's monitoring program are determined from time to time

by the Board. The Board will make such comments regarding the peer review program as it finds appropriate to the Executive Committee and Peer Review Committee and to such others as it deems advisable.

The objectives of the Board's program are to determine whether peer review standards have been adhered to with respect to the scope and conduct of review, excluded engagements, documentation of work performed, report and letter of comments issued. The Board's program relating to firm-on-firm reviews selected for monitoring and the attendant quality control review panels includes a review of all working papers prepared by the panels and preselected portions of the working papers prepared by the reviewing firms; additional portions are selected for review if results obtained from the preselected portions are inconclusive. The scope of the Board's monitoring of a committee-appointed team review is identical to that of a firm-on-firm review.

For selected reviews, visits are made by Board personnel to certain offices of the reviewed firm while the review is in process. These visits are generally made by Board staff representatives, except that one or more Board members attend selected exit conferences. In addition, interviews are held with, or questionnaires are sent to, reviewers regarding the conduct of review; interviews are held with, or questionnaires are sent to, top management of reviewed firms regarding the conduct of and results obtained from the engagement; and reviewers' qualifications are tested.

It is expected that most quality control system reviews will be conducted in the summer and fall months. To assist the full-time staff in monitoring these reviews on a timely basis, a cadre of qualified monitors will be employed on a part-time basis. The cadre will consist solely of retired partners of CPA firms who have had extensive experience in at least one of the following areas: (a) quality control system design and operation, (b) internal inspection program, (c) independent preissuance review, or (d) engagement partner on SEC audit clients. Generally, only partners who have retired within the prior three-year period will be employed.

The Board successfully tested this concept in its monitoring of the 1978 reviews by using the services of John W. Nicholson (formerly of Arthur Young & Company), R. Kirk Batzer (formerly of Coopers & Lybrand) and Harry F. Reiss, Jr. (formerly of Ernst & Ernst). Each one served as the Board's representative in monitoring one of the larger firm reviews; in each case, the Board representative was not formerly associated with either the reviewing firm or the reviewed firm. Their extensive experience provided the ad-

ditional benefit of suggestions for modifications to and refinement of the Board's program.

Based on its oversight of the 1978 reviews, the Board suggested to the Peer Review Committee several improvements in the peer review process, certain of which have been adopted.

### L. The Board's Conclusions on the Peer Review Program

Based on its experience with the program to date, the Board concludes that the standards and procedures for conducting, reporting on and administering the peer review program are satisfactory and that the program is being implemented in a professional manner.

The Board believes that the ultimate objectives of the program -- to improve financial reporting and the quality of audits of financial statements -- are being achieved. Even though it may be assumed that the majority of member firms have acceptable quality control systems or will have by the time they are reviewed, the Board believes improvements are likely to be effected as a result of the peer review process, both for the reviewed firms and the reviewers' firms.

The Board's observations of the 1978 reviews indicate that the dual reporting plan for firm-on-firm reviews is working satisfactorily. However, after some experience has been gained, the Board may seek a reconsideration of this plan in the hope that the duplicative aspects can be reduced or eliminated.

## IV. SCOPE OF SERVICES BY CPA FIRMS

A major study undertaken by the Board in 1978 focused on the "scope of services" issue. A basic question was raised as to whether a certified public accountant who provides management advisory services ("MAS") for an audit client impairs his ability to render an independent opinion on the fairness of that client's financial statements or impairs his professional image. Over the years, the profession, Congressional committees and other critics and commentators have studied the issue and offered varying opinions and advice. The SEC also expressed interest in the subject and in September 1977 solicited public comment on several questions relating to scope of services in Securities Act Release No. 5869 (September 26, 1977). The SEC, however, refrained from taking any action, beyond requiring certain disclosures in proxy material, to deal with the subject until the Board's views were added to the deliberative process.

The Board undertook the study of the scope of services issue in May 1978, pursuant to a request by the Executive Committee that the Board consider the proposal of that Committee to amend portions of the Organization Document relating to the permissible scope of MAS for members of the Section. The proposed amendments were tentatively approved by the Executive Committee on May 8, 1978, subject to obtaining the Board's views.

