

**Public Oversight Board**

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# **Annual Report 1980-81**

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

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**Public Oversight Board**

John J. McCloy, *Chairman*

William L. Cary

John D. Harper

Robert K. Mautz

Arthur M. Wood

Richard A. Stark, *Secretary*

*Staff:* Louis W. Matusiak, *Executive Director*

Charles J. Evers, *Technical Director*

David P. Boxer, *Assistant Technical Director*

Alan H. Feldman, *Assistant Technical Director*

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# Public Oversight Board

## SEC PRACTICE SECTION

American Institute of Certified Public Accountants

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Chairman

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Asst. Technical Directors

March 31, 1981

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

Annexed is the third annual report of the Public Oversight Board, reporting and commenting on the program of the Section during the twelve months ended March 31, 1981.

Robert K. Mautz was appointed to fill the vacancy on the Board created by the untimely death of Ray Garrett, Jr. His appointment reflects a change from the previous view that the Board should not include members from the accounting profession. As experience has been gained in dealing with peer review issues, the scope of management advisory services by CPA firms, and the developing disciplinary procedures, it has become apparent that a Board member with accounting and auditing experience would make a valuable contribution. We believe that Mr. Mautz' experience in the accounting profession will add a new dimension to our deliberations.

Almost 200 peer reviews have been conducted since the inception of the Section's peer review program, and another 330 reviews are scheduled for 1981, thus concluding the first 3-year cycle during which all member firms are required to undergo an initial peer review. Based on its monitoring of reviews conducted to date, the Board believes that the peer review process is constructive and is achieving its objectives. The Board believes that the public has a right to know the names of firms that have received a favorable peer review report and is giving consideration to publishing the names of all such firms in its next annual report.

The use of a Quality Control Review Panel in firm-on-firm reviews was instituted in response to criticism regarding the option of the reviewed firm to select the reviewing firm. Based on experience to date, questions have been raised regarding the cost-benefit of continued panel involvement and the Board has directed its staff to gather appropriate data to serve as a basis for evaluation of the continued need or desirability of panel involvement in peer reviews.

During the year, arrangements were concluded between the Section and the SEC under which, beginning in 1981, the SEC staff will have access to selected peer review workpapers prepared by reviewers, in addition to workpapers of the Board developed in its monitoring program. We understand the desire of the SEC to have a basis for objective evaluation of the adequacy of the peer review program. It is hoped, however, that, after an initial period of experience, the SEC will be satisfied to rely on review of the Board's workpapers for oversight of the program.

The Special Investigations Committee, which has been appointed to undertake specified investigations and disciplinary procedures in connection with alleged or possible audit failures, has begun operation. Thus far the SIC has been monitoring a number of cases but there has not been a sufficient basis to investigate any firm or specific audit failure. While the SIC has made significant progress in establishing operational procedures, it is too early to draw any conclusions regarding its performance or the effectiveness of the Section's disciplinary program.

The Board believes that the large number of members in the Section and the high percentage of the nation's business audited by them is sufficient to assure the ultimate success of the Section's program of self-regulation. Nevertheless, we feel that the public interest would be best served if all accounting firms that audit SEC clients were members of the Section.

After reviewing all aspects of the Section's program, we believe that the Section has displayed continuing evidence in the past year of its commitment to self-regulation and has made substantial progress. In our view, the profession deserves commendation for its efforts in developing and making operational a truly unique program of self-regulation.

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 1980-1981

This third annual report of the Public Oversight Board of the SEC Practice Section of the Division for CPA Firms of the American Institute of Certified Public Accountants covers its activities for the period April 1, 1980 through March 31, 1981.

### I. PUBLIC OVERSIGHT BOARD

The Board's primary responsibilities are to (1) monitor the performance of the Section's Peer Review, Special Investigations and Executive Committees; (2) determine whether the Peer Review Committee is taking the necessary steps to ensure appropriate action by 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.

During the first two years, when the Section's self-regulatory program was being formulated, the Board advised on major organizational and policy matters. Now that the major elements of the program are in place, principal attention is devoted to the Section's implementation of its programs and to consulting with the Securities and Exchange Commission on various aspects of the program.

#### A. Composition of the Board

John J. McCloy, chairman of the Board, was reappointed for an additional three-year term to expire on December 31, 1983. William L. Cary, John D. Harper and Arthur M. Wood continue as Board members.

Robert K. Mautz has been appointed to fill the vacancy created by the untimely death of Ray Garrett, Jr. Mr. Mautz has been the director since 1978 of the Paton Accounting Center at the University of Michigan and has served the accounting profession in many capacities. He was president of the American Accounting Association, a member of several AICPA committees, a member of the Cost Accounting Standards Board, and is currently serving as chairman of the Governmental Accounting Standards Board Organization Committee. An accounting professor and author, he served on the staffs of two CPA firms and was a partner in a third national CPA firm.

