Public Oversight Board

# Annual Report 1979-80

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

**Public Oversight Board**

John J. McCloy, *Chairman*
Ray Garrett, Jr., *Vice Chairman*
(Deceased February 3, 1980)
William L. Cary
John D. Harper
Arthur M. Wood

*Staff:* Louis W. Matusiak
Charles J. Evers

*Office:* 1270 Avenue of the Americas
New York, N. Y. 10020

IN MEMORIAM

RAY GARRETT, JR.
AUGUST 11, 1920 - FEBRUARY 3, 1980

With the death of Ray Garrett, Jr. on February 3, 1980, the accounting profession lost one of its more creative and dedicated advisers.

As a member and vice chairman of the Public Oversight Board of the SEC Practice Section for the past two years, Mr. Garrett was in the vanguard of the profession--making his manifold talents available in helping to resolve many of the substantive issues confronting the accounting profession's installations of a self-regulatory program.

His experience as a member of the staff and later as chairman of the Securities and Exchange Commission permitted him to provide invaluable guidance to this Board and to the profession. His views and recommendations were given great weight by the Securities and Exchange Commission, this Board and leaders of the accounting profession.

The Board wishes to record its recognition of the many contributions Ray Garrett made to it during its formative period as well as to express its deep sense of personal loss at the passing of a colleague of such character and capacity.

# Public Oversight Board

SEC PRACTICE SECTION

American Institute of Certified Public Accountants

1270 AVENUE OF THE AMERICAS • NEW YORK, NEW YORK 10020 • (212) 765-4628

JOHN J. McCLOY
Chairman
RAY GARRETT, JR.
Vice Chairman
WILLIAM L. CARY
JOHN D. HARPER
ARTHUR M. WOOD

LOUIS W. MATUSIAK
Executive Director


March 31, 1980

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

Attached hereto is the second annual report of the Public Oversight Board covering its activities for the twelve months ended March 31, 1980.

The Board was saddened by the death of its Vice Chairman, Ray Garrett, Jr., on February 3, 1980, and the Board's tribute to him is included in the report.

During the Board's second year, the Executive Committee of the SEC Practice Section adopted procedures for dealing with alleged or possible audit failures of SEC clients involving member firms and established a permanent Special Investigations Committee to carry out such procedures. Copies of relevant documents are annexed to the Board's annual report. This important step was taken at the suggestion of the Board and involved extensive discussion and consultation between the Board and the Executive Committee. The Board believes that a reasonable self-policing mechanism has been developed. The next few years will provide the opportunity to test and improve these procedures. The Board regards effective implementation of the Section's investigative and monitoring procedures to be essential features of the Section's self-regulatory program and intends to give particular attention to monitoring these procedures and to offer comments from time to time as appropriate.

This past year has seen an increase in peer review activity. The peer review process and the Board's monitoring program have been improved through experience with 40 peer reviews. Discussions were held with the SEC's staff regarding its access to peer review papers,

and progress was made with respect to the international aspects of peer reviews. The next year will see a sharp increase in peer reviews with 200 firms scheduled for initial reviews. This will provide the opportunity for further improvement in the peer review program of the Section and the Board.

The Section also studied the auditor's work environment in relation to possible substandard auditing as noted by the Cohen Commission. A position paper prepared by the Section's special task force on this topic, which is annexed to the Board's annual report, contains some practical observations and suggestions for firms in dealing with the problem should it exist.

The Board continues to be concerned that the Section's membership does not include all firms that audit SEC clients, although the percentage of SEC clients audited by member firms is very high. The Board has urged the Section to continue its efforts to increase its membership to the greatest possible extent. Among other things, the Board would favor the imposition by the SEC of a requirement that SEC registrants disclose in their proxy statements whether their auditing firms are members of the Section.

The Board believes that progress made during the past year is evidence of the continued strong commitment of the Section to the success of its self-regulatory program. The Board noted with appreciation that the SEC continues to be supportive with its constructive criticism and comments. The Section will face many challenges in 1980-1981 to make its program more effective. The Board believes, however, that the experience thus far gained, together with the continued encouragement and support of the SEC, will enable the profession to make continued progress in 1980 and the years ahead.

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
1979-1980

This second annual report of the Public Oversight Board ("Board") of the SEC Practice Section ("Section") of the Division for CPA Firms of the American Institute of Certified Public Accountants ("AICPA") covers its activities for the period April 1, 1979 through March 31, 1980.

## I. PUBLIC OVERSIGHT BOARD

The responsibilities and functions of the Board were not changed during the year. Its primary responsibilities are to (1) monitor and evaluate the performance of the Section's Peer Review, Special Investigations and Executive Committees, with special emphasis on the regulatory and sanction activities; (2) see that the Peer Review Committee is taking the necessary steps to ensure appropriate action on the part of member firms as a result of peer reviews; (3) make recommendations for improvement in the operation of the Section; and (4) publish an annual report and such other reports as may be deemed desirable with respect to its activities. The Board does not have line authority or responsibility; it acts purely in an oversight and advisory capacity.

### A. Meetings and Other Activities

The Board normally meets on the third Tuesday of each month. During the past year, ten such monthly meetings were held.

Major items considered by the Board and commented on in detail in subsequent sections of this report are (1) the peer review program, (2) the procedures for investigation of alleged or possible audit failures, (3) a study of the auditor's work environment, (4) the scope of services provided by CPA firms, and (5) membership in the Section.

At each meeting, the Board receives a report from its Executive Director on the recent activities of the Peer Review Committee and the Executive Committee. A Board staff member attends all meetings of these committees as well as meetings of several of their subcommittees and task forces.

In addition, Board members and staff met on several occasions with certain of the commissioners and staff of the Securities and Exchange Commission ("SEC"). The Board also submitted briefs

and comments to the SEC on matters relating to scope of services by CPA firms. Board Vice-Chairman Garrett offered testimony at the August 1-2, 1979, hearing conducted by the Senate Subcommittee on Governmental Efficiency and the District of Columbia.

B. Composition of the Board

John J. McCloy continued as Chairman and Ray Garrett, Jr. continued as Vice-Chairman of the Board until his untimely death on February 3, 1980. John D. Harper and Arthur M. Wood whose initial terms expired on December 31, 1979 were elected for additional three-year terms. Additional details are shown in Exhibit I of this report.

Annual Board remuneration continued at $30,000 per member, $40,000 for the Vice-Chairman and $50,000 for the Chairman.

In connection with work of the Board, each member is authorized to recruit staff assistance available in his office. Mr. McCloy designated Mr. Richard A. Stark, a partner in the New York law firm of Milbank, Tweed, Hadley & McCloy, as counsel for this purpose. Mr. Stark is also Secretary for the Board. Mr. Charles R. Manzoni, Jr., a partner in the Chicago law firm of Gardner, Carton & Douglas, served as counsel to Mr. Garrett.

C. Staff and Expenses

The Board employs full-time executive and technical directors. Louis W. Matusiak has served as the Executive Director since May 1, 1978. Stuart Newman served as Technical Director from February 1, 1979, until his untimely death in December. On February 1, 1980, Charles J. Evers joined the staff as Technical Director. Immediately prior to joining the POB staff, Mr. Evers served for over two years as a member of the senior staff of the Financial Accounting Standards Board. He has extensive public accounting experience, including six years as an audit partner with Peat, Marwick, Mitchell & Co. Because the number of peer reviews scheduled for 1980 exceeds 200, the Board at its March 1980 meeting authorized the addition of another full-time member to its technical staff.

All expenses of the Board and its staff are paid from membership dues of the Section. For accounting convenience, the Board reports its expenses on the same fiscal year basis used by the AICPA. The estimated expenses for the fiscal year ending July 31, 1980, are $652,000. Additional details are shown in Exhibit II.

II. PEER REVIEW PROGRAM

A major responsibility of the Board is to monitor and evaluate the activities of the Peer Review Committee ("Committee"), the peer reviews of member firms, and the actions taken by the Section with respect to peer reviews.

## A. Peer Review Committee

The peer review program is administered by the Committee which consists of fifteen individuals appointed from member firms by the Executive Committee. Since its inception, the Committee has been under the leadership of Donald L. Neebes, a partner in Ernst & Whinney, whose term expires in 1980. The Executive Committee has appointed Joseph X. Loftus, a partner in Price Waterhouse & Co., as Vice-Chairman, and he will succeed Mr. Neebes as Chairman in October 1980.

Committee members' time commitments have been considerable. The Committee held 10 meetings during the past year for a total of 19 days. In addition, Committee members are involved in subcommittee and task force meetings, oversight of specific peer reviews, and a number of special projects.

As noted in its 1978-79 Annual Report, the Board is aware that concerns have been expressed about a dominant representation of the larger firms on the Committee. Appointments to the Committee have been declined by several members of smaller firms, primarily because of the significant time commitment required. The Board is mindful of the need for Committee members to be a representative cross-section of larger and smaller firms and for the Committee to give appropriate consideration to the nature of practice of smaller firms in decisions that affect such firms. To date, the Board believes that the Executive and Peer Review Committees have given appropriate consideration to the nature of practice in a smaller firm.

### 1. Administration of Peer Reviews

In the interest of increasing the number of firms participating in the Section's program, the Committee has authorized the Private Companies Practice Section Peer Review Committee ("PCPS-PRC") and associations of CPA firms to administer certain aspects of the peer review program in compliance with the Committee's standards. However, the Committee has the sole responsibility for accepting and placing in the public file reports and letters of comments for all member firms of the Section. Further, the Committee Chairman may reject the review team or Quality Control Review Panel ("Panel") appointments of the PCPS-PRC.

For association-administered reviews, the Committee must approve each association's administrative plan and assigns a Panel for each such review. If an association has a common quality control element, that particular element must be reviewed by a team or firm that is independent of the association.

a. Summary of 1978 and 1979 Reviews

Fifty-one member firms have had their initial peer review under the Section's program: 11 1/ in 1978 and 40 in 1979. The firms reviewed vary widely in size, ranging from sole proprietorships to national firms. An indication of size of the firms reviewed and the extent of coverage of SEC clients is as follows:

| Size of Firm (by number of SEC Clients) | Number of Firms | Number of SEC Clients |
|---|---|---|
| None | 32 | 0 |
| 1 to 4 | 8 | 12 |
| 5 to 29 | 4 | 48 |
| 30 or more | 7 | 5,177 |
| | 51 | 5,237 |
| Total number of SEC clients audited by member firms | | 8,880 |
| Percentage of SEC clients audited by member firms which had a review in 1978 or 1979 | | 59% |

Of the 40 peer reviews conducted in 1979, 34 were conducted by committee-appointed review teams, 5 by another member firm, and one by an association.

The Standards for Performing and Reporting on Quality Control Compliance Reviews provide that the review team ordinarily furnish the reviewed firm with a letter of comments, which is placed along with the report in the public files, informing the reviewed firm of matters that the review team believes may require action. The Committee continued its practice of considering each report issued on a peer review together with the related letter of comments and the reviewed firm's response to determine whether further action was required, including whether it should recommend the imposition of sanctions to the Executive Committee.

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1/ Includes a firm that had a voluntary review and a subsequent review conducted under the auspices of the SEC. The Committee accepted these reviews as meeting the peer review membership requirement of the Section.

As of the date of this report, the Committee has considered and accepted the report, letter of comments, if issued, and the related response on only 21 of the forty 1979 reviews. The Committee has not been able to take action on the remaining 19 reviews because the report, letter, response, or reviewers' workpapers have not all been submitted to the Committee for action.

The 21 accepted reports consist of 18 unqualified reports, 2 modified reports and 1 adverse report. One report was modified because the reviewed firm did not comply with the minimum professional liability insurance required by member firms. The second modified report cited lack of compliance with the minimum professional liability insurance as well as documentation deficiencies in a few functional areas of the firm's quality control system. The adverse report was due to the reviewed firm's general failure to comply with its stated system of quality control as applied to its accounting and auditing practice.

After placing the adverse report and attendant letter of comments and response in the public file, the Committee conferred with the reviewed firm (a sole practitioner) and suggested a remedial course of action. Three months later, in March 1980, the Committee reviewed the progress made by the firm in correcting the deficiencies noted and will recommend to the Executive Committee that this firm be continued as a member but require the firm to undergo another peer review in 1980. The firm has shown serious intent to improve its practice and has indicated its willingness to have its quality control system reviewed again in 1980.

There are preliminary indications that approximately seven additional reports, on the 19 reviews not yet processed by the Committee, will be modified.

The results of peer reviews are discussed at meetings with the Chairmen of the AICPA Quality Control Standards Committee, Auditing Standards Board, Accounting and Review Services Committee and the PCPS-PRC. Through these discussions, information gathered through the peer review process can be considered by these committees for possible new pronouncements to improve practice.

b. Reviews Scheduled for 1980 and 1981

Since membership in the Section commenced in 1978 and membership requirements call for a peer review once every three years, no member firm was required to have a peer review prior to 1980. However, during the year, the Section encouraged firms to undergo their initial peer review in 1979 rather than in 1980. The results were disappointing to the Section and to the Board, especially since 70 of 110 member firms which had tentatively selected 1979 as the year of their initial review postponed their initial review to 1980.

Confronted with the probability of having to administer approximately 520 reviews in 1980 (and every three years thereafter), the Executive Committee decided to permit certain firms with fewer than five SEC clients to defer their initial review until 1981. Consequently, approximately 200 of the 520 firms have been assigned to have their initial reviews in 1980. The remainder, only ten percent of which had any SEC clients, have been allowed to defer their initial reviews to 1981.

Approximately 60 firms that joined the Section in 1978, and which were to have their initial peer reviews in 1980, requested the Committee to grant them extensions until 1981. The Committee granted seven of the requests and concluded that the remainder failed to establish existence of a significant unavoidable hardship. The Committee, together with the Executive Committee, considered the effect such rejections might have on membership in the Section and concluded that, in general, two years was sufficient time for a firm to prepare for its initial review.

c. Mergers and Acquisitions

The Organization Document2/ provides that member firms are required to have a peer review conducted every three years "or at such additional times as designated by the executive committee."

The Peer Review Committee, which is charged with the administration of peer reviews, studied the question of whether a merger of accounting firms should trigger a special peer review or accelerate the timing of the next scheduled review. The special review would involve a review of the segments of the member firm's practice acquired (merged) subsequent to its most recent review and which had not been previously subjected to peer review.

The Peer Review Committee recommended, and the Executive Committee adopted the recommendation, that no action was necessary in such circumstances. The primary reasons for the recommendation are (1) current quality controls literature requires a firm to give special attention to matters involved in mergers and acquisitions, (2) a reasonable amount of time should be allowed to the firm to assimilate the merged practice, and (3) the benefits of a special peer review could not be cost justified in view of the short time interval between the special review and the next regularly scheduled peer review.

The first peer review of the combined firm is to be no later than three years after the peer review of the predecessor firm which had the larger accounting and auditing practice.

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2/ The document which sets forth the structure and functions of the SEC Practice Section is entitled "Organizational Structure and Functions of the SEC Practice Section of the AICPA Division for CPA Firms" ("Organization Document").

The Executive Committee believes that effects of mergers should be reported and accordingly amended the Section's annual reporting requirements to include (1) the number of offices and the number of accounting and auditing personnel of the acquired firm and (2) the number of SEC clients of the acquired firm that will be (a) serviced by practice units which were combined with practice units of the acquiring firm or (b) continued as separate practice units in the combined firm.

The Board generally concurs with the position of the Peer Review and Executive Committees in this regard.

2. Other Significant Activities

Since the Board's last annual report, the Committee clarified and improved the standards and guidelines for performing and reporting on peer reviews. The Committee also made progress in resolving the difficult issues (1) of extending the peer review process to include engagements performed outside the United States and (2) of access by the SEC to reviewers' workpapers.

a. Changes in Standards and Guidelines

The Committee issued additional guidelines for selection of audit engagements to be reviewed and for testing compliance with the Section's revised membership requirements regarding management advisory services ("MAS"). These requirements were added during the year as recommended in the Board's report entitled Scope of Services by CPA Firms ("MAS Report").

b. Review of Audit Work Performed Outside the United States

As the SEC pointed out in its 1978 Report to Congress3/ and its 1979 Report to Congress,4/ it might take considerable time to resolve the question of subjecting audit work performed outside the United States to the peer review process. The Board observed in

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3/ Securities and Exchange Commission Report to Congress on the Accounting Profession and the Commission's Oversight Role, prepared for the Subcommittee on Governmental Efficiency and the District of Columbia of the Senate Committee on Governmental Affairs, 95th Cong., 2nd Sess., 27-28 (Comm. Print. 1978) ("SEC 1978 Report to Congress").

4/ Securities and Exchange Commission Report to Congress on the Accounting Profession and the Commission's Oversight Role, prepared for the Subcommittee on Governmental Efficiency and the District of Columbia of the Senate Committee on Governmental Affairs, 96th Cong., 1st Sess., 36 (Comm. Print. 1979) ("SEC 1979 Report to Congress").

its 1978-79 Annual Report that 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 discretion.