The scope of services criteria initially embodied in the Organization Document provided that members of the Section should refrain from providing MAS to audit clients that are SEC reporting companies if providing such services would impair their independence or if such services are predominantly commercial in character, inconsistent with the firm's professional status as certified public accountants, or inconsistent with the firm's responsibilities to the public. The Organization Document also stated that, in determining which MAS to perform, such services should be predominantly in "accounting and financial related areas." Psychological testing, conducting public opinion polls, and merger and acquisition work for a finder's fee were expressly prohibited. Marketing consulting, plant layout, and executive search were also specifically addressed.

The Executive Committee's May 8 proposal took a slightly different tack. As proposed, the membership requirement relating to scope of MAS would prohibit members of the Section from furnishing certain services to an SEC client when such services (1) impair the firm's independence in expressing an opinion on financial statements of that client or (2) require skills not related to accounting or auditing. The proposal also contained a discussion of the application of those two criteria to executive recruitment, marketing consulting, plant layout and design, product design and analysis, insurance actuarial services, and employee benefit consulting, indicating which types of services within those broad categories would and would not satisfy the criteria. Although the Executive Committee had previously asked the Board's views of the proposal, on May 26, 1978, it adopted that portion of the proposal proscribing executive recruiting services.

Because of the importance of this issue and the varied, sometimes conflicting, interests of persons most concerned, the Board resolved to solicit written comments and to hold public hearings on the subject. Written comments were received from 152 individuals and firms, and 31 persons testified at the hearings held in Chicago, Illinois on August 17 and 18, 1978.

In addition to developing its own record, the Board drew from the several studies, articles, and surveys that have focused on the scope of services issue over the last

fifteen years and from the more than 400 written public comments on the subject received by the SEC pursuant to Securities Act Release No. 5869. With that background material and after months of consideration and deliberation, in March 1979, the Board published its report on Scope of Services by CPA firms ("MAS Report").

The Board's conclusions and recommendations to the Executive Committee in the MAS Report under the caption "Conclusions and Recommendations" are set forth below:

> The conclusions and recommendations contained in this section of the report reflect the Board's views with respect to the specific scope of service limitations which are presently a condition of membership in the SEC Practice Section and those scope of service limitations which are embodied in the Proposal. While the Board's general conclusions and recommendations might be viewed in some respects as more permissive than the existing and proposed scope of service limitations, this should not suggest that the Board perceives no problems associated with accounting firms furnishing all forms of MAS to audit clients. The most fundamental departure by the Board from the existing and proposed scope of service limitations appears in the Board's treatment of those forms of MAS which do not impair auditor independence but which involve services not in accounting or financial related areas or which do not require skills related to accounting or auditing--that is, services which may impair the professional image of an accountant but not his independence.
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> As discussed more fully in the body of this report, the Board is concerned with professional image but does not believe that rule-making is the appropriate way to address the problem. Rather, the Board believes it is preferable to rely on public disclosure, supplemented by the admonition to members of the SEC Practice Section to exercise self-restraint and judgment before venturing into new areas of MAS.
>
> With this in mind, the Board has drawn the following conclusions and makes the following recommendations:
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> 1. There are many potential benefits to be realized by permitting auditors to perform MAS for audit clients which should not be denied to such clients without a strong showing of actual or potential detriment. The profession, therefore, should be careful not to impose unnecessarily broad prophylactic rules with respect to MAS and independence.