The appointment of Mr. Mautz reflects a change in the view that the Board should not include members from the accounting profession. As the Board has gained experience dealing with peer review issues, the scope of management advisory services by CPA firms, and the developing disciplinary procedures, it has become apparent that a Board member with accounting and auditing experience would make a valuable contribution. We believe that the addition of one member from the accounting profession will not compromise the Board's independence and objectivity but instead will add a new dimension to its deliberations. Additional information about Board members is set forth in Exhibit I.

#### B. Meetings and Other Activities

At its regular monthly meetings during the year, the Board considered several major items that are commented on in detail in other sections of this report: (1) the peer review program, including the question of access by the SEC to peer reviewers' workpapers, the cost and effectiveness of quality control review panels, and actions to be taken by a firm when it learns that it has issued an audit report without proper basis, (2) the disciplinary process, including activities of the Special Investigations Committee and (3) membership in the Section.

The Board monitors the day-to-day activities of the Section in a variety of ways. A Board staff member attends each meeting of the major committees of the Section. Individual Board members attend numerous individual meetings: formal meetings of the Special Investigations Committee, conferences where peer reviewers report their findings to top management of the reviewed firm, conferences between the SEC and members of the AICPA, special briefing sessions with members of its own staff, and joint meetings with the Section's Planning Committee.

#### C. Staff and Expenses

Messrs. David P. Boxer and Alan H. Feldman joined the staff as assistant technical directors during the year. The Board continues to employ part-time retired professionals to monitor peer reviews.

Expenses of the Board and its staff are paid from dues paid by the Section's member firms. The estimated expenses for the year ended July 31, 1981 are \$745,000, an increase of \$155,000 over the actual expenses of the prior year. The increase is due principally to normal increases in salary and related payroll expenses, to additions to professional and office staffs, and to travel and other costs associated with monitoring of peer reviews. Detailed statements 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, the peer reviews of member firms and the actions taken by the Section with respect to peer reviews.

### A. Peer Review Committee

The 1980-81 PRC consists of fifteen individuals appointed from member firms by the executive committee. (See Exhibit IV). PRC members' time commitments continue to be significant. The committee held twelve one-or-two day meetings in 1980-81. In addition, members are assigned to subcommittees and task forces conduct oversight of selected individual peer reviews and assist with special projects.

As noted in its previous annual reports, the Board is mindful of the PRC's need to give appropriate consideration to the nature of practice of smaller firms. The fact that nine of fifteen members of the PRC are representatives of firms that audit thirty or more SEC registrants might cause some concern that the PRC's decisions are heavily influenced by large firm considerations. Based upon the decisions made to date, however, we conclude that the PRC has given appropriate consideration both to the objectives of the program and to the size and nature of practice of member firms in establishing standards and procedures.

### B. Reviews Completed and Planned for 1981

Peer reviews may be conducted by a single firm (firm-on-firm review), by a committee-appointed review team (CART review), or by a team appointed or authorized by an association of CPA firms (association review). Quality control review panels are appointed for firm-on-firm and association reviews. The panel performs certain functions that provide it with a basis for issuing its own report on the reviewed firm's system of quality control. See Section II.I.1 for additional comments on the role of the panel.

The Board's 1979-80 report indicated that approximately 200 firms were expected to have their reviews in 1980. After resignations, terminations and mergers (see Section IV.C), 146 reviews were ultimately scheduled, as indicated in the following tabulation:

	Number of Firms, by Number of SEC Clients				Total
	30 or more	5 to 29	1 to 4	None	
CART reviews	1	1	35	31	68
Firm-on-firm reviews	7	9	21	13	50
Association reviews	<u>1</u>	<u>3</u>	<u>13</u>	<u>11</u>	<u>28</u>
	<u>9</u>	<u>13</u>	<u>69</u>	<u>55</u>	<u>146</u>

The "field work" for all reviews has been completed, but some reports on 1980 reviews have not yet been processed by the PRC, mainly because many firms scheduled their reviews for late in the year. The PRC has not granted extensions except in cases of clearly demonstrated undue hardship. All reviews undertaken in 1979 have been completed.

A total of 197 firms have had their initial peer review under the Section's program: eleven in 1978, forty in 1979, and one hundred forty-six in 1980 (including reviews still in process at March 31, 1981). The size of the firms reviewed and the extent of SEC client coverage are as follows:

Size of Firm by Number of SEC Clients	Number of	
	Firms	SEC Clients
None	90	-
1 to 4	74	149
5 to 29	17	212
30 or more	<u>16</u>	<u>8,148</u>
	<u>197</u>	<u>8,509</u>

The total number of SEC clients audited by these 197 member firms represents 95% of the total number of SEC clients audited by all member firms of the Section.

The Section presently expects to carry out 330 peer reviews in 1981, as follows: 208 firms that have no SEC clients, 109 that have one to four SEC clients, and 13 that have five or more SEC clients. Of these reviews, eleven will be of firms that had their initial reviews under the program in 1978.