During 1979, the Committee studied this matter in depth. Meetings were held with representatives of the profession in Australia, Canada, France, The Netherlands, West Germany, and the United Kingdom. In addition, representatives of the Committee met with representatives of the International Auditing Practices Committee ("IAPC") of the International Federation of Accountants, which was considering publication of an international auditing guideline dealing with reliance on other auditors. The Board has been informed that IAPC has decided to publish on June 1, 1980, an exposure draft on the subject.

The Committee adopted in principle an approach for review of work done outside the U.S. which the Committee believes will be supported by the professions in other countries and which is consistent with existing U.S. auditing standards and with the proposed international standard. The Committee has also agreed to adopt a similar approach for review of work done by domestic affiliates. The approach focuses on the supervision and control of segments of engagements performed by domestic or foreign affiliates or correspondents. To enable peer reviewers to test compliance, a firm will be required to document several specified matters relating to supervision and control. The Committee reports that it plans to amend its standards accordingly, effective for audit engagements beginning after June 30, 1980.

The Board supports the Committee's actions in this respect and concludes that the Committee's approach achieves all that can be done at this time, and appreciates the assistance of IAPC in helping resolve this difficult problem.

### B. Board Monitoring of 1979 Reviews

Board representatives monitoring a specific review are required to assess the appropriateness of the conduct of the review and the reports issued and to challenge those that are not done in accordance with standards. They also review the propriety of reviews terminated prior to completion.

#### 1. Types of Monitoring Programs

The Board used three different programs in monitoring 1979 peer reviews: a visitation-observation program, a workpaper-review program, and a report-review program.

The visitation-observation program consists of an examination of workpapers and reports prepared by reviewers and of visits to one or more offices of the reviewed firm during the performance of the review, with emphasis on attendance at the exit conference between reviewers and reviewed firm personnel. These visits are made by Board staff members with selective attendance by Board members as well. The workpaper-review program consists of an examination of workpapers, report and letter prepared by the reviewers and the reviewed firm's response. The report-review program consists of a reading of the report, letter of comments, and the reviewed firm's response.

2. Selection of Reviews To Be Monitored

The Board adopted the following plan for selecting the work programs to be used in monitoring peer reviews:

- Firms with 5 or more SEC clients--all reviews are monitored using the visitation-observation program.

- Firms with 1 to 4 SEC clients--20% of the reviews are monitored using the visitation-observation program, 50% using the workpaper-review program, and the remaining 30% using the report-review program.

- Firms with no SEC clients--10% of the reviews are monitored using the visitation-observation program, 20% using the workpaper-review program, and the remaining 70% using the report-review program.

The selections in the latter two groups are made at random. The Board's staff also examines the reviewers' workpapers on any firm receiving a modified report arising from a deficiency in its quality control system.

Because the number of reviews in 1979 was substantially fewer than anticipated, the above percentages were exceeded. The majority of the reviews were subjected to the workpaper-review monitoring program.

3. Excluded Engagements

The SEC 1979 Report to Congress (pages 134-135) repeated the SEC's concern regarding the right of the reviewed firm to exclude certain engagements from the scope of the review. Only 2 of the 40 firms reviewed in 1979 had requested a total of three engagements be excluded. Two non-public clients, one from each of the two reviewed firms, requested that workpapers on their audit engagements not be subjected to peer review. The third engagement was excluded because of potential litigation involving the reviewed firm and a former client.

In monitoring 1979 reviews, the Board determined the engagements which were excluded, and satisfied itself that each reason for exclusion was appropriate and that the exclusion did not adversely affect the scope of the review.

4. Supplemental Staff of the Board

As in the prior year, the Board employed three CPA firm retired partners on a part-time basis to monitor 1979 reviews, most of which are performed in the summer and fall months. Each of these persons, John W. Nicholson (formerly of Arthur Young & Company), R. Kirk Batzer (formerly of Coopers & Lybrand) and Harry F. Reiss, Jr. (formerly of Ernst & Whinney), has extensive experience in quality control systems of accounting and auditing practices. No member of either the full-time or part-time staff is assigned to monitor a review if the member was formerly associated with either the reviewing or reviewed firm.

5. Matters Raised by Staff on Specific Reviews

In two 1979 reviews, the Board's staff questioned whether the review had been conducted according to prescribed standards. Based upon the reviewers' workpapers, the Board's staff concluded that the engagements reviewed did not represent a cross-section of that firm's practice, and that a letter of comments should have been issued in one review on the basis that there was insufficient documentation of key areas in certain audit engagements. As a result, the Committee caused the reviewers to review additional engagements (expand the scope of the review) and assigned a committee member to consult with the reviewers as to the appropriateness of a letter of comments.

In its 1978-79 Annual Report, the Board reported that its staff questioned whether reporting standards were appropriately applied in one 1978 review and indicated that the Committee was reviewing two cases where reviews were commenced but discontinued prior to completion. These matters were resolved to the satisfaction of the Board's staff and the Board during the past year.

6. Review of Workpapers by the SEC

The workpapers prepared by the Board's staff in monitoring specific peer reviews in 1978 and 1979 have been made available to, and have been examined by, the staff of the Chief Accountant of the SEC. These workpapers will continue to be accessible by members of the staff of the Chief Accountant. Notwithstanding this access to the Board's workpapers, the SEC 1979 Report to Congress (pages 33-34) expressed concern as to whether the SEC would have sufficient access to the peer review process to make an objective evaluation of its adequacy.

In response to this concern, the Committee proposed a procedure under which the SEC staff would be given access to certain workpapers of reviewers; workpapers on review of individual audit engagements, because they contain confidential client data, would not be made available. The Board is hopeful that the combination of SEC access to all of the Board's peer review workpapers and those workpapers available under the Committee's recent proposal will satisfy the SEC's concerns regarding its ability to properly evaluate the peer review process.

The staff of the Chief Accountant of the SEC suggested ways in which the staff of the Board can improve documentation of the basis for its satisfaction that the reviewers fully considered and reported properly on the effects of the deficiencies noted in their workpapers. The Board's staff developed and discussed with the staff of the SEC a proposed work program which would require such additional documentation and the basis for its conclusions. These additional documentation requirements will be applied in monitoring future reviews.

### C. Board Conclusions on the Peer Review Program

1980 will be a key year for the peer review program. The Board believes the review program developed by the Committee, the monitoring program developed by the Board and the arrangements for SEC access to workpapers of the Board and certain papers of the reviewers will be severly tested in 1980. While the Board anticipates that 1980 experiences may afford opportunities for further improvements, it believes that the programs thus far developed are well conceived and should benefit the member firms and the profession and afford further assurances to the public.

## III. PROCEDURES WITH RESPECT TO AUDIT FAILURES

As noted in the Board's 1978-79 Annual Report, one of the first matters identified by the Executive Committee for consultation with the Board related to 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. An important question arose as to whether disciplinary or other proceedings by the Section should be deferred during the pendency of litigation or investigation and threatened enforcement action by the SEC or other governmental agencies.

### A. Board Recommendations

After extended study, the Board concluded that protection of users of audited financial statements should be the dominant consideration in any action taken by the Section with respect to a possible audit failure. The Board recommended 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. The principal purposes of the committee and its monitoring effort would be to determine whether facts relating to an audit failure indicate that auditing standards are inadequate or that the quality controls of the member firm need strengthening. In developing these primary purposes, the Board concluded that disciplinary proceedings directed toward the punishment of a member firm were of less immediate importance, particularly in view of the fact that the firm and individuals involved in an audit failure would likely be facing punitive and compensatory actions by governmental and regulatory bodies and by private litigants. Nonetheless, the Board recommended that the Section have the authority to institute formal disciplinary proceedings in those circumstances where such action is deemed appropriate, notwithstanding the pendency of litigation or governmental action.

B. Procedures Adopted by Executive Committee

On November 29, 1979, after extensive discussion and further consultation with the Board, the Executive Committee adopted a resolution set forth as Appendix B to the Organization Document authorizing the establishment of a Special Investigations Committee ("SIC") and adopted a document entitled The Special Investigations Committee of the SEC Practice Section of the AICPA Division for CPA Firms ("SIC Document") setting forth the procedures to govern the operations of the SIC. At the same time the Executive Committee adopted a separate document entitled Rules of Procedure for the Imposition of Sanctions ("Procedure Document") which sets forth procedures established by the Executive Committee applicable to all proceedings relating to the imposition of sanctions by the Section, i.e., proceedings by the Peer Review Committee, the SIC and the Executive Committee.

Copies of the Organization Document, the SIC Document and the Procedure Document are annexed as Exhibits III, V and VI to this report. Principal features of the Section's investigative and disciplinary mechanism established by these documents are summarized below, together with certain comments of the Board.

C. The Special Investigations Committee

The SIC is appointed by the Executive Committee and is composed of nine members who are partners or retired partners of different member firms. SIC members serve three-year staggered terms and are eligible to serve two such terms in addition to partial terms. Procedures are established to avoid conflict of interest situations. The SIC should have whatever staff it needs to perform its duties. Initial members of the SIC, appointed in December 1979, are shown in Exhibit VII.

The SIC Document requires member firms to report to the SIC, within 30 days of service on them of the first pleading in the matter, or within 30 days after joining the Section if later, any litigation (including criminal indictments) against them or their personnel, or any proceeding or investigation publicly announced by a regulatory agency, commenced on or after November 1, 1979 (not including additional proceedings arising out of or related to facts involved in litigation originally filed prior to November 1, 1979), that involves clients or former clients that are SEC registrants and that allege deficiencies in the conduct of an audit or in reporting thereon in connection with any required filing under the federal securities laws. The SIC will screen information thus reported and information from other sources relating to cases not involving litigation commenced on or before November 1, 1979.

The Board initially questioned the November 1, 1979 cutoff date as being too restrictive with the result that the Section would be powerless to deal with significant audit failures involving litigation commenced prior to November 1, 1979. After an extended conference with members of the Executive Committee, however, the Board concluded that the cutoff date was justified by practical considerations. Moreover, in response to the Board's concern, the Executive Committee, when it adopted the SIC Document and the Procedure Document, also agreed to refer to the SIC on an ad hoc basis any "case" (as defined below) that arose before November 1, 1979, and thus falls outside the SIC's jurisdiction, but which requires prompt attention because events subsequent to November 1, 1979, indicate the matter has great potential significance to the public and the profession.

On the basis of information screened by the SIC, it may (1) monitor further developments without an investigation, (2) investigate the firm (without investigating the "case," i.e., the specific alleged failure), to review certain of the firm's quality control policies and procedures or to review other engagements by the personnel involved in the case or of other engagements in the same industry as the case, or (3) recommend investigation of the case to the Executive Committee. The scope of an investigation of a firm will be established by the SIC, while the scope of an investigation of a case will be established by the Executive Committee. The SIC Document states that the purpose of any such investigation will be to determine whether

1. Quality controls are inadequate in a particular firm, or

2. There has been a material departure from generally accepted auditing standards or a material failure to comply with quality control standards by the individuals responsible for the engagement in question, or

3. There is a need for reconsidering the adequacy of certain generally accepted auditing standards or quality controls standards.

The SIC Document contemplates that an investigation of a case (but not of a firm) will not ordinarily be recommended by the SIC if the case is the subject of a court proceeding or a proceeding or investigation by the SEC, a grand jury, or other governmental body until such matters are concluded. Nevertheless, the SIC may decide that a particular case is of such significance to the public interest that the importance of immediately investigating it outweighs any possible prejudice to the firm.

A member firm is required to cooperate in furnishing information to the SIC and in any SIC-initiated investigation of a firm or case unless the firm can demonstrate to the satisfaction of the SIC (a) that there is a likelihood that the firm's rights in pending litigation or other proceeding or investigation will be unduly prejudiced by the firm's providing the requested information and (b) that the need for such information is not sufficient to override the interest of the firm or individuals in avoiding prejudice in such litigation or other proceeding or investigation. If a member firm fails to supply information to the SIC as required, such failure will be a basis for the SIC to recommend to the Executive Committee that sanctions be imposed on the firm.

D. Sanctioning Hearings

At the conclusion of an investigation of a firm or a case, the SIC may conduct a hearing to determine whether to recommend sanctions to the Executive Committee. (Sanctions may also be recommended after a hearing by the Peer Review Committee as a result of a regular peer review.) Sanctions that may be recommended and imposed include the following:

1. Requirements for corrective measures not voluntarily taken by the firm.

2. Additional requirements for continuing professional education.

3. Special or accelerated peer review.

4. Admonishment, censure or reprimand.

5. Monetary fine.

6. Suspension from membership in the Section.

7. Expulsion from membership in the Section.

Sanctions may be imposed only by the Executive Committee after a hearing governed by the procedures set forth in the Procedure Document. This document deals with the authority for and nature of the hearings, the rights of the parties, and procedural rules intended to provide for an orderly proceeding leading to a fair result while adequately safeguarding the rights of member firms and individuals.

Hearings are not open to the public and all matters relating thereto are confidential until a decision is made by the Executive Committee to impose sanctions. Then the Executive Committee will decide upon publishing in a membership periodical of the AICPA the notice of the case and the decision to be published, together with the name of the member firm. Documents setting forth sanctions imposed on a member firm will be placed in the Section's public file.

E. Board Oversight

The Organization Document provides that the Board shall monitor and evaluate the regulatory and sanction activities of the Peer Review Committee and Executive Committee, which includes the SIC. The Procedure Document provides that the Board or its representative may have access to all briefs, memoranda, documentary evidence, and stenographic transcripts of the hearing. The Board is required to maintain confidentiality with respect to all such information. Nevertheless, after giving the firm concerned an opportunity to present its views and after consultation with the Executive Committee, the Board may make public disclosure of information thus obtained which it deems necessary in the interest of the profession or the public.

F. The Board's Appraisal

The Board has consulted with the Executive Committee on all important aspects of the procedures outlined above and has concluded that the procedures embody a reasonable framework for self-policing and disciplinary measures to protect the public and the profession. Because the accounting profession has been the subject of substantial litigation in recent years, it should be recognized that the task of preparing the SIC Document and the Procedure Document involved issues of extreme importance to the profession. The Board believes that, all things considered, a balanced and practical result has been achieved. Because the procedures developed provide broad discretion to members of the profession, the Board believes that the success or failure of the overall program can only be judged by results which may require several years of experience.

The Board regards effective implementation of the Section's investigative and monitoring procedures to be essential features of the Section's self-regulatory program and intends to give particular attention to monitoring such procedures and to offer comments from time to time as appropriate.

## IV. Study of the Auditor's Work Environment

### A. Recommendation of Cohen Commission

After studying the audit environment as it existed prior to June 1977, the Commission on Auditors' Responsibilities ("Cohen Commission") issued a report5/ stating that its research indicated that substandard auditing was frequently caused by time and budget pressures placed on auditors. That research consisted of a survey conducted by John G. Rhode for the Cohen Commission6/ which also stated that inadequate supervision on audits resulted in auditors having signed for completing audit steps which were not in fact performed.

Rhode based his conclusions on replies to a questionnaire sent to present and former partners and staff members of auditing firms. While the Cohen Commission's analysis of legal cases did not identify instances where unreasonable time budgets caused an audit failure, the commission concluded that time pressure created significant problems. The lack of a proven relationship between unreasonable time budgets and problem cases, in part, led the commission to recommend that "individual public accounting firms immediately undertake to conduct studies to determine the extent of conditions revealed by the commission's study and the effects on their practices" of pressures induced by time budgets (page 118).

### B. Action Taken by the Section

At the suggestion of the Board, a task force on Certain Aspects of the Auditor's Work Environment ("Task Force") was formed by the Section's Executive Committee to consider what actions the Section should take relative to the conclusions of the Rhode study.

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5/ The Commission on Auditors' Responsibilities: Report, Conclusions, and Recommendations (New York: AICPA, 1978).

6/ John Grant Rhode, The Independent Auditor's Work Environment: A Survey. The Commission on Auditors' Responsibilities No. 4. (New York: AICPA, 1978).

After considerable discussion and study, the Task Force presented its conclusions and recommendations in a position paper entitled Certain Aspects of the Auditor's Work Environment, which is reproduced as Appendix VIII of this report. The position paper was accepted by the Executive Committee and copies were distributed to all member firms of the Section.

The Task Force position paper states that "serious consideration must be given to any indications that some audits may be performed at a substandard level, that excessive time and budget pressures may be the cause of substandard audits, and that inadequate supervision and improper sign-off practices may result from those pressures" and recommends that "firms" take steps to mitigate the possible effect of such conditions" (page 5).