2. The Board generally concludes that mandatory limitations on scope of services should be predicated only on the determination that certain services, or the role of the firm performing certain services, will impair a member's independence in rendering an opinion on the fairness of a client's financial statements or present a strong likelihood of doing so. Independence is generally defined as the ability to operate with integrity and objectivity. Integrity is an element of character, and objectivity relates to the ability of an auditor to maintain impartiality of attitude and avoid conflicts of interest. All conflicts of interest are not avoidable and some conflicts of interest produce countervailing benefits. Such conflicts are accepted, consistent with the concept of independence, because of practical necessity and the realization of important benefits, coupled with the fact that auditor integrity and various legal incentives provide adequate public protection. This helps explain public acceptance of the fact that auditors can be "independent" even though the client selects them and pays their fee. It also helps explain why there has been public acceptance of accounting firms furnishing a variety of tax advisory services to audit clients. Recognizing, therefore, that independence in an absolute sense cannot be achieved, when evaluating whether certain services should be prohibited, it is necessary to consider the potential benefits derived from the service and balance them against the possible or apparent impairment to the auditor's objectivity.

3. At this time no rules should be imposed to prohibit specific services on the grounds that they are or may be incompatible with the profession of public accounting, might impair the image of the profession, or do not involve accounting or auditing related skills.

4. The existing limitations on MAS concerning independence contained in the Professional Standards relating to Management Advisory Services ("MAS Professional Standards"), AICPA, Professional Standards, Vol. 1, MS §§ 101 et seq. and the Code of Professional Ethics, AICPA, Professional Standards, Vol. 2, ET §§ 50 et seq. [footnote omitted] embrace several provisions that are helpful in ensuring that independence will be maintained. Compliance with those applicable provisions should be made a condition of membership in the SEC Practice Section and peer reviews should be required to test for compliance.

5. Amendments to Regulation 14A (the proxy rules) of the Securities Exchange Act of 1934 and certain publicly available reports required of members of the SEC Practice Section will increase the amount of public disclosure concerning the nature and amount of MAS furnished by an auditor to an audit client and will reveal whether the client's audit committee or board of directors have both approved the MAS and considered its possible effect on independence. To the extent that certain MAS may be perceived publicly as impairing independence, the new disclosure rules, including the role of the audit committee or the board of directors, should either allay suspicion or cause clients and auditors to alter their relationships. These disclosure provisions should be given a chance to work, and they should serve to provide a stronger data base for monitoring of this area.

The Board does, however, recommend that SEC Practice Section members be required to include in their annual disclosure statements filed with the SEC Practice Section disclosure of gross fees both for MAS and tax services performed for audit clients expressed as a percentage of aggregate fees charged during the reporting period.

6. In the Board's view an accounting firm's independence is not impaired solely because a person associated with the firm acts as an enrolled actuary for an employee benefit plan of an audit client or as an enrolled actuary for such a plan which is an audit client. The Board, however, believes that an accounting firm should not provide actuarial services for an insurance company audit client unless those services are supplemental to primary actuarial advice furnished by another actuary not associated with the accounting firm.

7. The Board accepts the recent action of the Executive Committee proscribing certain executive recruiting services inasmuch as the services proscribed are perceived by others as having a strong likelihood of impairing independence, are available from other responsible sources, and do not otherwise produce sufficient countervailing benefits. In general, however, the Board is reluctant to support prohibitions against useful services which are based primarily on appearance without an adequate basis in fact.

Thus, in general, the Board rejected that aspect of the Executive Committee's proposal, as well as the then existing scope of services limitation, which attempted to pro-

scribe services that may be incompatible with the profession of accounting or the image of the accounting profession without also impairing independence. Rather, as a general principle, the Board recommended that maintenance of independence be the sole limiting criterion.

While the Board accepted the Executive Committee's decision to proscribe certain executive recruiting services and recommended that limitations be placed on members of the Section in performing primary or exclusive actuarial services that have an effect on the financial statements of insurance company audit clients, it counselled the profession not to undertake any other effort at this time to identify specific services which should be proscribed. Rather, the MAS Report notes that other less draconian measures or procedures should be employed before resorting to outright proscription. These other measures are the new disclosures in proxy statements7/ and in reports filed by members of the Section and the recent encouragement of audit committees and boards of directors to be aware of the existence of MAS engagements, to approve them, and in so doing, consider the matter of independence. In addition, the Board recommends that the scope of the Section's mandatory peer review be revised to require a review of MAS engagements performed for audit clients to test for compliance with the independence standards.