### C. Monitoring of CART Reviews by PRC

As previously noted, a panel is required in connection with each firm-on-firm and association review but is not required for a CART review since the reviewers are appointed by the PRC. In an effort to provide added control over the quality of reports and letters of comments issued by CART reviewers, the PRC assigned one of its own members to monitor each CART review in 1980 of a firm with one or more SEC audit clients. The assigned member was expected to consult with the team captain, review the reviewers' workpapers and read a draft of the report and letter of comments before issuance. For CART reviews of firms that audit two or more SEC clients, the member was also requested to visit the reviewed firm at the time of the exit conference. The PRC has concluded that this program was successful and plans to continue it in 1981.

### D. PCPS Administered Reviews

If a firm belongs to both sections, it can request the Private Companies Practice Section Peer Review Committee to appoint the review team and to administer certain other aspects of its review. However, the SEC Practice Section's PRC may veto such decisions and has the sole responsibility for accepting and placing in the public file reports on reviews of all firms that are members of its Section.

The delegation of these administrative activities took place as an effort to increase the Section's membership and appears to have had no adverse effect on the quality of reviews. However, the processing of reports and letters by the PCPS-PRC has caused significant delays, and such delays may become more acute in 1981 as the number of PCPS-administered peer reviews increases. Accordingly, the Board suggests that the two peer review committees take whatever action is considered necessary to reduce these delays.

### E. Review of Audit Work Performed by Domestic and Foreign Affiliates and Correspondents

The Board's 1979-80 report indicated that the PRC had adopted in principle an approach for review of work done outside the United States that focuses on the supervision and control of segments of engagements performed by foreign correspondents or affiliates. The approach has been expanded to include domestic correspondents and affiliates and is consistent with U.S. auditing standards and with an exposure draft entitled Using the Work of an Other Auditor, issued by the International Auditing Practices Committee of the International Federation of Accountants. Written responses to the exposure draft

generally have been supportive of the proposal. It is expected that the IAPC will approve the proposal with only minor changes at its spring 1981 meeting. The Section's peer review manual has been amended to incorporate this approach which is effective for audit engagements covering years beginning after June 30, 1980.

The Board previously expressed its support for this approach and continues to believe that it achieves all that can be reasonably accomplished at this time. The Board recognizes that its effectiveness is dependent upon how it is implemented, and will closely monitor this aspect of peer reviews during the coming years.

We have noted in some foreign countries indications of interest in peer review as a force in improving the quality of practice. The PRC should keep current with developments abroad to identify the appropriate time to discuss once more the benefits of peer review on a worldwide basis. However, this remains a delicate subject for discussion with accounting organizations in other countries.

#### F. Revisions of Standards

In response to concerns expressed by a number of smaller firms, the PRC issued an interpretation that states that a properly completed "Policies and Procedures Questionnaire" can serve as the firm's quality control document. The PRC also revised the peer review manual to require documentation of oral comments communicated by reviewers to management of the reviewed firm, and matters relating to supervision and control of work performed by foreign and domestic affiliates and correspondents.

#### G. Access by SEC to Peer Review Workpapers

One of the most difficult questions confronting the Section and the Board, that of SEC access to peer review workpapers, has been resolved.

The Commission had taken the position that it must have sufficient access to the peer review process to permit it to make an objective evaluation of the adequacy of the process, and that total reliance on the Board and its staff in this regard would not be consistent with this objective or the Commission's responsibilities. The Section objected to unlimited SEC access because of its concern for the confidentiality of client information.

An agreement was reached in 1980 that provides for SEC staff access commencing in 1981 to portions of peer review workpapers for firms that audit one or more SEC clients. However, workpapers relating to specific audit

engagements will not be made available to the SEC staff. The SEC will make a random selection of firms for SEC staff review using information that identifies selected characteristics of the firms undergoing peer review that year but does not disclose the names of the firms.

The SEC also has access to the Board's workpapers as discussed in Section II.H.5 below.

The SEC's 1980 Report to Congress acknowledged the Board's role in bringing about the agreement regarding SEC access to reviewers' workpapers:

The Commission has recently been encouraged about the prospect of future success for the venture by the effective leadership displayed by the Public Oversight Board in facilitating the Commission and the Section's efforts to reach an appropriate accommodation on the access issue. . . .

#### H. Board Monitoring of Peer Reviews

Board representatives have monitored each peer review since inception of the program. Three types of monitoring programs are used by the staff to assess peer reviewers' adherence to standards. These programs have been modified from time to time to incorporate refinements resulting from experience and from discussion with SEC staff members.

- The visitation-observation program consists of a review of workpapers prepared and reports issued including letters of comments and related responses ("reports") and visits to offices of the reviewed firm during the performance of the review.
- The workpaper review program consists of a review of workpapers and reports.
- The report review program consists of a review of reports issued and the reviewer's summary review memorandum.

During 1980 Board members and staff visited over 60 offices of member firms in connection with its visitation-observation program.

The Board staff's workpapers document the reasons for its concurrence or nonconcurrence with the reviewers' judgments. Because they are available for SEC review, the workpapers mask the identity of clients, the reviewed firm's offices and personnel involved.