In view of significant developments in the profession since publication of the Cohen Commission report, the Task Force does not believe that a pervasive condition of substandard audits exists as a result of audit procedures omitted because of excessive time pressures. Nevertheless, the Task Force recommended that firms (1) take steps to assure effective communication to staff of the objectives of time budgeting, (2) plan for and maintain adequate numbers of supervisory staff, and (3) provide personnel additional guidance, if needed, regarding the form and content of working papers, the proper procedures for signing off for work performed and for noting a change in planned procedures. These three recommendations are consistent with recent profession-wide developments, namely, issuance of Statement on Auditing Standards No. 22, Planning and Supervision, actions by the AICPA Division for CPA Firms (especially the mandatory triennial peer reviews for members of the Section), measures taken by the AICPA to discipline individual member CPAs, and the issuance of Statement on Quality Control Standards No. 1, System of Quality Control for a CPA Firm.

While some firms may choose to conduct an internal survey of partners and staff members concerning the auditor's work environment, the Task Force considers such survey unnecessary and concludes that the three procedures referred to above effectively address the Cohen Commission's concerns.

C. The Board's Appraisal

The Task Force position paper is a careful analysis of the problems cited in the Cohen Commission report. The problems must be solved in the first instance by individual public accounting firms. The profession's recent emphasis on the supervision and control aspects of the conduct of an audit will help eliminate the problems. Finally, the peer review process, which evaluates the reviewed firm's planning, supervision and control policies and procedures and compliance therewith, should also reduce the frequency of such deficiencies.

The Board accepts the judgment that failure to perform audit procedures because of constraints imposed by time budgets is not a pervasive problem. Yet the Board believes that some firms may have, in varying degrees, deficiencies attributable to time budget pressures on auditors. Accordingly, the Board endorses the recommendations made by the Task Force (and adopted by the Executive Committee) which essentially call for increased emphasis on supervision and control of audits, preparation of realistic time budgets and for raising the level of consciousness of staff members regarding the objectives of time budgeting and the appropriate manner for noting a change in a planned procedure or a decision not to carry out the procedure.

## V. SCOPE OF SERVICES BY CPA FIRMS

In March 1979, the Board published its report, Scope of Services by CPA Firms ("MAS Report"). A summary of the conclusions and recommendations of the MAS Report was included in the Board's 1978-79 Annual Report. Since the publication of the annual report, various interested parties have responded to the conclusions and recommendations contained in the MAS Report.

### A. Reactions to MAS Report

#### 1. Executive Committee of the Section

Several of the Board's recommendations called for affirmative action by the Executive Committee. In this regard, the Board generally recommended the following: (1) any rules relating to management advisory services ("MAS") engagements should be based on maintaining the independence and objectivity of the auditor in the course of his conduct of an audit; (2) compliance with the existing standards relating to MAS and independence contained in the AICPA Professional Standards on Management Advisory Services and in the AICPA Code of Professional Ethics should be made a condition of membership in the Section; (3) the peer review process should be expanded to require review of MAS engagements for SEC audit clients to test for compliance with independence standards enunciated by the AICPA; (4) member firms should be required to disclose in their annual statements filed with the Section the amount of fees received from audit clients for MAS and tax services performed, expressed as a percentage of aggregate fees received during the reporting period; and (5) members of the Section should be prohibited from performing exclusive or primary actuarial services for insurance company audit clients.

On June 21, 1979, the Executive Committee adopted several revisions of the Organization Document, many of which were in response to the recommendations in the MAS Report. That document was revised to require member firms to adhere to the AICPA Professional Standards on Management Advisory Services and the AICPA Code of Professional Ethics with respect to independence in performing MAS for audit clients that are SEC registrants. Pursuant to that revision, members are prohibited from serving as

an actuary for an insurance company audit client with respect to policy reserves and related accounts unless the primary actuarial assistance to management comes from actuaries not related to the auditing firm. Actuarial assistance in other areas is permissible, subject to the requirements that the service remain advisory.

Consistent with the recommendations in the MAS Report, members continue to be prohibited from furnishing certain executive recruiting services to SEC audit clients and from providing merger and acquisition assistance to such clients for a finder's fee. In addition, the Executive Committee continued the prohibition on providing such clients psychological testing services and public opinion polling services.

The Executive Committee took action in two additional areas in direct response to the Board's recommendation. The committee instructed its Peer Review Committee to incorporate into the peer review process a review of MAS engagements for audit clients to test for compliance with the independence standards. In addition, annual statements of members which are placed in the public file at the AICPA must now reveal gross fees for MAS and tax services performed for SEC registrant audit clients, expressed as a percentage of total fees charged to such clients.

As reflected in the foregoing discussion, the Executive Committee implemented all of the Board's recommendations, albeit not in all instances in precisely the form suggested. Nonetheless, the Board is satisfied with the action taken by the Executive Committee.

One of the possible deviations from the Board's recommendations exists in the continued proscription of psychological testing and public opinion polling. Any general proscription of these services would seem to be predicated on concerns for maintaining professional image and not on independence. While in its MAS Report the Board recommended against proscribing specific services on the basis of image impairment, it made that recommendation because of the difficulty of making such determinations in any fair and comprehensive way and because it believed that proxy statement disclosure regarding MAS, then recently imposed on SEC registrants, should be given a chance to work. At the same time, the Board expressed serious concern with unfettered proliferation of MAS and urged members to exercise self-restraint in expanding into new areas of MAS.

In light of the Board's concern over the potential impairment of professional image, it did not object to the Executive Committee's decision to retain the proscription with respect to psychological testing and opinion polling. In fact, recent publicly announced actions and advertisements by some large accounting firms suggest that they may have misinterpreted the Board's decision not to recommend the proscription of specific services which may impair professional image. The Board will

continue to monitor this aspect of the accounting profession, including formal disclosures contained in proxy statements of SEC registrants and in annual statements filed by members with the Section. It is the hope of the Board that the new disclosure provisions and, above all, an inclination toward self-restraint will operate to preserve and enhance the accountant's image, which, in itself, is a confidence-building factor in the public attitude toward auditors.

2. Securities and Exchange Commission

On June 14, 1979, the Securities and Exchange Commission published Accounting Series Release 264 ("ASR 264") which contains the Commission's views of the issues raised by MAS. While the Commission in ASR 264 endorsed several of the conclusions reached by the Board in its MAS Report, it stated that the MAS Report did "not adequately sensitize the profession and its clients to potential effects on the independence of accountants of performance of non-audit services for audit clients." A similar criticism was made in the SEC 1979 Report to Congress (page 81).

Since the Commission invited comments on ASR 264, the Board, in a letter to the SEC dated October 10, 1979, commented on certain aspects of ASR 264 with which it disagreed. Generally, the Board commented that ASR 264 (1) fails to recognize adequately the efforts of the AICPA over the years in addressing problems raised by MAS; (2) fails to give sufficient guidance as to whether adherence to the MAS standards for membership in the Section will be a sufficient defense against a charge that MAS impaired an auditor's independence; and (3) confuses notions of independence and professional image. The Board also commented that ASR 264 may discourage managements and boards of directors from retaining their auditors for MAS engagements in circumstances where it may very well be in the interest of shareholders to do so, and that it incorrectly concluded that the MAS Report recommended no proscriptive rules solely on the basis that there was an absence of empirical evidence showing that MAS impairs independence. Finally, the Board advised the SEC that ASR 264 unnecessarily and unfortunately casts a cloud over the performance of MAS related to internal controls at a time when the Foreign Corrupt Practices Act makes it essential for boards of directors and audit committees to seek assurances of their independent auditors with respect to internal control systems.

The Board believes that audit committees and boards of directors are qualified to make reviews and determinations as to the effect of MAS on independence of their auditors as called for by ASR 250. It regrets the confusion that seems to have resulted among audit committees and boards of directors from the issuance of ASR 264.

On January 3, 1980, in a speech before the AICPA Seventh National Conference on Current SEC Developments, SEC Chairman Williams clarified and expanded upon certain aspects of ASR 264, stating that the Commission, in issuing ASR 264, did not intend to "deprecate the benefits that may accrue from certain MAS activities." He indicated that assisting clients in reviewing internal accounting control systems would typically be the type of service that would produce enough benefits to more than offset the danger that such assistance might impair the auditing firm's independence. Chairman Williams also acknowledged that ASR 264 inadvertently uses the terms "non-audit services" and "MAS" interchangeably, but recognized that MAS encompasses a narrower scope of activities and stated that the Commission did not intend to stigmatize firms that receive a substantial amount of their fees from tax work and so-called "accounting and review services."

With respect to whether a firm's dependence on MAS could affect its independence, Chairman Williams indicated that, even though ASR 264 suggested that an auditor's independence might be impaired by the magnitude of the ratio of the firm's non-audit fees to audit fees for a specific client or for the firm as a whole, the Commission did not mean to suggest that it would, after the fact, question an auditor's independence based solely on a percentage relationship. The Chairman did say that the profession cannot ignore the magnitude of MAS on a firm-wide basis since "undue emphasis on MAS could ultimately translate into an effect on the quality of audit work performed."

In its MAS Report (page 25), the Board expressed a similar concern by stating that a disproportionate amount of MAS performed on a firm-wide basis may result in a dilution or perceived dilution of the accounting firm's primary service which, in turn, may impair its professional image. Whether the threat is to the quality of audits, as suggested by Chairman Williams, or to the image of the profession, as suggested in the MAS Report, or both, is not important to decide now, but the profession should recognize the concern expressed by both the Commission and the Board and act to prevent any such impairment.

3. Other Comments

Under a letter dated May 24, 1979, the American Academy of Actuaries ("Academy"), furnished the Board a copy of its comments, prepared for the SEC's Chief Accountant, criticizing the analyses and conclusions in the MAS Report relating to actuarial services. The criticism alleged that the MAS Report contained certain inconsistencies and that the Board incorrectly interpreted

and applied Statement of Auditing Standards Number 11 ("SAS 11")7/. The Board relied on SAS 11 in its conclusion that performing both actuarial and audit services for a client did not pose a problem of self-review.

The Academy argued that the Board had incorrectly concluded that SAS 11 could be relied upon by an auditing firm in circumstances where an employee of the firm performed the specialized services to which SAS 11 refers, intending instead that SAS 11 may be applied only where the specialist has no relationship with the auditor.

The Board presented the Academy's position on SAS 11 to the AICPA and sought clarification of the question presented by the Academy's argument. The AICPA confirmed that the MAS Report properly interpreted the application of SAS 11 and that the position taken by the Academy was incorrect. In a letter to the SEC's Chief Accountant, dated August 9, 1979, the Board advised that it had reviewed the Academy's contentions regarding SAS 11 and other matters and that it wished to affirm the conclusions it had reached in the MAS Report on all points raised by the Academy. Copies of this correspondence are available from the Board's executive director.

Aside from the Academy's comment to the Commission, the Board received no other formal comments on the MAS Report. However, several persons in their written comments to the SEC on ASR 264 included reference to the MAS Report, in most instances criticizing the Commission for failing to give adequate recognition to the conclusions reached by the Board.

B. Monitoring MAS Disclosures

As indicated in the MAS Report (pages 46 and 56), proxy statement disclosures and peer reviews of MAS performed for audit clients will supply new data on the nature and extent of MAS furnished to audit clients who are SEC registrants. The Board intends to monitor this new source of information and comment if the facts suggest that the self-restraint urged by the Board is ignored by the profession or if the magnitude of MAS appears to increase to an extent that it threatens professional image generally.

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7/ SAS 11, issued by the AICPA Auditing Standards Board, generally provides that an auditor obtain an understanding of the methods and assumptions used by a specialist and need not perform comprehensive audit procedures or challenge the specialist's methods or assumptions, unless his limited review procedures lead him to believe that the findings are unreasonable under the circumstances.

## VI. SEC PRACTICE SECTION

### A. Changes in Executive Committee

The Section's Organization Document states that the Executive Committee shall be composed of representatives of at least twenty-one member firms. The document further provides that

> The executive committee shall at all times include representatives of all member firms which audit the financial statements of thirty or more registrants under section 12 of the Securities and Exchange Act of 1934 and at least five representatives of firms which audit financial statements of fewer than thirty such registrants plus one additional such representative for each representative, in excess of sixteen, of firms which audit thirty or more such registrants.

At the date of the Board's 1978-79 Annual Report, the Executive Committee consisted of representatives of sixteen firms that were entitled to representation on the committee because of the number of SEC audit clients and representatives of six other member firms. During the past year, because of mergers between four such firms, the number of representatives entitled to automatic representation was reduced to fourteen.

In June 1979, Walter E. Hanson of Peat, Marwick, Mitchell & Co. reported that he would not be available to serve as Chairman of the Executive Committee for 1979-80. At the August 7, 1979, meeting of the Executive Committee, Archibald E. MacKay of Main Hurdman & Cranstoun was elected to serve as Chairman for the 1979-80 committee year. The Chairman serves at the pleasure of the committee but in no event for more than three one-year terms.

The firms represented on the Executive Committee as of March 31, 1980, are shown in Exhibit IV of this report.

### B. Changes in Membership Requirements

The number of firms auditing SEC clients that are not members of the Section is a matter of major importance that the Board has discussed with the Executive Committee on several occasions.

Since the Board's 1978-79 Annual Report, the Section has made changes in certain of its requirements to encourage more accounting firms that audit at least one SEC client to join the

Section. The changes were made on the basis of information gathered by the Section's membership committee and staff and are summarized below:

1. Membership dues for firms that audit less than five SEC clients were limited to a maximum of $100 per year. (Firms with five or more SEC clients are assessed dues -- $15 per capita for 1980 -- based on the number of all professional staff with no upper limit.)

2. Insurance requirements for firms that audit less than five SEC clients were reduced to require such firms to maintain $50,000 of liability insurance coverage per qualified staff person, with a minimum of $250,000; maximum of $5,000,000. (Firms that audit five or more SEC clients are required to maintain a minimum of $2,000,000 of insurance; maximum of $10,000,000).

3. Billing rates for peer reviews of firms with less than 20 professionals were reduced to the rates used by the Private Companies Practice Section.

4. As noted in Section II of this report, steps were taken to permit PCPS-PRC participation in the administration of peer reviews of firms that audit less than five SEC clients.

The Board believes that these changes are responsive to concerns expressed by smaller firms and do not weaken in any way the Section's effectiveness.

C. Changes in Membership

A summary of the changes in the membership of the Section is presented below:

| | Total Number of Firms | Breakdown by Number of SEC Clients: 5 or More | Less Than 5 | None |
|---|---|---|---|---|
| March 31, 1979 | 550 | 44 | 167 | 339 |
| New Members | 140 | 9 | 54 | 77 |
| Resignations | (112) | - | (24) | (88) |
| Mergers | (4) | (1) | (1) | (2) |
| Reclassifications, net | - | (10) | 7 | 3 |
| March 31, 1980 | 574 | 42 | 203 | 329 |

The increase during the year in the number of accounting firms that are members of the Section was disappointing to the Section and the Board, especially in light of the changes made in the Section's membership requirements in order to encourage new members. The SEC has noted with concern that approximately 600 accounting firms that audit at least one SEC client have still not joined the Section. Without minimizing that concern, there have been some positive signs. For example, there has been a positive trend in the number of U.S. companies listed on the New York Stock Exchange and the American Stock Exchange that are audited by member firms, as indicated in the following tabulation:

| | NYSE | ASE |
|---|---|---|
| Listed U.S. companies whose auditors were not members of the Section at March 31, 1979 | 11 | 64 |
| Less: Companies whose auditors during the year | | |
| -- joined the Section | 6 | 20 |
| -- resigned from the Section | - | (1) |
| Companies that changed to auditors who | | |
| -- are members of the Section | 2 | 4 |
| -- are not members of the Section | (1) | - |
| Effect of changes in listed companies -- net | - | 3 |
| Listed U.S. companies whose auditors were not members of the Section at March 31, 1980 | 4 | 38 |

More importantly, the firms that are members of the Section do represent, in terms of the SEC clients they audit, a significant commitment to effective self regulation. The Section's records indicate that member firms audit 8,880 SEC clients and that those clients represent

- 92% of the estimated 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 1934.
- All but 4 of the U.S. companies listed on the New York Stock Exchange (based on December 1979 NYSE listing).
- All but 38 of the U.S. companies listed on the American Stock Exchange (based on December 1979 ASE listing).

- 93% of the 2,027 companies included in NASD listings of over-the-counter securities reported in the January 8, 1980, Wall Street Journal that could be located in Moody's Complete Corporate Index.

D. Efforts of the Section to Increase Membership

During the year, the Section continued its efforts to increase membership by appealing directly to firms that had not yet joined and by engaging in general promotional activities.

- A December 1977 "Auditor Listing" obtained from Disclosure Incorporated included the names of approximately 325 accounting firms that could not be identified in AICPA records. The Section, with the aid of member firms and state societies, was able to locate addresses for 161 of those firms and mailed them appropriate promotional literature.

- The Section contacted by telephone all nonmember firms that audit five or more SEC clients and a sample of firms that audit one to four SEC clients. (Information gained from these conversations was useful to the Section in deciding on the changes that were made in the Section's requirement.)