The Board believes that these new measures should serve to allay public suspicion, to the extent it exists, and will furnish a data base for further monitoring in this area.

In its MAS Report, the Board cautioned the Executive Committee that its "conclusions should not be interpreted to mean that the Board views the matter of scope of services with complacency or believes that possible dangers can be avoided solely with general exhortations to members to preserve independence." While it does not believe that rule-making is the appropriate way to address the problem, the report states "the Board believes it is preferable to rely on public disclosure, supplemented by the admonition to members of the SEC Practice Section to exercise self-restraint and judgment before venturing into new areas of MAS."

## V. PROCEDURES FOR ALLEGED OR POSSIBLE AUDIT FAILURES

One of the first matters identified by the Executive Committee for consultation with the Board relates to

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7/ Accounting Series Release No. 250 (June 29, 1978).

the investigative and disciplinary action that should be taken by the Section with respect to an alleged or possible audit failure involving a member firm.

The Organization Document provides that the Executive Committee shall have the authority to impose sanctions on member firms either on its own initiative or on the basis of recommendations of the Peer Review Committee and shall establish procedures designed to ensure due process to firms in connection with disciplinary proceedings. Sanctions contemplated in the Organization Document include (a) required corrective measures by the firm, (b) additional requirements for continuing professional education, (c) accelerated or special peer reviews, (d) admonishments, censures, reprimands, (e) monetary fines, (f) suspension of membership and (g) expulsion from membership. Under these provisions, upon the occurrence of an alleged or possible audit failure, which might raise a question concerning the quality controls of the member firm involved, the Section could accelerate the commencement of a regular triennial peer review or order a special peer review. The purpose of such a peer review would be to determine whether the member firm is maintaining and applying quality controls in accordance with standards established by the Section. Under the existing structure such reviews would not deal with the specific case involving an alleged audit failure, but could examine the quality controls of the member firm and of the office of the firm (including the individuals) involved in the alleged audit failure.

It should be noted that individual CPAs who are members of the Institute are subject to disciplinary action by the AICPA Ethics Committee ("Ethics Committee"). Proceedings of the Ethics Committee are generally deferred during the pendency of litigation, a fact that was noted and criticized by the Cohen Commisson.8/ Since an alleged audit failure will often cause civil litigation to be commenced or threatened, as well as investigation and threatened enforcement action by the SEC or other government agencies, the question is presented whether the Section should adopt the deferral policy of the Ethics Committee in such circumstances.

Before addressing the basic policy issues, the Board received from Milbank, Tweed, Hadley & McCloy a comprehensive memorandum dated September 11, 1978 entitled "Disciplinary Procedures for Audit Failures: an Analysis of Legal Issues." The purpose of the memorandum was to pro-

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8/ The Commission on Auditors' Responsibilities: Report, Conclusions, and Recommendations (1978), pp. 149-150.

vide background information to the Board regarding legal issues raised by a private self-disciplinary system for member firms in the event of an alleged or possible audit failure. The memorandum reviewed reports of Congressional committees, the SEC, the Cohen Commission and other interested commentators, and described the disciplinary structures already in place. The memorandum analyzed the potential prejudice to member firms which may result from conducting disciplinary proceedings prior to the conclusion of any civil or criminal actions and discussed the question of whether the simultaneous conduct of disciplinary proceedings raises constitutional problems. It further discussed issues relating to the effectiveness of a disciplinary system which, absent legislation, would have to rely on the contractual consent of member firms to provide testimony and documents in the event of disciplinary proceedings. Requirements that disciplinary procedures provide due process safeguards for member firms also were considered. The memorandum also mentioned certain antitrust implications of disciplinary procedures.

The memorandum concluded generally that there are no insurmountable legal impediments to the conduct of disciplinary proceedings while litigation is pending or threatened, but that any such proceedings must provide minimum due process protections and in certain cases there may be practical limitations on the ability of such proceedings to obtain necessary evidence.