## 1. Selection of Reviews to Be Monitored

The Board applies one of its monitoring programs to individual reviews, using stratified sampling techniques. Reviews of firms with five or more SEC clients are all subjected to the visitation-observation program. In addition, a more comprehensive level is applied for all other reviews if the level of oversight initially chosen causes concern about whether the review was conducted in accordance with promulgated standards.

The level of Board oversight on reviews performed in 1980 by type of review and by number of SEC clients audited by the reviewed firm is shown below.

<u>Type of Review</u>	POB Oversight			<u>Total</u>
	<u>Visitation- Observation Program</u>	<u>Workpaper Review Program</u>	<u>Report Review Program</u>	
Firm-on-firm	21	12	17	50
CART	13	29	26	68
Association	<u>9</u>	<u>10</u>	<u>9</u>	<u>28</u>
Total	<u>43</u>	<u>51</u>	<u>52</u>	<u>146</u>
<u>Number of SEC Clients Audited by Reviewed Firm</u>				
Five or more	22	-	-	22
One to four	15	33	21	69
None	<u>6</u>	<u>18</u>	<u>31</u>	<u>55</u>
Total	<u>43</u>	<u>51</u>	<u>52</u>	<u>146</u>

## 2. Excluded Engagements

The Board's staff continued to evaluate the reasons given by firms that requested that certain engagements be excluded from the scope of the peer review. Seven of the 146 firms reviewed in 1980 requested a total of twelve engagements be so excluded. All engagements so excluded are allowed under the Section's rules, i.e., because litigation was in process, because an investigation by a governmental agency was in process, or because the reviewed firm's client would not permit review of the workpapers. None of the exclusions caused an impairment in the scope of the review.

### 3. Questions Raised by Board Staff on Specific Reviews

In applying its monitoring programs, the staff challenged several reviews that were judged not to have been performed or seemed not to have been performed in accordance with established standards. Many of the cases could be attributed to the fact that the reviewer was performing his initial review and, therefore, may have misunderstood the documentation requirement for a peer review.

The staff also noted apparent unevenness in reporting by different reviewers. Similar findings resulted in some cases in an unqualified report and in others in a modified report; some letters of comments were not sufficiently specific while others reported unnecessary details. As a result, the staff made specific recommendations, which the PRC adopted, to strengthen the standards or to issue clarifying interpretations.

The Board's staff also caused some reviewers to expand the scope of the review to conform with standards or to provide additional documentation concerning the significance to financial report users of noncompliance with generally accepted accounting principles.

All of the foregoing matters were resolved to the satisfaction of the Board and its staff. In this connection, it should be noted that the preponderance of reviews were performed and reported on in a satisfactory manner.

### 4. Board Recommendations Regarding Engagements Not Performed in Accordance with Professional Standards

The staff noted isolated instances where, in the opinion of the reviewers, the deficiency in performance of an engagement in accordance with generally accepted auditing standards was so great that the firm did not have a proper basis for issuing its report, but there was no evidence that the financial statements were not in accordance with generally accepted accounting principles. Existing professional literature does not deal specifically with the situation. Therefore, the Board in a letter to the Section's executive committee dated October 29, 1980 recommended that

- (1) an appropriate standard-setting body of the AICPA issue guidance on the steps an auditor should take when he becomes aware that he may have issued an audit report on an engagement not performed in accordance with generally accepted auditing standards, and

- (2) require reporting by the peer reviewer to the PRC of each case where a member firm has issued a report for which it did not have a proper basis.

The executive committee took immediate action. As a result, the PRC has amended its standards accordingly and the AICPA Auditing Standards Board has appointed a task force to consider what action an auditor should take in such circumstances and to recommend appropriate guidance.

#### 5. Review of Workpapers by SEC Staff

The Board's workpapers on peer reviews are made available to the SEC staff for review. While the 1980 SEC Report to Congress was critical of some aspects of the Board's oversight of the review process, it did indicate overall satisfaction with the Board's role:

These [POB] files document that the POB staff is reviewing the working papers of the peer reviewers, and, in an appropriate number of instances, observing the conduct of peer reviews in progress and attending closing conferences between reviewers and reviewed firm personnel at which the results of the peer review are discussed. [p. 33]

\* \* \*

In addition, the POB's files include, in many instances, objective evidence that the POB staff is substantively challenging the reports being issued, the letters of comments and the reviewed firm's response thereto, as well as the adequacy of the scope and documentation of the work of the peer reviewers. [p. 33]

As indicated earlier, arrangements were concluded between the profession and the SEC under which beginning with the 1981 reviews the SEC staff will have access to selected workpapers prepared by reviewers. The Board understands the desire of the SEC to have a basis for objective evaluation of the adequacy of the Section's peer review program. It is hoped, however, that, after an initial period of experience, the SEC will be satisfied to rely on review of the Board's workpapers for oversight of the peer review program.