- Personal letters were sent to firms that audit one or more SEC clients but are members only of the Private Companies Practice Section.

- Letters were sent to firms that are not members of the Section and that are included in the fourth edition of Who Audits America.

- A brochure was published on the Division for CPA Firms and given wide distribution, including a gratis distribution to all members of the Robert Morris Associates.

- Representatives of member firms, particularly those on the Executive and Peer Review Committees, and the Section's staff have accepted all available opportunities to speak or write about the Section's activities. In that connection, the executive directors of certain larger state societies have been specifically asked for help in identifying speaking opportunities for representatives of the Section and the Board.

disclose in proxy statements whether their auditing firms are members of the Section and whether they have been subjected to a peer review. The Board believes that this suggestion recognizes the benefits accruing to the public from membership in the Section, and more particularly from the requirement that member firms undergo triennial peer reviews. Moreover, a direct salutary effect of such a requirement would be to increase the pressure on accounting firms to join the Section. Accordingly, the Board would favor such a disclosure requirement.

The Board urges the profession to seek out speaking opportunities before financial analysts, bankers and other users of financial statements to inform them of the Section's purpose and especially of its peer review program. Such publicity could cause financial statement user groups to induce audit firms to become members of the Section.

## VII. CONCLUSIONS

The Board believes that in the past year the Section has shown continued strong commitment to the success of its self-regulatory program. This is evidenced by (1) further progress in developing and administering its peer review program, (2) adoption of an initial program for surveillance and disciplinary action in cases of alleged or possible audit failure, (3) the review of the auditor's work environment, (4) efforts to enlarge membership of the Section, and (5) continued attention to the scope of services issue. The SEC continues to be supportive with its constructive criticism and comments.

The Section will face many challenges in 1980-1981 to make its programs more effective. The SIC will have the opportunity to develop surveillance and investigatory procedures. The increased activity in peer reviews will require a major expenditure of time by the profession and the Board. The Board believes, however, that the experience thus far gained will enable the profession to make continued progress in 1980 and the years ahead.

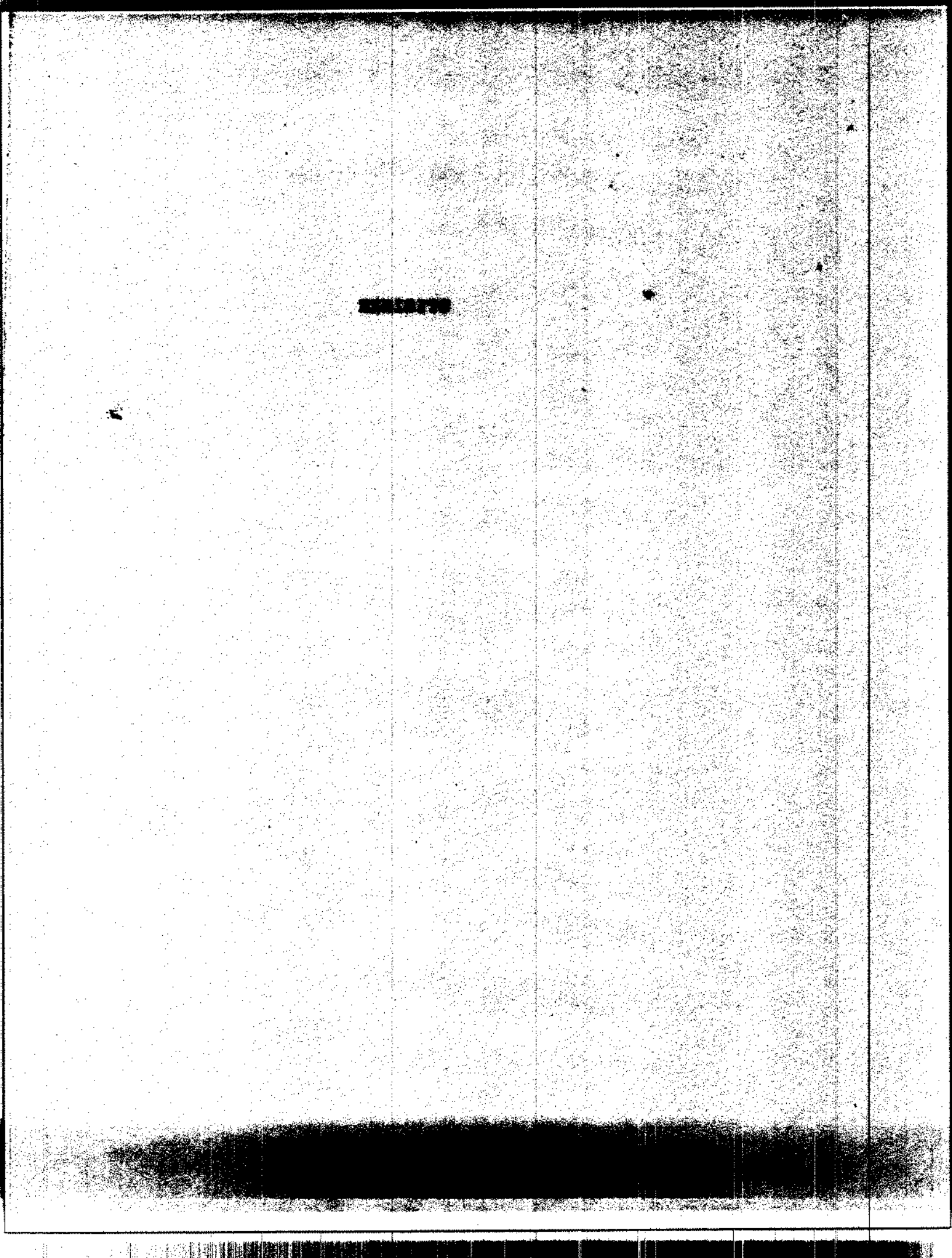

Exhibit I

COMPOSITION OF PUBLIC OVERSIGHT BOARD
YEAR ENDING DECEMBER 31, 1980

| ame | Position | Term Expires | Affiliation |
|---|---|---|---|
| ohn J. McCloy | Chairman | December 31, 1980 | Partner, Milbank, Tweed, Hadley & McCloy, New York |
| ay Garrett, Jr.* | Vice-Chairman | December 31, 1981 | Partner, Gardner, Carton & Douglas, Chicago |
| illiam L. Cary | Member | December 31, 1981 | Professor of law, Columbia University, New York |
| ohn D. Harper | Member | December 31, 1982 | Former chairman of the board and chief executive officer of Aluminum Company of America, Pittsburgh |
| rthur M. Wood | Member | December 31, 1982 | Former chairman of the board and chief executive officer of Sears, Roebuck & Co., Chicago |

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taff and Counsel to Board Members

| | | |
|---|---|---|
| ichard A. Stark | Secretary of Board and Counsel to Mr. McCloy | Partner, Milbank, Tweed, Hadley & McCloy, New York |
| ıarles R. Manzoni, Jr. | Counsel to Mr. Garrett | Partner, Gardner, Carton & Douglas, Chicago |
| ›uis W. Matusiak | Executive Director | |
| ıarles J. Evers | Technical Director | |

r. Garrett died on February 3, 1980. As of this date, his replacement as not been selected.

Exhibit II

# PUBLIC OVERSIGHT BOARD
## STATEMENT OF ACTUAL EXPENSES
## FOR THE YEAR ENDING JULY 31, 1979
## AND STATEMENT OF ESTIMATED EXPENSES
## FOR THE YEAR ENDING JULY 31, 1980

| | Estimated Expenses for 12 Months Ending July 31, 1980 | Actual Expenses for 12 Months Ending July 31, 1979 |
|---|---|---|
| Regular fees of board members | $180,000 | $147,500 |
| Fees for professional services paid to firms of board members: | | |
| Milbank, Tweed, Hadley & McCloy | 75,000 | 100,250 |
| Gardner, Carton & Douglas | 50,000 | 70,752 |
| Reimbursement of expenses to Board members and their firms: | | |
| Milbank, Tweed, Hadley & McCloy | 12,000 | 10,945 |
| Gardner, Carton & Douglas | 14,000 | 10,340 |
| All others | 8,000 | 4,355 |
| Salaries of staff, including part-time reviewers | 200,000 | 161,773 |
| Office expenses: | | |
| Personnel | 25,000 | 23,633 |
| Occupancy | 29,000 | 21,131 |
| Printing and paper | 4,000 | 11,713 |
| General | 55,000 | 55,225 |
| Total office expenses | 113,000 | 111,702 |
| Total expenses | $652,000 | $617,617 |

# Organizational Structure and Functions of the SEC Practice Section of the AICPA Division for CPA Firms

## I. Source of Authority

The section was established by a resolution of the Council of the AICPA adopted on September 17, 1977.

## II. Name

The name of the section shall be the "SEC Practice Section" of the AICPA Division for CPA Firms.

## III. Objectives

The objectives of the section shall be to achieve the following:

1. Improve the quality of practice by CPA firms before the Securities and Exchange Commission through the establishment of practice requirements for member firms.
2. Establish and maintain an effective system of self-regulation of member firms by means of mandatory peer reviews, required maintenance of appropriate quality controls, and the imposition of sanctions for failure to meet membership requirements.
3. Enhance the effectiveness of the section's regulatory system through the monitoring and evaluation activities of an independent oversight board composed of public members.
4. Provide a forum for development of technical information relating to SEC practice.

## IV. Membership

*1. Eligibility and Admission of Members*

All CPA firms are eligible for membership in the section even though they do not practice before the SEC. Membership in the section shall not constitute membership in the AICPA nor entitle any member firm to any of the

rights or privileges of membership in the AICPA. To become a member, a firm must submit to the section a written application agreeing to abide by all of the requirements for membership. The application must be accompanied by firm information for the most recent full fiscal year as described under 3 (*g*) of this section.

The membership of the section shall consist of all firms which meet with the admission requirements and continue to maintain their membership in good standing.

2. *Termination and Reinstatement of Members*

(*a*) Membership of a CPA firm may be terminated—

(1) By submission of a resignation, provided the firm is not the subject of a pending investigation or recommendation of the peer review committee for sanctions or other disciplinary action by the executive committee or under review by the public oversight board.

(2) By action of the executive committee for failure to adhere to the requirements of membership.

(*b*) Membership of a terminated CPA firm may be reinstated—

(1) By complying with the admission requirements for new members if termination occurred by resignation.

(2) By complying with the admission requirements for new members and obtaining the approval of the executive committee if termination was imposed as a sanction.

3. *Requirements of Members*

Member firms shall be obligated to abide by the following:

(*a*) Ensure that a majority of members of the firm are CPAs, that the firm can legally engage in the practice of public accounting, and that each proprietor, shareholder, or partner of the firm resident in the United States and eligible for AICPA membership is a member of the AICPA.

(*b*) Adhere to quality control standards established by the AICPA Quality Control Standards Committee.

(*c*) Submit to peer reviews of the firm's accounting and audit practice every three years or at such additional times as designated by the executive committee, the reviews to be conducted in accordance with review

standards established by the section's peer review committee (see Appendix C).

(*d*) Ensure that all professionals in the firm resident in the United States, including CPAs and non-CPAs, participate in at least one hundred twenty hours of continuing professional education over three years, but in not less than twenty hours in any given year.[1]

(*e*) Assign a new audit partner to be in charge of each SEC engagement[2] that has had another audit partner-in-charge for a period of five consecutive years and prohibit such incumbent partner from returning to in-charge status on the engagement for a minimum of two years except as follows:

(1) This requirement shall not become effective until two years after a firm becomes a member.[3]

(2) In unusual circumstances, the chief executive partner of a firm or his designee may grant no more than one two-year extension so long as there is an in-depth supplemental review by another partner.

(3) An application for relief is granted by the peer review committee on the basis of unusual hardships.

(*f*) Ensure that a concurring review of the audit report by a partner other than the audit partner in charge of an SEC engagement is required before issuance of an audit report on the financial statements of an SEC registrant (see Appendix E).[4] The peer review committee may authorize alternative procedures where this requirement cannot be met because of the size of the member firm.

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[1] See section 6 of this manual for additional information about the continuing professional education requirement, including a requirement to file an annual educational report within four months after the completion of each educational year.

[2] See Appendix D—"Definition of an SEC Engagement," for purposes of determining compliance with the membership requirements of 3(e), (f), and (g) of this section.

[3] Effective for audits of financial statements of SEC clients for periods ending after June 30, 1980, or two years after the date the firm becomes a member, whichever is later.

[4] Effective for audits of financial statements of SEC clients for periods ending after June 30, 1978, or the date the firm becomes a member, whichever is later.

(g) File with the section for each fiscal year of the United States firm (covering offices maintained in the United States and its territories) the following information, within ninety days of the end of such fiscal year, to be open to public inspection:[5]

(1) Form of business entity (e.g., partnership or corporation) and identification of domestic affiliates rendering services to clients.

(2) Description or chart of internal organizational structure and international organization (including the nature of relationships maintained in each geographic region).

(3) Number and location of offices.

(4) Total number of partners and non-CPAs with parallel status within the firm's organizational structure.

(5) Total number of CPAs (including partners).

(6) Total number of professional staff (including partners).

(7) Total number of personnel (including item 6, above).

(8) Number and names of SEC clients for which the firm is principal auditor-of-record and any changes of such clients.

(9) Number of SEC audit clients each of whose total domestic fees exceed 5 percent of total domestic firm fees and the percentage which each of these clients' fees represents to total domestic firm fees.

(10) A statement indicating that the firm has complied with AICPA and SEC independence requirements.

(11) Disclosure regarding pending litigation as required under generally accepted accounting principles and indicating whether such pending litigation is expected to have a material effect on the firm's financial condition or its ability to serve clients.

(12) Gross fees for accounting and auditing, tax, and MAS expressed as a percentage of total gross fees.

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[5] The annual report should disclose the member firm's educational year, if different from its fiscal year, and any change in the educational year (see section 6 of this manual, I.C).

(13) Gross fees for both MAS and tax services performed for SEC audit clients, expressed as a percentage of total fees charged to all SEC audit clients.

(*h*) Maintain such minimum amounts and types of accountants' liability insurance as shall be prescribed from time to time by the executive committee.

(*i*) Adhere to the portions of the AICPA Code of Professional Ethics and Management Advisory Services Practice Standards dealing with independence in performing management advisory services for audit clients whose securities are registered with the SEC. Refrain from performing for such clients services that are inconsistent with the firm's responsibilities to the public or that consist of the following types of services:

(1) Psychological testing.
(2) Public opinion polls.
(3) Merger and acquisition assistance for a finder's fee.
(4) Executive recruitment as described in Appendix A.
(5) Actuarial services to insurance companies as described in Appendix A.

(*j*) Report annually to the audit committee or board of directors (or its equivalent in a partnership) of each SEC audit client on the total fees received from the client for management advisory services during the year under audit and a description of the types of such services rendered.

(*k*) Report to the audit committee or board of directors (or its equivalent in a partnership) of each SEC audit client on the nature of disagreements with the management of the client on financial accounting and reporting matters and auditing procedures which, if not satisfactorily resolved, would have caused the issuance of a qualified opinion on the client's financial statements.[6]

(*l*) Pay dues as established by the executive committee and comply with the rules and regulations of the section, as established from time to time by the

[6] Effective for audits of financial statements of SEC clients for periods ending after June 30, 1978, or the date the firm becomes a member, whichever is later.

executive committee, and with the decisions of the executive committee in respect of matters within its competence; in connection with their duties, including disciplinary proceedings, cooperate with the peer review committee and the special investigations committee established by resolution of the executive committee as set out in the Appendix B hereto; and comply with any sanction that may be imposed by the executive committee.

(*m*) Report to the special investigations committee, within 30 days of service on the firm or its personnel of the first pleading in the matter or within 30 days of joining the section if later,[7] any litigation (including criminal indictments) against it or its personnel, or any proceeding or investigation publicly announced by a regulatory agency, commenced on or after November 1, 1979 (not including additional proceedings arising out of or related to facts involved in litigation originally filed prior to November 1, 1979), that involves clients or former clients that are SEC registrants and that alleges deficiencies in the conduct of an audit or reporting thereon in connection with any required filing under the Federal securities laws.[8] With respect to matters previously reported under this subparagraph, member firms shall report to the committee additional proceedings, settlements, court decisions on substantive issues, and the filing of appeals within 30 days of their occurrence.

## V. Governing Bodies

The activities of the section shall be governed by an executive committee having senior status within the AICPA with authority to carry out the activities of the section. Such activities shall not conflict with the policies and standards

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[7] Since the Committee is not expected to be appointed before December 1979, the first report by member firms is to be filed by January 31, 1980. The initial report shall identify the litigation and be accompanied by copies of the complaints or indictment or other charges filed with the courts involved.

[8] An allegation in such formal litigation, proceeding or investigation that a member firm or its personnel have violated the Federal securities laws in connections with services other than an audit for an SEC registrant shall be reported.

of the AICPA. All activities of the section shall be subject to the oversight and public reporting thereon by a public oversight board.