The Board also received from Milbank, Tweed, Hadley & McCloy a memorandum dated November 10, 1978 and revised December 29, 1978 entitled "Disciplinary Proceedings for Audit Failures: Areas for Discussion" which sought to identify some of the broad policy issues and other considerations involved in the disciplinary procedure question. In addition, at the Board's request, Willkie Farr & Gallagher, legal counsel for the Institute, furnished the Board a memorandum dated December 1, 1978, entitled "Deferral of Disciplinary Proceedings" which discussed various legal considerations involved in the Institute's policy of deferring disciplinary actions against individual members during the pendency of civil, criminal or administrative proceedings arising out of the matter which is the subject of the disciplinary proceeding.

After extended study of the matter, including the memoranda mentioned above and discussions with the Executive Committee, the Board concluded that the protection of users of audited financial statements should be the dominant consideration in any response by the Section to information suggesting the possibility of an audit failure. Some apparent audit failures may raise a question with respect to auditing standards and procedures. This was the case, for example, when the difficulties of Equity Funding Corporation first became generally known and the press suggested that it

involved a great "computer fraud" accomplished by electronic devices that defied the auditors' procedures. These suggestions turned out to be wrong, but, should a case giving rise to such suggestions occur in the future, the Section should be prepared to begin a prompt inquiry and to recommend appropriate changes.

The more usual type of alleged or possible audit failure could raise questions concerning the quality controls of the member firm, or perhaps the firm's office responsible for the audit. In such cases the Board has recommended that the Section be prepared to take measures, including special peer reviews, to assure itself and others that there is no likelihood of future harm from the auditing work of that firm or office.

Formal disciplinary proceedings directed toward the punishment of the member firm are of less immediate importance. One purpose of disciplinary action, to be sure, is the deterrent effect on the firm that is punished and its example to others. Nevertheless, where the Section satisfies itself that an alleged or possible audit failure does not indicate any significant danger of avoidable future failures, or, if it does, that corrective measures have been taken, the Board believes that the Section will not be derelict if it postpones formal disciplinary proceedings in deference to considerations of fairness and due process arising from the pendency of civil or criminal litigation or government action, or in the end foregoes such proceedings on the ground that the member firm has suffered enough and that punishment resulting from the other actions has accomplished all of the prophylactic benefit that can be expected. However, the Section should have the authority to institute formal disciplinary proceedings in those circumstances where such action is deemed appropriate notwithstanding the pendency of litigation or government action.

To that end, the Board has recommended to the Section that a permanent committee be established to monitor, and to determine what action if any should be taken with respect to, alleged or possible audit failures involving member firms. At its March 27, 1979 meeting, the Executive Committee agreed in general with the concepts expressed by the Board and appointed a task force to develop recommendations for implementation.

## VI. CONCLUSIONS

During its first year the Board has participated in the development of the Section, which is a new mechanism within the accounting profession for self-regulation and self-discipline of CPA firms engaged in auditing SEC clients. Members of the Section have committed themselves

to burdensome and costly mandatory peer reviews, and the Section is dealing with other major issues, including the scope of services issue and the question of the Section's role with respect to alleged or possible audit failures.

The Institute deserves much credit for its aggressive development of the Section and its programs. It is also important to acknowledge the substantial contribution of the SEC through constructive criticism provided by Chairman Williams and other Commissioners and by A. Clarence Sampson, Chief Accountant, and members of his staff in many meetings and telephone conferences. It is too early to state that all concerns of the SEC have been or can be dealt with to its satisfaction. Nevertheless, the close coordination and exchange of views between the Section and the SEC have been important ingredients in moving forward to date.

The Board believes that, due to the substantial progress to date, the strong commitment of the profession and the encouragement and support of the SEC, the Section's program for self-regulation will be effective. Moreover, the Board believes that, as a matter of principle, self-regulation is preferable to additional governmental regulation and that every effort should be made to ensure the success of the Section's program.

PUBLIC OVERSIGHT BOARD

March 31, 1979

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