## I. Board Conclusions on the Peer Review Program

### 1. Role of Panel

As noted in Sections IV.B and C of this report, the cost associated with peer reviews may be a deterrent to membership in the Section. A significant factor in such cost is the multiple layers of oversight: workpapers of firm-on-firm and association reviews are, in turn, reviewed by a panel, the Board's staff, and on a sample basis beginning in 1981, by the SEC staff. As noted, the SEC staff also reviews the Board's workpapers. \*

The panel became a part of the process in response to criticism regarding the reviewed firm's option to select the reviewing firm. However, based on involvement at peer review exit conferences and conversations with others involved in the review process, the Board has raised questions regarding the cost/benefit of continued panel involvement and has directed its staff to gather appropriate data to serve as a basis for evaluation by the Board of the continued need or desirability of panel involvement in peer reviews.

### 2. General Conclusions

The monitoring of reviews performed in 1980 provided the Board's staff with additional persuasive evidence that the peer review program is effective and that the reviews were performed and reported on objectively. The following table summarizes the types of reports issued and processed to date:

	<u>Review Year</u>			
	<u>Total</u>	<u>1980</u>	<u>1979</u>	<u>1978</u>
Firms receiving unqualified reports	114	74	30	10
Firms receiving modified reports	16	7	8	1
Firms receiving adverse reports	<u>3</u>	<u>1</u>	<u>2</u>	<u>-</u>
	<u>133</u>	<u>82</u>	<u>40</u>	<u>11</u>

Of the one hundred fourteen firms receiving unqualified reports, all but nine received a letter of comments recommending changes that, in the opinion of the

reviewer, would substantially improve the firm's quality control policies and procedures. Responses from these firms, as well as from those receiving modified or adverse reports, indicate that these recommendations are being considered. One firm, that received an adverse report in 1979 and agreed to undergo another review in 1980, demonstrated a dramatic improvement in the quality of its practice and received an unqualified report on its 1980 review. Two other firms receiving highly modified reports in 1980 have agreed to correct the quality control deficiencies identified in the reviews and to undergo follow-up reviews early in 1981.

Several reviews uncovered isolated cases of inappropriate reporting by the reviewed firm on client financial statements. These reports were revised after they were called to the firm's attention, providing strong evidence of the effectiveness of the peer review program.

In addition, the Section's and the Board's experience gained from nearly 200 peer reviews to date has led to significant improvements in peer review standards, the creation of a sizeable number of competent reviewers and the development of an effective monitoring program.

Based upon its monitoring of reviews conducted to date under Section requirements, the Board believes that the peer review process is constructive and is achieving its objectives. The improvements being implemented by firms as a result of peer review demonstrate the real value of the process. Thus, we believe the general public can and should place reliance on the quality control system of a firm that has "passed" its peer review. While undoubtedly there are firms that do not belong to the Section that do high quality work and have effective quality control systems, we believe the public has a right to know the names of firms that have received favorable peer review reports. Assuming that our monitoring of 1981 reviews confirms experiences to date, the Board will consider publishing the names of all such firms in its 1981-82 report.

### III. SPECIAL INVESTIGATIONS COMMITTEE

As noted in our 1979-80 report, the Section's executive committee authorized on November 29, 1979, the establishment of a Special Investigations Committee to undertake specified investigations and disciplinary procedures in connection with certain alleged or possible audit failures involving member firms and to recommend sanctions, where appropriate.

#### A. Composition of 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. The initial members of the SIC were appointed in December 1979, with Rholan E. Larson, a partner in Larson, Allen, Weishair & Co., as chairman. The present composition of the SIC and firm affiliations of the members are set forth in Exhibit IV.

#### B. Committee Procedures

The procedures governing the investigative and disciplinary activities of the SIC are set forth in two documents, both of which were included as exhibits to our 1979-80 report: The Special Investigations Committee of the SEC Practice Section of the AICPA Division for CPA Firms and Rules of Procedures for the Imposition of Sanctions. Neither of these documents has been amended, but the SIC did request and receive certain clarifications of its responsibilities and authority, as indicated below:

- The executive committee confirmed that the SIC should confine its activities to alleged or possible audit failures involving SEC registrants and subsidiaries and affiliates of SEC registrants. However, the executive committee is not precluded from asking the SIC to investigate an alleged or possible audit failure involving a client that is not an SEC registrant.
- Recognizing that in a firm-on-firm peer review the workpapers are the property of the reviewing firm, the executive committee adopted a resolution stating that reviewing firms should honor requests by the SIC for access to review workpapers.

In addition, the SIC and the AICPA Professional Ethics Executive Committee prepared a joint memorandum setting forth the policies and procedures to coordinate their activities. The intent of the memorandum, which has been approved by the executive committee, is to minimize the possibility of concurrent investigations and duplication of effort. The memorandum essentially provides, among other things, that the professional ethics division will refer to the SIC any case that is within the jurisdiction of the SIC.