## Executive Committee

1. *Composition and Terms*

   (*a*) The executive committee shall be composed of representatives of at least twenty-one member firms.

   (*b*) The terms of executive committee members shall be for three years, with initial staggered terms to provide for seven expirations each year.

   (*c*) Executive committee members shall continue in office until their successors have been appointed.

2. *Appointment*

   (*a*) The members of the executive committee shall be appointed by the AICPA chairman with the approval of the AICPA Board of Directors.

   (*b*) All appointments after the initial executive committee is established shall also require approval of the then existing executive committee.

   (*c*) Nominations for appointments of representatives of member firms to the executive committee shall be provided to the chairman of the AICPA by a nominating committee of the section. The section's nominating committee shall be elected by the AICPA Council and consist of individuals drawn from seven of the member firms of the section. It is intended that nominations shall adhere to the principle that the executive committee shall at all times include representatives of all member firms which audit the financial statements of thirty or more registrants under section 12 of the Securities and Exchange Act of 1934 and at least five representatives of firms which audit financial statements of fewer than thirty such registrants plus one additional such representative for each representative, in excess of sixteen, of firms which audit thirty or more registrants.

3. *Election of Chairman*

   The chairman of the executive committee shall be elected from among its members to serve at the pleasure of the

executive committee but in no event for more than three one-year terms.

4. *Responsibilities and Functions*
   The executive committee shall—
   (*a*) Establish general policies for the section and oversee its activities.
   (*b*) Amend requirements for membership as necessary, but in no event shall such requirements be designed so as to unreasonably preclude membership by any CPA firm.
   (*c*) Establish budgets and dues requirements to fund activities of the section not provided for in the AICPA general budget. Such dues shall be scaled in proportion to the size of member firms.
   (*d*) Determine sanctions to be imposed on member firms based upon recommendations of the peer review committee of the section.
   (*e*) Receive, evaluate, and act upon other complaints received with respect to actions of member firms.
   (*f*) Establish the initial public oversight board with the approval of the AICPA Board of Directors.
   (*g*) Appoint persons to serve on such committees and task forces as necessary to carry out its functions.
   (*h*) Make recommendations to other AICPA boards and committees for their consideration.
   (*i*) Consult from time to time with the public oversight board.

5. *Quorum, Voting, Meetings, and Attendance*
   (*a*) A majority of the members of the executive committee or their designated alternates must be present to constitute a quorum.
   (*b*) Affirmative votes of a majority of the members of the executive committee shall be required for action on all matters.
   (*c*) Meetings of the executive committee shall be held at such times and places as determined by the chairman.
   (*d*) Representatives of member firms of the section may attend meetings of the executive committee as observers under rules established by the executive committee. Such attendance will not be permitted when the committee is considering disciplinary matters.

## VII. Public Oversight Board

1. *Size, Appointment, Removal, and Compensation*
   The public oversight board shall consist of five members. Members of such board 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.

   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. However, such board shall automatically terminate in the event of the termination of the SEC practice section of the AICPA Division for CPA Firms.

2. *Responsibilities and Functions*
   The public oversight board shall—
   (*a*) Monitor and evaluate the regulatory and sanction activities of the peer review and executive committees to assure their effectiveness.
   (*b*) Determine that the peer review committee is ascertaining that firms are taking appropriate action as a result of peer reviews.
   (*c*) Conduct continuing oversight of all other activities of the section.
   (*d*) Make recommendations to the executive committee for improvements in the operations of the section.
   (*e*) Publish an annual report and such other reports as may be deemed necessary with respect to its activities.
   (*f*) Engage staff to assist in carrying out its functions.
   (*g*) Have the right for any or all of its members to attend any meetings of the executive committee.

## VIII. Peer Reviews

1. *Review Requirements*
   Peer reviews of member firms shall be conducted every three years or at such additional times as designated by the executive committee (see Appendix C).

2. *Peer Review Committee*
   (*a*) *Composition and appointment*
   The peer review committee shall be a continuing

committee appointed by the executive committee and shall consist of fifteen individuals selected from member firms.

(*b*) *Responsibilities and functions*

The peer review committee shall—

(1) Administer the program of peer reviews for member firms.
(2) Establish standards for conducting reviews.
(3) Establish standards for reports on peer reviews and publication of such reports.
(4) Recommend sanctions and other disciplinary decisions (including whether the name of the affected firm is published) to the executive committee.
(5) Consult from time to time with the public oversight board.
(6) Keep appropriate records of peer reviews which have been conducted.

*3. Peer Review Objectives*

The objectives of peer reviews shall be to determine that—

(*a*) Member firms, as distinguished from individuals, are maintaining and applying quality controls in accordance with standards established by the AICPA Quality Control Standards Committee. Reviews for this purpose shall include a review of working papers rather than specific "cases." (The existence of "cases" in a firm might raise questions concerning its quality controls.)
(*b*) By reviewing the procedures of member firms, appropriate steps are being taken to gain proper assurance about the quality of work done on those portions of audits performed in other countries.
(*c*) Member firms are meeting membership requirements.

## IX. Sanctions Against Firms

*1. Authority to Impose Sanctions*

The executive committee shall have the authority to impose sanctions on member firms either on its own initia-

tive or on the basis of recommendations of the peer review committee and shall establish procedures designed to assure due process to firms in connection with disciplinary proceedings.

2. *Types of Sanctions*

The following types of sanctions may be imposed on member firms for failure to maintain compliance with the requirements for membership:

(*a*) Require corrective measures by the firm including consideration by the firm of appropriate actions with respect to individual firm personnel.
(*b*) Additional requirements for continuing professional education.
(*c*) Accelerated or special peer reviews.
(*d*) Admonishments, censures, or reprimands.
(*e*) Monetary fines.
(*f*) Suspension from membership.
(*g*) Expulsion from membership.

## X. Financing and Staffing of Section

1. *Section Staff and Meeting Costs*

(*a*) The president of the AICPA shall appoint a staff director and assign such other staff as may be required by the section.
(*b*) The cost of the section staff and normal meeting costs shall be paid out of the general budget of the AICPA.

2. *Public Oversight Board and Special Projects*

(*a*) The costs of the public oversight board and its staff shall be paid out of the dues of the section.
(*b*) The cost of special projects shall be paid out of the dues of the section.

## XI. Relationship to Other AICPA Segments

Nothing in the organizational structure and functions of this section shall be construed as taking the place of or changing the operations of existing senior committees of the AICPA or the status of individual CPAs as members of the AICPA.

## APPENDIX A—Executive Recruiting and Insurance Actuarial Services

*Executive Recruiting Services*

The hiring of persons for managerial, executive, or director positions is a function that is properly the client's responsibility. Accordingly, the member firm's role in this function should be limited. In serving an audit client whose securities are registered with the SEC (including subsidiaries and affiliates of such clients), a member firm should not

1. Accept an engagement to search for, or seek out, prospective candidates for managerial, executive, or director positions with its audit clients. This would not preclude giving the name of a prospective candidate known to someone in the member firm, provided such knowledge was not obtained as a result of the performance of executive recruiting services for another client.
2. Engage in psychological testing, other formal testing or evaluation programs, or undertake reference checks of prospective candidates for an executive or director position.
3. Act as a negotiator on the client's behalf: for example, in determining position status or title, compensation, fringe benefits, or other conditions of employment.
4. Recommend, or advise the client to hire, a specific candidate for a specific job. However, a member firm may, upon request by the client, interview candidates and advise the client on the candidate's competence for financial, accounting, administrative, or control positions.

When a client seeks to fill a position within its organization that is related to its system of accounting, financial, or administrative controls, the client will frequently approach employees of the member firm directly as candidates or seek referral of the member firm's employees who may be considering employment outside of the profession. Such employment from time to time is an inevitable consequence of the training and experience that the public accounting profession provides to its staff, is beneficial to all concerned, including society in general, and therefore is not proscribed.

*Insurance Actuarial Services*

Actuarial skills are both accounting and auditing related. The bodies of knowledge supporting the actuarial and accounting professions have a substantial degree of overlap. Both professions involve the analysis of various factors of time, probability, and eco-

nomics and the quantification of such analysis in financial terms. The results of their work are significantly interrelated. The professions are logical extensions of each other; indeed, they have been practiced jointly for many years and even shared the same professional society in Scotland prior to their becoming established in the United States.

The work of actuarial specialists generally is necessary to obtain audit satisfaction in support of insurance policy and loss reserves. To assist them in meeting their audit responsibilities, a number of CPA firms have hired qualified actuaries of their own.

The actuarial function is basic to the operation and management of an insurance company. Management's responsibility for this function cannot be assumed by the CPA firm without jeopardizing the CPA firm's independence. Because of the special significance of a CPA firm's appearance of independence when auditing publicly held insurance companies—

1. The CPA firm should not render actuarially oriented advisory services involving the determination of policy reserves and related accounts to its audit clients unless such clients use their own actuaries or third-party actuaries to provide management with the primary actuarial capabilities. This does not preclude the use of the CPA firm's actuarial staff in connection with the auditing of such reserves.
2. Whenever the CPA firm renders actuarially oriented advisory services, it must satisfy itself that it is acting in an advisory capacity and that the responsibility for any significant actuarial methods and assumptions is accepted by the client.
3. The CPA firm should not render actuarially oriented advisory services when the CPA firm's involvement is continuous because such a relationship might be perceived as an engagement to perform a management function.

Subject to the above limitations, it is appropriate for the CPA firm to render certain actuarially oriented advisory services to its audit clients. Such services include:

1. Assisting management to develop appropriate methods, assumptions, and amounts for policy and loss reserves and other actuarial items presented in financial reports based on the company's historical experience, current practice, and future plans.
2. Assisting management in the conversion of financial statements from a statutory basis to one conforming with generally accepted accounting principles.

3. Analyzing actuarial considerations and alternatives in federal income tax planning.
4. Assisting management in the financial analyses of various matters such as proposed new policies, new markets, business acquisitions, and reinsurance needs.

(Approved by the executive committee June 21, 1979.)

## APPENDIX B—Resolution Establishing the Special Investigations Committee

WHEREAS: The objectives of the SEC practice section include the improvement of the quality of practice by CPA firms before the SEC through the establishment of practice requirements for member firms, and the establishment and maintenance of an effective system of self-regulation of member firms by various means including the imposition of sanctions for failure to meet membership requirements; and

WHEREAS: The executive committee is authorized to carry out the activities of the section and to receive, evaluate, and act upon complaints received with respect to actions of member firms, impose sanctions and establish procedures designed to assure due process to firms in connection with disciplinary proceedings, and appoint persons to serve on such committees and task forces as are necessary to carry out its functions;

IT IS HEREBY RESOLVED THAT:

There is hereby established a special investigations committee consisting of nine partners or retired partners of different member firms who, under procedures established by the executive committee, shall make such investigation as it considers necessary to (*a*) determine whether facts relating to alleged audit failures (*1*) indicate a possible need for corrective measures by the member firm involved, (*2*) indicate that changes in generally accepted auditing standards or quality control standards need to be considered, or (*3*) indicate that sanctions should be imposed on the member firm involved, and (*b*) recommend to the executive committee such actions as are deemed appropriate.

(Approved by the executive committee August 7, 1979.)

## APPENDIX C—Timing of Peer Reviews and Filing of Reports

The executive committee has established the following timetable according to which member firms must have their initial peer reviews completed.

| *Calendar Year Firm Joins the Section* | *Initial Peer Review Must Be Completed* |
|---|---|
| 1978 | December 31, 1980[1] |
| 1979 | December 31, 1981 |
| 1980 | December 31, 1981 |
| 1981 and subsequent calendar years | One year from the date the firm joins the section. |

A member firm's subsequent peer reviews must be completed by the end of the third calendar year following the calendar year that included the previous review year-end. Although it is expected that a firm ordinarily will not change its review year-end, a firm may do so without the peer review committee's prior approval, provided that the new review year-end is not beyond three months of the previous review year-end and provided that the peer review is completed in accordance with the requirement in the preceding sentence.

The review team's report on the peer review is to be filed with the peer review committee promptly (but no later than sixty days) after the completion of the peer review. The report should be accompanied, if applicable, by the quality control review panel's report, the review team's letter of comments on matters that may require action by the reviewed firm, and the reviewed firm's response to that letter. Upon application by a member firm, the peer review committee may grant one sixty-day extension for filing the report.

(Approved by the executive committee June 21, 1979.)

[1] Certain randomly selected member firms with less than five SEC clients will be granted an extension until December 31, 1981, to have their initial peer review completed. The purpose of this extension is to equalize the number of peer reviews to achieve an appropriately balanced work load.

## APPENDIX D—Definition of an SEC Engagement

For purposes of implementing the membership requirements of section IV *3(e)* and *(f)* of the organizational structure and functions document with respect to partner rotation and concurring review, the executive committee has defined an SEC engagement as the examination of the financial statements of

1. An issuer making an initial filing, including amendments, under the Securities Act of 1933.
2. Registrants that file periodic reports (for example, Forms N-1R and 10-K) with the Securities and Exchange Commission (SEC) under the Investment Company Act of 1940 or the Securities Exchange Act of 1934 (except brokers or dealers registered only because of section 15 (a) of that act).

When an existing audit engagement becomes an SEC engagement, time served as partner in charge of the engagement before it became an SEC engagement is to be considered in applying the five-year partner rotation requirement. However, the incumbent partner may serve as partner in charge of the engagement for two consecutive annual examinations subsequent to the date of the latest annual audited financial statements included in the filing.

Examples of entities that are not encompassed by the above definition include

1. Banks and other lending institutions that file periodic reports with the Comptroller of the Currency, the Federal Reserve System, the Federal Deposit Insurance Corporation, or the Federal Home Loan Bank Board, because the powers, functions, and duties of the SEC to enforce its periodic reporting provisions are vested, pursuant to section 12 (i) of that act, in those agencies.
2. Subsidiaries or investees (including regulation S-X rule 4-02 (e) companies) of an entity encompassed by the definition of an SEC engagement, which subsidiaries or investees are not themselves entities encompassed by such definition, even though their financial statements may be presented separately in parent and/or investor companies' filings under the 1934 act.
3. Companies whose financial statements appear in the annual reports and/or proxy statements of investment funds because they are sponsors or managers of such funds, provided they are not themselves registrants required to file periodic reports under the 1940 act or section 13 or 15 (d) of the 1934 act.

The executive committee has also authorized the foregoing definition for purposes of determining the names of clients for which a firm is the principal auditor of record and any changes of such clients for which information is required (under the membership requirements) to be filed with the section for each fiscal year of a U.S. member firm (see section IV 3 (*g*) of the organizational structure and functions document).

The foregoing definition of an SEC engagement is not intended to change section VI 2 (*c*) of the organization structure and functions document regarding the appointment of members to the executive committee of the section.

(Approved by the executive committee October 25, 1978.)

## APPENDIX E—Scope of Concurring Review

A member firm of the SEC practice section agrees to ensure that a concurring review of the audit report by a partner other than the audit partner in charge of an SEC engagement is required before issuance of an audit report on the financial statements of an SEC registrant.[1] This requirement also applies to the reissuance of such an audit report.

The purpose of the review is to provide additional assurance that (1) the financial statements are in conformity with generally accepted accounting principles or other comprehensive basis of accounting and (2) the firm's report thereon is in accordance with generally accepted auditing standards.

The partner assigned as the concurring reviewer should make an objective review of the significant accounting and auditing considerations influencing the firm's report. His responsibilities include reading the financial statements and the firm's report thereon. The concurring reviewer should be informed regarding significant accounting, auditing, or reporting considerations.

The concurring partner may deem it necessary to review relevant working papers to understand significant accounting, auditing, or reporting considerations.

If the concurring partner and the partner in charge of the engagement have differing views regarding important matters, the disagreement should be resolved in accordance with applicable firm policy.[2]

The engagement files should contain evidence that the concurring review was completed prior to the issuance of the firm's report.

(Approved by the executive committee October 25, 1978.)

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[1] The peer review committee may authorize alternative procedures when this requirement cannot be met because of the size of the member firm.

[2] See SAS no. 22, *Planning and Supervision*.