### C. Screening and Monitoring Cases of Alleged or Possible Audit Failure

The screening process is usually initiated by the SIC being provided copies of complaints filed with the courts against a member firm. Member firms are required to submit such information to the SIC within thirty days of service on them of the first pleading in the matter. Compliance with this membership requirement is reviewed during the triennial peer review. As an added check, and to identify other matters that may be of sufficient public interest to be screened by the SIC, its staff scans major financial publications for information that might reveal the existence of alleged or possible audit failures.

The SIC organization document requires the SIC to determine whether (1) to monitor developments without investigation of the firm or the case; (2) to investigate the firm (i.e., its quality control system) without investigating the case (i.e., the specific alleged audit failure); (3) to request authorization from the executive committee to investigate the case; or (4) to close its files on the case.

When a case is to be monitored by the SIC, its staff (1) obtains copies of relevant filings with the SEC; (2) summarizes the issues in the complaint; (3) researches professional literature for authoritative statements that bear on the issues; and (4) makes comments and suggestions for consideration by the SIC. These materials are reviewed and discussed by the SIC, with particular emphasis on the issues in the complaint and the relevant professional literature. The SIC then assigns one of its members to do a more intensive and continuing review of the case until such time as the SIC decides to initiate an investigation or close its files on the case. Monitoring developments in the case may, depending on the circumstances, include making certain inquiries of the firm involved with respect to the issues.

### D. Status of Reported Cases

From inception to date, fourteen cases were reported to the committee by member firms. Thus far, there has not been a sufficient basis to investigate any firm or specific audit failure. Of the cases reported, ten were raised to monitoring status, three of which were subsequently closed.

### E. Board Conclusions

As stated in its 1979-80 report, the Board believes that the success of the overall program can only be judged by its results. The SIC has made significant

progress in its initial year in establishing operational procedures and its members appear to take their responsibilities seriously. However, it is too early to draw any conclusions regarding the SIC's performance or the effectiveness of this aspect of the Section's program.

#### IV. SEC PRACTICE SECTION

##### A. Composition of Executive Committee

The Section's organization document provides that its governing body, the executive committee, shall be composed of representatives of at least twenty-one member firms and shall include representatives of all member firms that audit the financial statements of thirty or more registrants under Section 12 of the Securities Exchange Act of 1934. The firms currently represented on the executive committee are shown in Exhibit III of this report.

Fourteen firms are entitled to automatic representation on the committee at March 31, 1981; thus, seven seats are available to firms that audit fewer than thirty registrants, as defined, compared to the five seats that were available at the Section's inception. During the year, representatives of two such firms who had served for three years were replaced by representatives of firms that had previously not been represented on any of the Section's committees.

Chairman Archibald E. MacKay declined to stand for re-election because his retirement from Main Hurdman & Cranstoun would become effective at March 31, 1981, precluding him from serving as chairman for the full committee year. Accordingly, the committee elected Ray J. Groves as chairman for 1980-81. Mr. Groves is chairman and chief executive of Ernst & Whinney.

##### B. Changes in Membership Requirements

As indicated in our 1979-80 report, the Section had made changes in certain membership requirements to encourage more firms to join the Section. Since cost of membership was thought to be a deterrent to joining, most of the changes were intended to reduce such cost for firms that audit SEC clients, and affect dues, insurance requirements, and billing rates for peer reviews. The analysis of member firms presented in the next section indicates that these changes did not increase membership. Nevertheless, the executive committee continues to be concerned that certain membership requirements may create unreasonable burdens for smaller firms. For example, during the past year, the executive committee made certain changes in the Section's continuing professional education

requirements relative to program development and presentation, which were perceived as burdensome for smaller firms.

The 1980 SEC Report to Congress stated that the Section must "remain sensitive to the concerns of this segment [smaller firms] of the profession and ensure that its interests are fairly represented." The actions described above, in our opinion, demonstrate the Section's continuing attention to this matter.

### C. Analysis of Member Firms \*

An analysis of the changes in the membership of the Section shows some attrition over the last two years:

	Total Number of Firms	Breakdown by Number of SEC Clients		
		<u>5 or More</u>	<u>1 to 4</u>	<u>None</u>
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	<u>574</u>	<u>42</u>	<u>203</u>	<u>329</u>
New members	75	3	25	47
Resignations	(109)	-	(34)	(75)
Terminations	(18)	-	(5)	(13)
Mergers	(7)	(1)	(3)	(3)
Reclassifications, net	-	3	(8)	5
March 31, 1981	<u>515</u>	<u>47</u>	<u>178</u>	<u>290</u>

The firms having SEC clients that resigned during the year offered a variety of reasons, the most recurring ones being loss of SEC clients and either the cost of peer review or not being prepared to undergo a review in 1980 (the PRC had not granted their request to defer the review to 1981).

The memberships of five firms that audited a total of seven SEC clients were terminated under procedures for automatic termination: failure to (1) file an annual report, (2) pay dues, or (3) file requested information with the PRC incident to arrangements for its required triennial peer review.

In the aggregate, the number of firms, especially those with SEC clients, that joined the Section during the

past two years is disappointing and is evidence that the changes made in Section membership requirements to attract or retain smaller firms were not effective. The Board notes with interest that 1,600 firms belong only to the Private Companies Practice Section and that over the past year the number of such firms that audit SEC clients has increased from 58 to 107.

However, focusing only on the number of firms that are or are not members of the Section does not give an accurate assessment of the impact that the Section has on the practice of public accounting. For example, firms that are members of the Section currently audit 8,946 SEC clients; those clients represent:

- 91% of the estimated 9,800 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 7 of the U.S. companies listed on the New York Stock Exchange.
- All but 32 of the U.S. companies listed on the American Stock Exchange.

The following tabulation from the fifth edition of Who Audits America provides an indication that member firms audit the vast majority of SEC clients with "public interest" significance:

	SEC Registrants*		Annual Sales*	
	Number	Percent	Dollars	Percent
Companies with annual sales of \$1 million or more audited by Section members:				
By the eight largest U.S. firms	5,721	68.0%	\$2,536,500	93.0%
By others	1,303	15.4	89,400	3.3
Companies audited by foreign firms	73	0.9	68,300	2.5
Companies whose auditors are not identified**	245	2.9	19,400	0.7
Companies audited by U.S. firms not members of the Section	<u>1,075</u>	<u>12.8</u>	<u>12,900</u>	<u>0.5</u>
	<u>8,417</u>	<u>100%</u>	<u>\$2,726,500</u>	<u>100%</u>

\* Clients with annual sales of less than \$1 million are excluded from this tabulation.

\*\* Many of the companies are banking institutions, which are not "SEC clients" as defined. The Section hopes to be able to obtain "harder" data for analysis purposes later in 1981.

#### D. Membership Promotion Campaign

During the year, the Section continued several activities to promote membership:

- Representatives of the executive and peer review committees and the Section's staff accepted all available speaking opportunities to promote the Section.
- A session at the AICPA annual meeting was devoted exclusively to the Section.
- The Division for CPA Firms was discussed by AICPA staff vice presidents at "member roundtables" in nine different states.



- Discussions were held with representatives of nonmember firms to explain the Section's objectives and its relationship to the profession as a whole.
- Firms that audit SEC clients and that resigned during the year were contacted to determine the reason for the resignation and to encourage them to reconsider.

The Section did not undertake a formal membership campaign last year. Such appeals in the past have not produced notable results except for the initial campaign. Instead, the Section is making a serious attempt to identify why nonmember firms have not joined. Questionnaires were sent to 274 nonmember firms to determine whether there were specific membership requirements that such firms considered to be especially burdensome. The responses have been analyzed and indicate that peer review costs and documentation requirements are the most frequently cited deterrents to membership in the Section. The executive committee will appoint a task force to consider whether each membership requirement is appropriate and should be continued.

#### E. Directory of Member Firms

At its spring 1979 meeting, the AICPA Council agreed to publish in 1980 a directory of firms that are members of the Division for CPA Firms, which would not include Section designation. At its spring 1980 meeting, the AICPA Council voted to delay publication until summer 1982.

Some AICPA members express serious concerns about the establishment of the division with two sections. Some believe it has led to an inappropriate distinction between firms. Some members that do not audit SEC clients fear that a directory will be used by competitors to solicit their privately-held clients. Other members believe that a directory will be used to force firms into the division or the Section. The Board understands these concerns, even though it believes too much weight has been attached to them.

However, since the principal objectives of the division are improvement of the profession and protection of the public, we believe the public is entitled to know the identity of firms that are members of the division and the types of standards with which they must comply. Accordingly, we continue to feel that the identity of firms that are members of each section of the division should be made available to the public, by means of a directory or otherwise, as soon as practicable.

The Board believes that the large number of members in the Section and the high percentage of the nation's business that is audited by such members is sufficient to assure the ultimate success of the Section's program of self-regulation. Nevertheless, we are convinced that the public interest would be best served if all accounting firms that audit SEC registrants were members of the Section.

#### V. OVERALL SUMMARY AND CONCLUSIONS

After reviewing all aspects of the Section's program, we believe that the Section displayed continuing evidence in the past year of its commitment to self-regulation and has made substantial progress. In our view, the profession deserves commendation for its efforts in developing and making operational a truly unique program of self-regulation.

SECRET

COMPOSITION OF PUBLIC OVERSIGHT BOARD  
YEAR ENDING DECEMBER 31, 1981

<u>Member</u>	<u>Term Expires</u>	<u>Affiliation</u>
John J. McCloy Chairman	1983	Partner, Milbank, Tweed, Hadley & McCloy, New York
William L. Cary	1981	Professor of Law, Columbia University, New York
John D. Harper	1982	Former chairman of the board and chief executive officer of Aluminum Company of America
Robert K. Mautz	1981	Director of Paton Accounting Center and Professor of Accounting, University of Michigan
Arthur M. Wood	1982	Former chairman of the board and chief executive officer of Sears, Roebuck & Co.
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Richard A. Stark	Legal Counsel and Secretary to the Board and Counsel to Mr. McCloy	Partner, Milbank, Tweed, Hadley & McCloy, New York
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<u>Permanent Staff</u>		
Louis W. Matusiak	Executive Director	
Charles J. Evers	Technical Director	
David P. Boxer	Assistant Technical Director	
Alan H. Feldman	Assistant Technical Director	
Marcia E. Brown	Administrative Assistant	
Miriam Freilich	Secretary	
<hr/>		
<u>Supplemental Staff</u>		
Sidney M. Braudy	Retired, formerly with Main Lafrentz & Co.	
Adolph G. Lurie	Retired, formerly with Alexander Grant & Company	
John W. Nicholson	Retired, formerly with Arthur Young & Company	