EXECUTIVE COMMITTEE
SEC PRACTICE SECTION
1979-1980

Representatives of Firms That Audit 30 or More Registrants
Under Section 12 of the Securities and Exchange Act of 1934

| Representative | Firm Affiliation |
|---|---|
| Archibald E. MacKay, Chairman | Main Hurdman & Cranstoun |
| Ivan O. Bull | McGladrey, Hendrickson & Co. |
| George R. Catlett | Arthur Andersen & Co. |
| Robert M. Coffman | Fox & Company |
| Robert L. Ferst | Laventhol & Horwath |
| W. Donald Georgen | Touche Ross & Co. |
| Howard Groveman | Alexander Grant & Company |
| Ray J. Groves | Ernst & Whinney |
| Walter E. Hanson | Peat, Marwick, Mitchell & Co. |
| William S. Kanaga | Arthur Young & Co. |
| William B. Keast | Coopers & Lybrand |
| Bernard Z. Lee | Seidman & Seidman |
| Charles G. Steele | Deloitte Haskins & Sells |
| John W. Zick | Price Waterhouse & Co. |

Representatives of Firms That Audit Fewer Than 30 Registrants
Under Section 12 of the Securities and Exchange Act of 1934

| Representative | Firm Affiliation |
|---|---|
| Peter Arnstein | John F. Forbes & Company |
| Robert R. Harden | Clarkson, Harden & Gantt |
| Raymond L. Hellmuth | Meahl, McNamara & Co. |
| Irving S. Kroll | Kenneth Leventhal & Co. |
| John J. van Benten | Geo. S. Olive & Co. |
| Bert B. Weinstein | Altschuler, Melvoin & Glasser |
| Gary J. Wolfe | Cherry, Bekaert & Holland |

Exhibit V

THE SPECIAL INVESTIGATIONS COMMITTEE
OF THE SEC PRACTICE SECTION OF THE
AICPA DIVISION FOR CPA FIRMS

November 29, 1979

## FOREWORD

This document sets forth the procedure established by the executive committee to govern the operations of the Special Investigations Committee of the SEC Practice Section of the AICPA Division for CPA Firms. The Special Investigations Committee was formed pursuant to a resolution of the Section's executive committee that has been published as Appendix B to the Organizational Structure and Functions document of the Section.

A separate document, Rules of Procedure for the Imposition of Sanctions, sets forth procedures established by the executive committee that are designed to assure due process to firms in connection with all proceedings related to the imposition of sanctions undertaken by the Section.

# THE SPECIAL INVESTIGATIONS COMMITTEE OF THE SEC PRACTICE SECTION OF THE AICPA DIVISION FOR CPA FIRMS

## I. OBJECTIVES

The Special Investigations Committee (the "Committee") has been established by the executive committee of the SEC Practice Section in recognition of the significant public interest in matters concerning the practice of public accounting that have a bearing on the reliability of financial statements of SEC registrants. Those matters relate to such considerations as the adequacy of generally accepted auditing standards and quality control standards, compliance by member firms with those standards in the conduct of their accounting and audit practice and, when necessary, the imposition of sanctions on member firms.

The Section has established membership requirements that provide, among other things, for a peer review of each member firm's accounting and audit practice at least every three years and that empower the executive committee to impose sanctions on member firms for failure to meet the membership requirements.

The Committee's primary objectives are as follows:

1. Assist in providing reasonable assurance to the public and to the profession that member firms are complying with professional standards in the conduct of their practice before the Securities and Exchange Commission by identifying corrective measures, if any, that should be taken by a member firm involved in a specific alleged audit failure.

2. Assist in improving the quality of practice by member firms before the Securities and Exchange Commission by determining whether facts relating to specific alleged audit failures indicate that changes in generally accepted auditing standards or quality control standards need to be considered.

3. Recommend to the executive committee, when deemed necessary, appropriate sanctions with respect to the member firms involved.

## II. COMMITTEE STRUCTURE AND PROCEDURES

The Committee structure and procedures shall be as follows:

1. The Committee shall be composed of nine members who are partners or retired partners of different member firms. Committee members shall be appointed by the executive committee, with one member being designated as the chairman by the executive committee.

2. The term of each Committee member shall be three years, with initial terms staggered to provide for three expirations at the end of each of the first three years.

3. Members of the Committee shall be eligible to serve only two three-year terms in addition to a partial term in the beginning or to the unexpired portion of a term.

4. Committee members shall not serve concurrently as a member of the Committee and of either the executive committee or the peer review committee.

5. A majority of the Committee members must be present to constitute a quorum. (With respect to a quorum for a hearing, see section 4.2(c) of the Rules of Procedure for the Imposition of Sanctions.)

6. A member of the Committee shall be excluded from all deliberations with respect to his firm or, if he has or believes he has a conflict of interest, with respect to any other firm (see section 3.11 of Rules of Procedure for the Imposition of Sanctions).

7. Affirmative votes of a majority of the Committee members eligible to vote shall be required for action on all matters relating to specific member firms. If less than five Committee members are eligible to vote on such a matter, the executive committee shall appoint an additional member(s) to the Committee, who shall be a partner or retired partner of a member

firm that is not represented on the Committee, who shall not be concurrently a member of the executive committee or the peer review committee, and whose responsibilities and authority shall be restricted to the matter involving the specific member firm. On matters not involving specific member firms, such as administrative and procedural matters, a majority of the Committee members present at a meeting and voting shall be required for action.

8. The meetings and proceedings of the Committee and any of its task forces and all related information available to the Committee and any of its task forces shall be treated as confidential, except that the executive committee may authorize public disclosure of information with respect to any investigation or sanction.

9. The Committee's files and its meetings shall be open at all times to members of the Public Oversight Board and its representatives on a confidential basis, except that, after giving the firm concerned an opportunity to present its views and after consultation with the executive committee, the Public Oversight Board may make public disclosure of information thus obtained which it deems necessary in the interest of the profession or the public.

The Committee shall have whatever staff it needs to perform its functions.

## III. GENERAL CONSIDERATIONS

In carrying out its duties, the Committee shall give primary consideration to the significant interests of the public as outlined in section I, and shall also seek to deal fairly with the legitimate interests of member firms. In this connection, the Committee shall take into consideration in deciding upon its course of action that substantial incentives are already in place for a firm and individuals in such firm to adhere to professional standards in the performance of the audit function, including penalties and publicity resulting from court and SEC actions, sanctions resulting from peer reviews

pursuant to membership requirements of the Section, and disciplinary proceedings against individuals by the AICPA and state professional societies and boards. It shall also consider both the importance to the public interest of having a prompt investigation and the fact that substantial prejudice to a firm or individuals in that firm could occur if the Committee were to commence and continue an investigation while the firm or individuals in it are involved, or about to be involved, in a court proceeding or a proceeding or investigation by the SEC, a grand jury, or other governmental body.

A firm shall cooperate in furnishing information to the Committee and in any investigation of the firm or of the case initiated by the Committee unless it can demonstrate to the satisfaction of the Committee (a) that pending litigation or other proceeding or investigation is directly related to the subject of the inquiry and that there is a likelihood that such litigation, proceeding or investigation will be unduly influenced by the firm's providing the requested information and (b) that the need for such information as of the date requested is not sufficient to override the interest of the firm or individuals in avoiding prejudice in such litigation or other proceeding or investigation. Also, the firm has no obligation to provide the Committee with information that would invade the attorney-client or other privilege or the litigation work product of the firm or any of its partners or employees.

## IV. INFORMATION TO BE REPORTED TO AND SCREENED BY THE COMMITTEE

All member firms shall report to the Committee, within 30 days of service on them of the first pleading in the matter or within 30 days of joining the Section if later,[1] any litigation (including criminal indictments) against them or their personnel, or any proceeding or investigation publicly announced by a regulatory agency, commenced on or after November 1, 1979 (not including additional proceedings arising out of or related to facts involved in litigation originally filed prior to November 1, 1979), that involves clients or former clients that are SEC registrants and that alleges deficiencies in the conduct of an audit or reporting thereon in connection with any required filing under the Federal securities laws.[2] The initial report shall identify the litigation and be accompanied by copies of the complaints or indictment or other charges filed with the courts involved.

With respect to matters reported under the requirements of the preceding paragraph, member firms shall report to the Committee additional proceedings, settlements, court decisions on substantive issues, and the filing of appeals within 30 days of their occurrence. Member firms may also report such other information with respect to such matters as they consider appropriate.

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[1] Since the Committee is not expected to be appointed before December 1979, the first report by member firms is to be filed by January 31, 1980.

[2] An allegation in such formal litigation, proceeding or investigation that a member firm or its personnel have violated the Federal securities laws in connection with services other than an audit for an SEC registrant shall be reported and is included in the definition of "case."

The term "case," as used hereinafter, refers to an engagement or engagements with respect to which there are allegations that a member firm with respect to a report or reports on the financial statements or related financial data of an SEC registrant failed to observe generally accepted auditing standards, whether or not litigation is involved.[3] Hereinafter, the term "firm" refers to a member firm.

The Committee shall screen information that comes to its attention through (a) the reporting requirement referred to above, or (b) other sources when the cases are determined by the Committee to be of sufficient public interest, provided such cases do not involve litigation commenced prior to November 1, 1979.

The procedures for reporting litigation by each firm shall be reviewed in the triennial peer reviews. Also, the Committee's staff shall review compliance with the reporting requirements by monitoring published accounts of litigation that are available to it.

## V. COORDINATION WITH THE PROFESSIONAL ETHICS DIVISION

The Committee shall prepare, in cooperation with the professional ethics executive committee, and submit to the SEC Practice Section's executive committee for approval, a memorandum setting forth the policies and procedures to be followed in coordinating the activities of the Committee with those of the committees of the Professional Ethics Division.

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[3] See footnote 2.

## VI. SCREENING PROCEDURES

The Committee shall screen the information discussed in section IV to determine whether (1) to monitor developments in the case without investigation of the firm or the case, pending the conclusion of litigation or other proceeding or investigation; (2) to investigate the firm without investigating the case; (3) to recommend investigation of the case to the executive committee; and/or (4) to close its files on the case. Such determinations may be changed from time to time as a result of information available to the Committee.

In deciding what action to take or recommend, the Committee shall consider such available relevant information as is needed to make such a decision, including the date and results of the most recent peer review of the firm and when the next peer review is scheduled. The Committee may request additional information from the firm, or have one or more representatives visit the firm, to obtain such additional information as could reasonably be expected to be a part of the screening process.

The Committee shall complete its original screening of information with respect to a case expeditiously, ordinarily within 90 days of the date of the first Committee meeting after the case has first been reported, unless additional time is reasonably required.

## VII. MONITORING PROCEDURES

When the Committee monitors developments in a case without investigation of the firm or the case, it shall consider any new information it receives to determine whether to continue the

monitoring, to initiate an investigation of the firm, to recommend an investigation of the case to the executive committee, or to close its files on the case.

## VIII. INVESTIGATIONS--GENERAL POLICIES

The purpose of an investigation of a firm or of a case shall be to determine whether one or more of the following conditions exist:

1. Quality controls are inadequate in a firm (including any segment, such as an office or a specialized industry practice).

2. There has been a material departure from generally accepted auditing standards or a material failure to comply with quality control standards by the individuals responsible for the engagement in question (such individuals ordinarily being limited to the partner and manager on the engagement and other partners involved in decisions affecting the engagement).

3. There is a need for reconsidering the adequacy of certain generally accepted auditing standards or quality control standards.

The Committee shall establish the scope of any investigation of a firm undertaken without investigating the case itself (see section IX). The executive committee shall establish the general scope of any investigation of a case (see section X). While the persons responsible for the investigation may carry out some of the procedures that might be included in a peer review, such an investigation should not be as extensive as a peer review of the firm conducted in accordance with the Section's Standards for Performing and Reporting on Quality Control Compliance Reviews.

Depending upon the extent and complexity of the investigation, a Committee member may perform it with the assistance of the Committee staff, or a task force may be appointed by the Committee to perform it. (A Committee member who conducts an investigation is precluded from serving as a member of a hearing body with respect to that case.) If a task force is appointed, it generally would be comprised of three or five partners or retired partners of firms, with the number and background of its members dependent on the complexity of the matter under investigation. The member firm being investigated shall be advised of the names of the members of the task force and their firms. If there is a possible conflict of interest, the member firms shall have the opportunity to request reconsideration of any proposed task force member.

Upon completion of its investigation, the task force (or such other persons who may conduct an investigation) shall submit its findings and recommendations to the Committee, which shall consider such findings and recommendations and determine what action is appropriate. If the Committee concludes that it will conduct a hearing to consider whether to recommend sanctions, it shall notify the firm in the manner prescribed in the Rules of Procedure for the Imposition of Sanctions.

If the Committee concludes that certain generally accepted auditing standards or quality control standards may need to be modified, it shall recommend to the executive committee that the matter be referred to the appropriate AICPA technical committee for action.

The Committee shall consider corrective measures voluntarily taken by the firm with respect to its quality control policies and procedures or its personnel in deciding what further action, if any, should be taken.

If a firm fails to supply information to the Committee or its representatives in accordance with the procedures specified herein, such failure shall constitute a basis on which the Committee may recommend to the executive committee that sanctions be imposed on the firm. The Committee shall hold a hearing in accordance with the Section's Rules of Procedure for the Imposition of Sanctions to determine whether the firm has failed to supply information reasonably requested of it and what sanction should be recommended.

## IX. INVESTIGATIONS OF MEMBER FIRMS

Following screening or monitoring, the Committee may decide to investigate a firm without investigating the case. Such an investigation could include, for example, one or more of the following:

1. A review of certain of the firm's quality control policies and procedures, or a review of compliance with those policies and procedures by certain offices or individuals.

2. A review of other engagements performed by the firm's office or offices or by the personnel involved in the case or of other engagements in the same industry as in the case.

3. Interviews of the firm's personnel with functional responsibility for a specialized industry if the case involves such an industry.

Consideration shall also be given to any corrective action the firm has taken, including any action with respect to individuals involved in the case.

## X. INVESTIGATIONS OF CASES

Following screening, monitoring, or investigation of a member firm, the Committee may decide to recommend that the executive committee authorize an investigation of the case. However, the Committee will not ordinarily recommend that the executive committee authorize an investigation of a case that is the subject of a court proceeding or a proceeding or investigation by the SEC, a grand jury, or other governmental body until such matters are concluded. During that period, the Committee may monitor developments or make an investigation of the firm, without investigating the case. In determining whether there should be an investigation of the case after litigation is concluded, the Committee and the executive committee may consider whether the public interest has been safeguarded in other ways.

Notwithstanding the foregoing, the Committee may decide that particular cases are of such significance to the public interest that the importance of investigation of the case outweighs any possible prejudice to the firm and that such an investigation should not be deferred. In such an instance, the Committee shall request an authorization from the executive committee before proceeding to investigate the case.

Before recommending to the executive committee that an investigation of a case be instituted, the Committee shall advise the firm of its intention to make such a recommendation and shall give the firm (through counsel or otherwise) an opportunity to present its views in writing as to whether such recommendation is appropriate in the circumstances. If the recommendation is made to the executive committee, the firm shall be given an opportunity to express its views in writing to the executive committee.

When an investigation of a case has been authorized by the executive committee, the Committee shall proceed promptly with its investigation.

## XI. DISPOSITION OF CASES

The Committee shall submit periodic reports to the executive committee concerning cases on its agenda.

The Committee may close its files on a case whenever it concludes that further action by it is not necessary, except in the following instance. When the executive committee has authorized an investigation of a case, only the executive committee can authorize that the files on the case be closed.

The Committee shall consider the need to recommend sanctions to the executive committee when the Committee has found that material departures from generally accepted auditing standards or quality control standards have occurred, or when it has found that

a firm has not been cooperative in providing information. Such sanctions shall be recommended only after findings have been made in a hearing held in accordance with the Section's Rules of Procedure for the Imposition of Sanctions.

One or more of the following sanctions may be recommended for a firm:

1. Requirements for corrective measures not voluntarily taken by the firm.

2. Additional requirements for continuing professional education.

3. Special or accelerated peer review (the cost of which is to be paid for by the firm being reviewed), with the possibility of special attention being given to the quality controls of the firm as they relate to particular offices or individuals and with the peer review committee taking whatever action it deems appropriate as a result of the peer review under its administrative procedures.

4. Admonishment, censure or reprimand.

5. Monetary fine.

6. Suspension from membership in the Section.

7. Expulsion from membership in the Section.

The public file will include a copy of the documents setting forth sanctions approved by the executive committee with respect to member firms.

Exhibit VI

SEC PRACTICE SECTION
AICPA DIVISION FOR CPA FIRMS

# RULES OF PROCEDURE
# FOR THE IMPOSITION OF SANCTIONS

November 29, 1979

## FOREWORD

This manual of rules of procedure has been prepared for the use of members of certain committees of the SEC Practice Section of the AICPA Division for CPA Firms in connection with proceedings related to the imposition of sanctions under section IX of the Organizational Structure and Functions document of the section. The affected committees are the executive committee, the special investigations committee, and the peer review committee. It has also been prepared for the information of those member firms that may be a party to such a proceeding.

The procedures described in this manual are significantly different from those in a proceeding at law. Hearings conducted under these procedures are, for the most part, informal in nature. The formal rules of evidence do not apply.

The overriding objective of this manual is to provide for an orderly proceeding, achieve a fair result, and adequately safeguard the rights of member firms and individuals that may become a party to a proceeding.

# 1. GENERAL

## 1.1 Authority to Conduct Proceedings

The executive committee of the section is authorized (a) to impose sanctions on member firms either on its own initiative or on the basis of recommendations of the peer review committee or the special investigations committee and (b) to establish procedures designed to assure due process to firms in connection with proceedings related to the imposition of sanctions (hereinafter, "proceedings"). The peer review committee and the special investigations committee cannot impose sanctions; they can only make recommendations to the executive committee as to the sanctions that they believe should be imposed.

## 1.2 Use of Hearings

Proceedings conducted by components of the SEC Practice Section of the AICPA Division for CPA Firms involve formal hearings which enable the member firm to challenge or contest the charges or recommendations being made.

## 1.3 Applicability of Rules of Procedure

The rules of procedure set forth in this manual become applicable:

(a) When the peer review committee or the special investigations committee decides that it will conduct a hearing to consider whether to recommend to the executive committee the imposition of sanctions on a member firm.

(b) When the executive committee decides that it will conduct a hearing to consider imposing sanctions on a member firm.

For purposes of these rules of procedure, sanctions that may be imposed on member firms are described in section IX.2 of the section's Organizational Structure and Functions document.

Once these rules of procedure become applicable to a proceeding, they are to be applied until a decision by the executive committee to impose sanctions becomes effective or the matter is otherwise disposed of.

1.4 Nature of Hearings

Hearings before the peer review committee, the special investigations committee, and the executive committee (hereinafter the "hearing bodies") are designed to assist those bodies in developing sufficient facts on which to base a decision as to whether or not the imposition of sanctions or a recommendation to impose sanctions is appropriate in a particular case. Hearing procedures are informal to afford all parties maximum flexibility in presenting every side of an issue. Member firms may be represented by counsel. No hearings before hearing bodies shall be open to the public (see section 3.8).

1.5 Role of the Hearing Body

The hearing body determines whether or not sanctions should be imposed or recommended, as applicable. The hearing body consists of the respective committee sitting en banc unless for good reason one or more members of the respective committee are unable to sit or it is inappropriate for a member to hear and decide a particular case (see section 3.11); hearings shall not be conducted by panels or by hearing officers appointed for that purpose.

1.6 Parties to the Proceeding

Only the affected firm and components of the SEC Practice Section are parties to the proceeding. Intervention by third parties in proceedings shall not be permitted.

## 2. THE RIGHTS OF PARTIES

2.1 Right to Appear

A party to a proceeding has the right to appear and be heard at a hearing. A member firm may be represented by counsel or other representatives. A hearing body is empowered to conduct a hearing in the absence of a representative of the member firm, provided that a Notice of Hearing has been properly served, the representative of the member firm has failed to appear at the hearing without good reason, and there is no compelling reason, in the view of the hearing body, not to proceed.

2.2 Right to Present Evidence and to Cross-Examine

A party to a proceeding has the following rights in a hearing:

(a) To present evidence.

(b) To present arguments on issues relevant to the subject of the proceeding.

(c) To cross-examine witnesses present at the hearing.

2.3 Right to Copy of Testimony

A member firm that is a party to a proceeding may purchase a copy of the transcript of the hearing. Any person who gives evidence

as a witness may purchase a copy of the transcript of his testimony. The fee for photocopying the transcript will be determined from time to time by AICPA staff.

## 3. BASIC PRINCIPLES

### 3.1 Purpose of Rules of Procedure

Although hearings conducted by the hearing bodies are informal, these rules of procedure have been adopted to insure fairness during the orderly disposition of proceedings before hearing bodies.

### 3.2 Rules of Evidence

In hearings governed by these rules of procedure, the formal rules of evidence applicable to proceedings at law or in equity do not apply, and evidence that would be inadmissable in a court of law may be received so long as it is relevant in the discretion of the presiding officer after due consideration of any objection by any party. The hearing body shall determine the weight to be given to such evidence.

### 3.3 Notification of Proceeding

Designated staff shall provide a member firm that is named as a party to a proceeding adequate notice of such proceeding by causing to be mailed to the member firm:

(a) Within 10 days after a hearing body decides that it will conduct a hearing (except hearings to be conducted by the executive committee to consider

recommendations of other hearing bodies), an "Advice of Proceeding" stating that it has been determined that a hearing should be held, describing the charges that caused the hearing to be authorized, indicating the approximate date on which briefs and memoranda will be mailed to the member firm, and affording the member firm a reasonable time (not more than 60 days from the date of mailing) to respond, if the firm so desires. The hearing body may determine after a response is made that a hearing would be inappropriate or unnecessary and terminate the matter at that time.

(b) At least 45 days prior to a proposed hearing date of any hearing body, a "Notice of Hearing" which shall contain a description of the matters to be dealt with at the hearing, the time and place of the hearing, and which shall be accompanied by a copy of all briefs and memoranda to be presented at the hearing in support of the charges or recommendations, as applicable, and by a list of the names and addresses of all witnesses, if any, scheduled to be called by the staff or other individuals with responsibility for presenting the charges or recommendations to the hearing body.

Such Advice or Notice, when mailed by registered mail, postage prepaid, addressed to the managing partner (chief executive officer) of the member firm at its last known business address as reflected in the section's public files, shall be deemed to be properly served. A copy of these rules of procedure shall accompany all Advices and Notices.

3.4 Answer to Notice of Hearing

The member firm is required to provide designated staff with an answer in writing to a Notice of Hearing. If mailed, such answer must be mailed registered mail, postage prepaid, at least 17 days before the hearing date specified in the notice. If hand delivered, delivery must be made to the AICPA offices at least 14 days before the hearing date specified in the notice. (A member firm is not

required to answer an Advice of Proceeding.) The answer may be in the form of a reply memorandum to the briefs and memoranda accompanying the Notice of Hearing, or a request for postponement that states the reason for the request (see sections 3.5 and 3.6).

3.5 Briefs and Memoranda

The staff or other individuals responsible for presenting the charges to a hearing body shall prepare a hearing memorandum and necessary appendices thereto containing the material upon which they intend to rely at the hearing.

The member firm shall furnish a reply memorandum to designated staff at least 14 days (or if mailed, 17 days) before (a) the hearing date specified in the Notice of Hearing or (b) such date as may be set after postponement of a hearing. The reply memorandum may contain a denial of some or all of the charges, an explanation of some or all of the facts described in the hearing memorandum, any defenses being asserted, and any other information deemed relevant by the member firm. The reply memorandum shall contain a list of the names and addresses of all witnesses scheduled to be called by the member firm.

All material furnished to the hearing body shall be reproduced on 8½ x 11 paper, insofar as possible, by any standard duplicating process that provides legible copies.

3.6 Postponements

At any time prior to the time set for the hearing, the presiding officer of the hearing body is empowered to postpone the hearing. He shall, within 10 days from the date postponement is granted, reschedule the hearing. A postponement is not a matter of right and will be granted only upon the showing of good and sufficient reason.

A hearing body, when in actual session for the purpose of hearing a case, may postpone the hearing and designate a new date upon a showing of good cause. Such action shall be taken as a body and by majority vote.

Denial of postponement is not subject to an appeal to any other component of the section or of the AICPA which would prevent or delay the holding of the hearing. However, this shall not prevent a member firm whose request for postponement is denied by the special investigations committee or by the peer review committee from asserting as a basis for rejecting the recommendations of such committee at any subsequent hearing before the executive committee that its rights were prejudiced by the denial of its request for a postponement.

3.7 Witnesses

Both the representatives of the member firm and the staff or other individuals with responsibility for presenting the charges to a hearing body may produce such witnesses as they deem appropriate.

On motion of either of the parties to the proceeding, or of any member of the hearing body, witnesses will be excluded from a hearing except during such time as they are actually giving testimony. Witnesses at a hearing will not be sworn.

3.8 Confidentiality of Proceedings

No hearings before hearing bodies shall be open to the public Briefs, memoranda, documentary evidence adduced at hearings, and stenographic transcripts of hearings shall be available for the confidential information of the following interested parties only except as otherwise provided in section 2.3:

(a) The parties to the proceeding.

(b) The executive committee of the SEC Practice Section.

(c) The Public Oversight Board or its representatives.

Members of hearing bodies, staff, parties to the proceeding, and witnesses should be appropriately advised of the need to maintain confidentiality.

Notwithstanding the above, after giving the firm concerned an opportunity to present its views and after consultation with the executive committee, the Public Oversight Board may make public disclosure of information thus obtained which it deems necessary in the interest of the profession or the public.

3.9 Full Hearing

Normally, once a hearing body is convened and assembled to hear a case, every effort will be made to reach a decision while it is convened and all parties shall be prepared to present their full case at that time. However, a member firm shall have the opportunity, if it so requests, to submit post-hearing briefs or memoranda within 10 days of the completion of a hearing. In such circumstances, or with the consent of the presiding officer, the staff or other individuals with responsibility for presenting the charges to the hearing body also may submit post-hearing briefs or memoranda.

3.10 Public Disclosure of Sanctions

When a decision is made by the executive committee to impose sanctions pursuant to section IX of the section's Organizational Structure and Functions document, the executive committee shall decide, by a majority of its members present and voting, on the form of the notice of the case and the decision to be published, along with the name of the member firm, in a membership periodical of the Institute. No such public disclosure shall be made until a decision to impose sanctions has become effective.

Information in the section's nonpublic files concerning matters that are the subject of pending proceedings, matters that may result in initiation of a proceeding, and matters referred to other components of the AICPA, are to be held in confidence. However, the

executive committee may authorize public disclosure of information with respect to the existence of an investigation or the imposition of a sanction.

3.11 Disqualification of Committee Members from Participation in a Proceeding

The following preclude a committee member from participating in any part of a proceeding:

(a) The committee member's firm has performed the most recent peer review of the affected member firm's accounting and audit practice or the committee member has served on a review team or on a quality control review panel in connection with the affected member firm's most recent peer review.

(b) The committee member's firm has performed a peer review of the affected member firm's accounting and audit practice for a year coinciding with or preceding (depending on the timing of the triennial reviews) the year in which a significant audit failure or other identifiable incident that is the subject of the proceeding is alleged to have taken place or the committee member served on a review team or on a quality control review panel in connection with such a peer review.

(c) The committee member's firm is the subject of the proceeding.

(d) The committee member believes he could not be impartial and objective with respect to the charges or has a conflict of interest. (A committee member who conducts an investigation and/or presents charges to a hearing body is precluded from serving as a member of a hearing body with respect to that case.)

For purposes of this section, a retired partner of a member firm shall be considered in the same category as an active partner for a period of three years after retirement.

### 3.12 Hearing by the Executive Committee to Consider Findings of Another Hearing Body

The executive committee shall be convened as a hearing body to consider sanctions recommended by the peer review committee or the special investigations committee. At such hearing, the executive committee shall consider the entire record of the original hearing body together with such new relevant evidence or additional memoranda as the member firm may desire to bring before it. A summary of such new evidence and any additional memoranda shall be filed with the member firm's answer to the Notice of Hearing (see section 3.4). The record also may be supplemented by any additional evidence which the chairman of the executive committee considers to be relevant and of sufficient importance to merit consideration or review.

### 3.13 Effective Date of Decisions

A decision by the executive committee to impose sanctions shall become effective as prescribed by the executive committee, but within 15 to 30 days from the date of the decision.

## 4. CONDUCTING A HEARING

### 4.1 Responsibilities of the Presiding Officer

The chairmen of the executive committee, the special investigations committee and the peer review committee, respectively, serve as the presiding officer when such committees assemble as hearing bodies.

If the chairman is disqualified from participation in the proceeding, a presiding officer will be elected by majority vote of the members present and voting. The presiding officer is authorized to hold conferences for the simplification or settlement of issues; take action necessary to maintain order; rule on motions and procedural questions arising during the hearing; call recesses or adjourn the hearing; examine witnesses; determine the admissibility of evidence; and take such reasonable actions as may be necessary to provide for a fair and orderly hearing.

4.2 Order of Proceedings -- Initial Hearing

The following is an outline of the order of proceedings for a hearing under these rules.

(a) The presiding officer calls the session to order, appoints a secretary, and identifies the case by name and number. He determines that a reporter is present and prepared to make a stenographic record of the hearing.

(b) The presiding officer requests that the representatives of the member firm and counsel, if any, appear.

(c) The secretary identifies the staff or other individuals with responsibility for presenting the charges to the hearing body, and counsel for the section, if present, and the reporter. He calls the roll of the members of the hearing body by name and firm, identifying those members, if any, who had disqualified themselves as members of a hearing body on the specific case. The secretary announces for the record whether a quorum is present, a quorum of a hearing body being a majority of those members of the respective committee who have not disqualified themselves from participating in the proceeding, but not less than five.[1]

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[1] If less than five members of the special investigations committee or the peer review committee, respectively, are eligible and able to serve on a hearing body, the matter shall be referred to the executive committee, which may appoint an individual(s) to serve on the hearing body.

(d) If no representatives of the member firm are present, the presiding officer may proceed if he determines on the record that it is appropriate to do so.

(e) The presiding officer states for the record a brief summary of the subject of the hearing and the authority for holding it.

(f) The presiding officer states that the hearing will be conducted under these rules of procedure, noting in particular the informal nature of the hearing, especially as it relates to rules of evidence, and the need to maintain confidentiality.

(g) The presiding officer allows the parties to the proceeding to state for the record any objections they have to any prehearing proceedings, such as service of the Advice of Proceeding or Notice of Hearing, and to make any prehearing motions they have, such as a request for postponement (see section 3.6).

(h) The presiding officer requests the parties to the proceeding to identify their witnesses for the record.

(i) The presiding officer requests the person representing the SEC Practice Section, or counsel, to present the evidence against the member firm. In the course of this presentation, any exhibits to be introduced as evidence are passed to the representative of the member firm for inspection. They are then passed to the presiding officer, who indicates orally whether they are to be admitted. The presiding officer should see that all documentary and physical evidence is marked for identification and that a list is kept that describes the exhibit and its identification.

(j) The presiding officer permits the following individuals to question witnesses called by the representatives of the SEC Practice Section, or counsel, upon completion of their testimony:

  (i) The representative of the member firm, or counsel.

  (ii) Members of the hearing body.

(k) The presiding officer requests the representative of the member firm, or counsel, to present any evidence in support of their defense, following the same procedure in (i) above.

(l) The presiding officer permits the following individuals to question witnesses called by the representative of the member firm, or counsel, upon completion of their testimony:

(i) The representative of the SEC Practice Section, or counsel.

(ii) Members of the hearing body.

(m) The presiding officer permits the person presenting evidence against the member firm to offer rebuttal evidence.

(n) The presiding officer permits the representative of the member firm, or counsel, to make a closing statement which is then followed by the closing statement of the person presenting evidence against the member firm.

(o) If the member firm does not request the opportunity to submit a post-hearing brief or memorandum (see section 3.9), the presiding officer requests that all individuals, other than the members of the hearing body, retire from the hearing room.

(p) The hearing body determines by majority vote in executive session its disposition of the case by polling all participating members, including the presiding officer (see section 5). In the event the hearing body is unable to reach a decision during the executive session, it may adjourn the executive session to such later date as it shall determine.

(q) If a decision is reached immediately after the hearing, all parties to the proceeding present prior to executive session and the reporter are recalled for the purpose of recording the decision. If a decision cannot be reached immediately after the hearing or the parties are given an opportunity to submit post-hearing briefs or memoranda, the parties to the proceeding shall be informed of the decision by letter mailed within 10 days of the decision in the same manner as a Notice of Hearing (see section 3.3).

4.3 Order of Proceedings -- Hearing by the Executive Committee to Consider Findings of Another Hearing Body

A hearing before the executive committee to consider the recommendations of the peer review committee or the special investigations committee with respect to sanctions that should be imposed on a member firm shall be conducted substantially in accordance with section 4.2.

## 5. THE HEARING BODY'S DECISION

### 5.1 Decisions to be Made

The hearing body must make the following determinations based on the evidence presented at the hearing:

(a) The facts in issue.

(b) Whether the facts, as determined, support the charges brought against the member firm.

(c) Whether the charges brought are a violation of the membership requirements.

(d) Whether and what sanctions are appropriate.

(e) What the effective date of the final decision should be.

### 5.2 Burden of Proof

A determination that the facts support the charges brought against the member firm must be based on the preponderance of the evidence.

Exhibit VII

SPECIAL INVESTIGATIONS COMMITTEE
SEC PRACTICE SECTION
1979-1980

| Member | Firm or Former Firm Affiliation | Term Expires* |
|---|---|---|
| Rholan E. Larson, Chairman | Partner, Larson, Allen, Weishair & Co. | 1982 |
| Leroy Layton | Retired, former partner, Main Hurdman & Cranstoun | 1982 |
| John B. O'Hara | Partner, Price Waterhouse & Co. | 1982 |
| Edwin P. Fisher | Partner, Arthur Andersen & Co. | 1981 |
| Leon P. Otkiss | Retired, former partner, Peat, Marwick, Mitchell & Co. | 1981 |
| David Wentworth | Partner, McGladrey, Hendrickson & Co. | 1981 |
| Harry L. Laing | Partner, A. M. Pullen & Company | 1980 |
| Harry F. Reiss, Jr. | Retired, former partner, Ernst & Whinney | 1980 |
| Lawrence J. Seidman | Retired, former partner, Seidman & Seidman | 1980 |

*Concides with date of AICPA annual meeting.