PUBLIC OVERSIGHT BOARD  
 STATEMENT OF ACTUAL EXPENSES  
 FOR THE YEAR ENDING JULY 31, 1980  
 AND STATEMENT OF ESTIMATED EXPENSES  
 FOR THE YEAR ENDING JULY 31, 1981

	Actual Expenses for 12 Months Ending <u>July 31, 1980</u>	Estimated Expenses for 12 Months Ending <u>July 31, 1981</u>
Regular fees of Board members	\$166,667	\$165,000
Fees for professional services paid to firms of Board members	89,452	73,000
Reimbursement of expenses to Board members and their firms	15,398	20,000
Salaries of staff, including part-time reviewers	209,148	345,000
Other expenses:		
Personnel	29,080	50,000
Occupancy	30,123	33,000
Staff travel and related expenses	24,942	33,000
Printing and paper	10,224	8,000
General office expenses	<u>14,790</u>	<u>18,000</u>
Total other expenses	<u>109,159</u>	<u>142,000</u>
Total expenses	<u>\$589,824</u>	<u>\$745,000</u>

EXECUTIVE COMMITTEE  
SEC PRACTICE SECTION  
1980-1981

<u>Representative</u>	<u>Firm Affiliation</u>
Ray J. Groves, Chairman	*Ernst & Whinney
Peter Arnstein	John F. Forbes & Company
George L. Bernstein	*Laventhol & Horwath
T. Frank Booth	A. M. Pullen & Company
Iwan O. Bull	*McGladrey, Hendrickson & Co.
Robert M. Coffman	*Fox & Company
J. Michael Cook	*Deloitte Haskins & Sells
Mario J. Formichella	*Arthur Young & Company
W. Donald Georgen	*Touche Ross & Co.
Howard Groveman	*Alexander Grant & Company
William D. Hall	*Arthur Andersen & Co.
Raymond L. Hellmuth	Meahl, McNamara & Co.
Thomas L. Holton	*Peat, Marwick, Mitchell & Co.
William B. Keast	*Coopers & Lybrand
Charles E. Keller, III	Stoy, Malone & Company
Bernard Z. Lee	*Seidman & Seidman
Archibald E. MacKay	*Main Hurdman & Cranstoun
John J. van Benten	Geo. S. Olive & Co.
Bert B. Weinstein	Altschuler, Melvoin & Glasser
Gary J. Wolfe	Cherry, Bekaert & Holland
John W. Zick	*Price Waterhouse & Co.

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\* Firm entitled to permanent seat because firm audits 30 or more registrants under Section 12 of the Securities Exchange Act of 1934.

SEC PRACTICE SECTION  
PEER REVIEW COMMITTEE  
1980-1981

<u>Member</u>	<u>Firm Affiliation</u>
Joseph X. Loftus Chairman	Price Waterhouse & Co.
James R. Albano	Deloitte Haskins & Sells
John F. Barna	Peat, Marwick, Mitchell & Co.
Ernest E. Bartholomew	Arthur Young & Company
Clark C. Burritt	A. M. Pullen & Company
Robert S. Campbell	Thorsen, Campbell, Rolando & Lehne
Paul B. Clark, Jr.	Main Hurdman & Cranstoun
Robert W. Egnor	Coopers & Lybrand
Larry D. Ellison	Baird, Kurtz & Dobson
Robert E. Hammond	Ernst & Whinney
James I. Konkel	Touche Ross & Co.
Harry T. Magill	Arthur Andersen & Co.
Fred P. Mesch	Ray, Mesch & Company
William B. Nicol	Meaden & Moore
Michael A. Walker	Mann Judd Landau

SPECIAL INVESTIGATIONS COMMITTEE  
1980-1981

<u>Member</u>	<u>Firm Affiliation</u>
Rholan E. Larson Chairman	Larson, Allen, Weishair & Co.
Mark J. Feingold	Laventhol & Horwath
Edwin P. Fisher	Arthur Andersen & Co.
*Thomas B. Hogan	Deloitte Haskins & Sells
Harry L. Laing	A. M. Pullen & Company
*Leroy Layton	Main Hurdman & Cranstoun
John B. O'Hara	Price Waterhouse & Co.
*Leon P. Otkiss	Peat, Marwick, Mitchell & Co.
David Wentworth	McGladrey, Hendrickson & Co.

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\* Retired