Exhibit VIII

# THE SEC PRACTICE SECTION OF THE AICPA DIVISION FOR CPA FIRMS

# POSITION PAPER OF TASK FORCE ON CERTAIN ASPECTS OF THE AUDITOR'S WORK ENVIRONMENT

March 1980

AICPA

American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

March 17, 1980

To the Members of the:
AICPA Board of Directors
Public Oversight Board
Private Companies Practice Section
Executive Committee

Some months ago, the Executive Committee of the SEC Practice Section appointed a task force to consider certain portions of the Report of the Commission on Auditors' Responsibilities related to certain aspects of the auditor's work environment. The task force has prepared a position paper on that subject, and the paper has been accepted by the Executive Committee.

The position paper has been distributed to the firms that are members of the SEC Practice Section. A copy of the paper, together with a transmittal letter that summarizes its findings, is enclosed for your information.

I would be happy to answer any questions you might have about this position paper.

Sincerely,

A. E. MacKay

A. E. MacKay
Chairman
SEC Practice Section
Executive Committee

AEM:jmk

AICPA

American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

March 17, 1980

To Managing Partners of
Member Firms of the
SEC Practice Section

Dear Colleague:

Enclosed is a copy of a position paper of the task force appointed by the SEC Practice Section Executive Committee to consider certain conclusions of the Commission on Auditor's Responsibilities (Cohen Commission). The position paper, which has been accepted by the Executive Committee, sets forth the task force's considerations and conclusions about portions of the Cohen Commission's Report (the Report; issued in 1978) that are related to the auditor's work environment and that resulted, in part, from a profession-wide survey of selected partners and staff members of CPA firms. The position paper also sets forth recommendations to firms about steps that they should take in response to concerns expressed in the Report.

The Cohen Commission expressed concern about specific audit practices that it believed cause or result from "excessive time pressures." Serious consideration must be given to these concerns; but, in light of several factors relating to the results of the Cohen Commission's survey and developments in the profession (discussed in the position paper), the task force believes that there is not persuasive evidence that firms have sacrificed audit quality -- because of time pressures on audits or otherwise. Furthermore, it believes that those concerns are not as serious or pervasive as some apparently have inferred from the Report and, most importantly, that there are pervasive positive factors at work on audit quality and specifically on those concerns.

Accordingly, the task force recommends that firms should continue to reassess, and otherwise monitor the effectiveness of, their policies and procedures on the use of time budgets, the level of audit partner supervision, and the signing off for audit work. Feedback from firms' employees to the partners would provide useful information for such monitoring activities and might be obtained through various means that ordinarily exist already within firms. Accordingly the task force does not believe that a firm needs to conduct an internal survey to obtain such feedback; however, some firms might decide to do so.

I hope you will carefully consider this position paper. However, please note that it does not establish membership requirements or peer review standards.

Sincerely,

A. E. MacKay

A. E. MacKay
Chairman
SEC Practice Section
Executive Committee

AEM:jmk

# POSITION PAPER OF TASK FORCE ON CERTAIN ASPECTS OF THE AUDITOR'S WORK ENVIRONMENT

1. The SEC Practice Section of the AICPA Division for CPA Firms appointed a task force to consider certain conclusions of the Commission on Auditors' Responsibilities (Cohen Commission) that were related to the auditor's work environment. This position paper sets forth the considerations, conclusions, and recommendations of the task force with respect to certain portions of the Cohen Commission's Report (1) that are discussed in the Report's section, "Management Policies and Procedures of Public Accounting Firms and Their Effect on Independence."

## COHEN COMMISSION REPORT

2. The Cohen Commission studied, among other things, aspects of the business environment that affect the independence of auditors. The Cohen Commission concluded that possible excessive competition, rather than lack of it, appears to present a problem to the public accounting profession today.

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(1) Commission on Auditors' Responsibilities, Report, Conclusions and Recommendations (New York: AICPA, 1978) referred to herein as "Report."

3. In explaining that conclusion, the Cohen Commission stated that its research on selected cases involving alleged "audit failures," its conferences with SEC staff, technical partners of CPA firms and others, and its survey of partners' and staff members' attitudes "provide persuasive evidence that time and budget pressures frequently cause substandard auditing" (Report, p. 109). The Cohen Commission's survey, frequently referred to as the "Rhode Survey," (2) was a questionnaire sent to present and former partners and staff members of auditing firms, principally to determine their attitudes and practices related to the quality of their work and independence. Although a single cause of time and budget pressures was not determined, one probable cause was believed to be excessive competition among firms to offer lower fees -- but the Cohen Commission was unable to document this relationship.

4. Furthermore, the Report (p. 115) stated, "Although there are other factors, the Commission believes that excessive time pressures are one of the most pervasive causes of audit failures." The Report discussed specific audit practices that the Cohen Commission believed cause or result from the

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(2) John Grant Rhode, The Independent Auditor's Work Environment: A Survey, Commission on Auditors' Responsibilities Research Study No. 4 (New York: AICPA, 1978).

excessive time pressures. Those discussions and related conclusions that are addressed later in this position paper are summarized in paragraphs 5 through 7.

5. The Cohen Commission stated that excessive time pressures are caused in some cases by inappropriate policies and procedures of firms concerning audit time budgets. The budgets have a negative effect on the auditor's performance if they are unrealistic or if variances from them are used inappropriately for evaluating personnel performance. Unrealistic time budgets result from their being established too low, either from arbitrary decisions or from invalid information about time spent in the prior year audit because chargeable hours were underreported.

6. The Cohen Commission also stated that excessive time pressures result, in some cases, in the undesirable situations of inadequately supervised audits and of auditors having signed for completing audit steps (not covered by another compensating step) when they had not performed the work. As to the former situation, the Cohen Commission believed its research found that many of the alleged audit failures fit the general picture of a "partner supervising fifteen or twenty engagements, many with identical year ends, working considerable overtime, unable to find adequate time to

review work papers, and faced with several crucial decisions, some of which were ultimately made incorrectly" (Report, page 115). As to the latter situation, the Cohen Commission indicated that 58% of respondents to the Rhode Survey who were still in public practice had at least once in their career signed for work not performed and that the situation was the most serious deficiency revealed by the survey, "for it reflects on the auditor's own control system for the audit" (Report, p. 116).

7. With respect to these audit practices, the Cohen Commission made the following recommendations:

> "Public accounting firms should not abandon time budgets, but they must improve current methods, particularly for the evaluation of variances and their effect on the evaluation of personnel.... Any revision of the budgeting process should include careful consideration of safeguards to avoid arbitrarily establishing excessively low budgets because fees have been set too low" (Report, pp. 117-118).

> "Firms [should] immediately undertake to conduct studies to determine the extent of conditions revealed by the Commission's study and the effects on their practices" (Report, p. 118).

8. Serious consideration must be given to any indications that some audits may be performed at a substandard level, that excessive time and budget pressures may be the cause of substandard audits, and that inadequate supervision and improper sign-off practices may result from those pressures or for any other reasons. As discussed in the "Task Force Conclusions and Recommendations" section below, public accounting firms should take steps to mitigate the possible effect of any such conditions. However, the task force believes that several factors concerning the results of the Rhode Survey and developments in the profession, which are discussed in paragraphs 9 through 16, should be considered in judging the pervasiveness and significance of such conditions and in determining the appropriate response.

Interpretation Of Rhode Survey Results

9. The results of the Rhode Survey are subject to a variety of interpretations regarding the effect of time pressures on audit quality. As indicated earlier, the Cohen Commission's Report (p. 116) stated that 58% of respondents to the Rhode Survey who were still in public practice answered "Yes" to the question, "During the course of an audit, have

you ever signed off a required audit step, not covered by another audit step, without completing the work or noting the omission of procedures?" The available details of those responses are interesting. For example, those responses can be summarized from page 121 of the Rhode Survey report [2] as follows:

| Percentage of Responses | Choice of Answers Available for the Question (A respondent was instructed to check one of the following.) |
|---|---|
| 0.2 | Yes, frequently (10 or more times) even though you were not satisfied with the extent of the examination in that area |
| 2.9 | Yes, infrequently (less than 10 times) even though you were not satisfied with the extent of the examination in that area |
| 3.1 | [Subtotal] |
| 7.9 | Yes, frequently, (10 or more times) although you were satisfied with the extent of the examination in that area |
| 46.7 | Yes, infrequently (less than 10 times) although you were satisfied with the extent of the examination in that area |
| 57.7 | [Subtotal -- i.e., the 58% referred to earlier] |
| 42.3 | No, never in my auditing experience |
| 100.0 | [Total] |

As indicated by this summary, only 3.1% of all respondents (who were still in public practice) had engaged in the conduct described in the question and were not satisfied

with the extent of the examination in that area. Page 121 of the report [2] also indicates that the comparable figure for those no longer in public practice was 4.3%. Furthermore, it would appear from correlated questions in the Survey that in a substantial number of instances "the omission of required work was discovered" (Report, pp. 179-180) -- presumably, discovered in the review process.

10. The details of the key question discussed in paragraph 9 do raise concerns regarding the adequacy of audit documentation and the inclusion of unnecessary procedures in audit programs (that is, overauditing). However, the task force believes that those concerns -- although important -- are not so serious as to imply that a pervasive condition of "substandard audits" exists where essential audit procedures are being omitted because of excessive time pressures.

Effects of Developments in the Profession

11. Certain profession-wide developments have occurred since the publication of the Cohen Commission's report that should have the effect of enhancing audit quality: issuance of SAS No. 22 on planning and supervision, actions by the AICPA Division for CPA Firms with related membership requirements, measures taken by the AICPA to discipline its individual-

member CPAs, and the inauguration of separate authoritative pronouncements on quality control standards.

12. Statement on Auditing Standards No. 22, Planning and Supervision, was issued in March, 1978. Generally it discusses, among other things, the development of an overall strategy for the expected conduct and scope of an audit, the early identification of areas that may need special consideration, and the continuous participation of the partner throughout the audit. The task force believes that this SAS should serve to reduce the possibility of inadequate partner supervision. It also should help to increase the information base from which the audit time budgets are prepared (see paragraphs 3 and 4 of the SAS).

13. The AICPA Division for CPA Firms began in 1977 and continued in 1978 and 1979 to develop its activities and to make both the SEC Practice Section and the Private Companies Practice Section fully effective. This division has provided the profession an organizational structure through which regulatory requirements, disciplinary actions, and sanctions can be imposed on CPA firms.

14. The task force believes that two of the SEC Practice Section's membership requirements, in particular, should serve to improve audit quality on a profession-wide basis: the concurring review of a firm's audit reports as to SEC engagements and the periodic peer review of a firm's quality controls. (The Private Companies Practice Section has a similar membership requirement for periodic peer review.) Programs developed by the SEC Practice Section and contained in its Peer Review Manual specifically identify time budgets and supervision on selected audits as areas that ordinarily should be subjected to the appropriate peer-review procedures.

15. In addition to the actions taken to regulate CPA firms, the AICPA has taken measures to strengthen its effectiveness in disciplining its individual-member CPAs. These measures provide for, among other things, a public accountability of the ethics committee and trial board with respect to disciplinary matters, and a continuing review of the entire disciplinary machinery applicable to the profession to determine how it can be made more effective. Several state boards of accountancy and state societies of CPAs also have increased their disciplinary activities.

16. A newly-formed senior committee of the AICPA issued in November, 1979 its first Statement on Quality Control Standards (SQCS) entitled "System of Quality Control for a CPA Firm." This statement incorporates the elements of quality control discussed in SAS No. 4, "Quality Control Considerations for a Firm of Independent Auditors" issued December, 1974, which date probably was too recent for the statement to have been adequately reflected in the mid-1976 Rhode Survey. SQCS No. 1 requires, among other things, that firms have a system to assure that quality control considerations are addressed, that the quality control policies and procedures are communicated to the firms' personnel, and that the system is monitored. Furthermore, in 1978, examples were provided by a special committee to illustrate the types of policies and procedures that firms might establish for each element of quality control specified in SAS No. 4 and later incorporated into SQCS No. 1 (see AICPA Professional Standards, Volume 2, QC Section 200, "Quality Control Policies and Procedures for Participating CPA Firms").

17. Competition among firms and time pressures on audits necessarily exist because public accounting firms operate in a business environment similar to that of the firms they audit. Thus, the firms' operational goals of growth and profitability may at times appear to conflict with goals relating to quality of work. However, the task force believes there is not persuasive evidence that firms have sacrificed quality. More specifically, based primarily on the considerations discussed in paragraphs 9 through 16, the task force believes that the Cohen Commission's concerns about inadequate supervision and improper sign-off practices are not as serious or pervasive as some apparently have inferred from its Report. Most importantly, the task force believes there are pervasive positive forces at work on audit quality and specifically on the Cohen Commission's concerns -- those forces resulting from the effects of developments in the profession described in paragraphs 11 through 16.

18. The need to balance apparently conflicting goals requires firms to establish, clearly and decisively, their goals for quality of work. Also, the fact that inappropriate audit practices were identified to any extent by the Cohen Commission emphasizes that firms should be watchful to determine that their quality goals are in fact being achieved. Accordingly,

firms should continue to reassess, and otherwise monitor the effectiveness of, their policies and procedures concerning the use of audit time budgets, the level of audit partner supervision, and the signing off for audit work. The task force believes that this reassessment and monitoring of certain aspects of the auditor's work environment should be made in order to reduce, to the lowest possible level, the types of concerns discussed in paragraphs 4 through 6. In making the reassessment, firms should consider the matters discussed in paragraphs 19 through 22; and in otherwise monitoring the effectiveness of their prescribed policies and procedures, firms should consider the matters discussed in paragraphs 23 through 25.

19. Firms should communicate to their personnel the objectives of the time-budgeting process and should indicate that audit time budgets should be realistic and kept in proper perspective in evaluating personnel performance. Firms also should communicate a policy of not permitting excessively low budgets to be arbitrarily established. Furthermore, such communication should establish procedures for the preparation and use of audit time budgets, and for the appropriate recording of audit time spent, in order that excessive time pressures are not created. Comments in the Report (p. 117) on time budgets might be useful to firms in developing or revising such communication.

20. As indicated in SAS No. 22, the extent of partner supervision appropriate in a given instance depends on many factors, including the complexity of the audit and the qualifications of the persons performing the work. Therefore, in addition to having established policies and procedures concerning the nature, timing and extent of partner supervision of audits, firms should plan for and maintain adequate numbers of supervisory personnel.

21. The signing off for a required audit procedure without completing the work or noting the omission of the procedure is undesirable and unacceptable behavior. This is true even where an individual believes that the procedure is not necessary, is covered by another procedure, or for any other reason. In order that the partner and other supervisors can make audit decisions based on reliable information, firms should provide guidance to their personnel on, generally, the form and content of working papers and, specifically, the proper procedures for signing off for (or otherwise indicating) work performed and the appropriate manner for noting a change in the planned procedure or a decision not to perform the procedure.

22. The specific form and extent of communications to firms' employees -- that provide guidance on audit time budgets, partner supervision, and sign-off practices -- will vary depending on the size, structure, and nature of practice of the firms. For example, some firms might decide that a portion of an employee code of conduct, containing strong admonitions, might be the appropriate means to set forth the responsibilities of each professional in the firm with respect to those matters. Such firms also might decide to request a confirmation from each professional as to compliance with the code of conduct. Alternatively, some firms might decide that periodic meetings of their professionals, in which those matters are discussed, would be equally effective.

23. Firms also should continue to monitor the effectiveness of their prescribed policies and procedures concerning the three matters discussed earlier (audit time budgets, partner supervision, and sign-off practices) and to determine whether any modifications thereto are required. The task force believes that feedback from firms' employees to the partners concerning those three matters would provide useful information for such monitoring activities.

24. The feedback discussed in paragraph 23 might be obtained through various means that ordinarily exist already within firms. Those means, for example, might include:

25. Each of the activities listed in paragraph 24 would not necessarily provide employee feedback on one or all of the three matters discussed earlier. The task force believes, however, that a combination of those activities listed -- or others not shown -- can provide a firm such feedback that is sufficient in relation to the firm's overall monitoring activities, its size, structure, and nature of its practice.

26. Accordingly, the task force does not believe that a firm needs to conduct an internal survey to obtain feedback with respect to the auditor's work environment in the firm; however, some firms might decide to do so. The recommendations in paragraphs 18 through 25 apply to a firm regardless of whether it performed an internal survey. Therefore, a firm might proceed, without performing an internal survey, to implement the above-discussed recommendations as appropriate -- based on, among other things, an assessment of the effectiveness of prescribed policies and procedures that address the concerns expressed by the Cohen Commission.