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Public Oversight Board

Annual Report 1982-83

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

Public Oversight Board

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IN MEMORIAM

WILLIAM L. CARY

November 27, 1910 – February 7, 1983

The Members of the

PUBLIC OVERSIGHT BOARD

of the SEC Practice Section-AICPA

Present this Symbol of Appreciation

of

WILLIAM L. CARY

Whereas, in 1977, the Public Oversight Board was appointed to monitor and evaluate the activities of an enhanced program of self-regulation of the accounting profession through the American Institute of Certified Public Accountants, and

Whereas, for more than four years, your talent, vision and fine judgment have benefitted the accounting profession, the SEC Practice Section of the American Institute of Certified Public Accountants, and most particularly, the Public Oversight Board, and

Whereas, you played an instrumental role in formulating the Board's jurisdiction and operating policies and in formulating the Board's thoughts relative to the accounting profession's self-regulating program, and

Whereas, your sound reasoning, judgment and legal scholarship, as well as your wide experience, including that of former chairmanship of the Securities and Exchange Commission, were relied upon heavily by the Board in its decision-making process, and

Whereas, your ideas were invariably imaginative and provocative and it is with sincere regret that the Board accepts your decision to resign. Now, therefore, be it

Resolved: That the members of the Public Oversight Board individually and collectively express to you their deep appreciation for the efforts you expended in behalf of the Board's progress. Your service has earned you the admiration and affection of all your fellow Board members. Your contribution to the profession and to the Board will have continuing effect.

John J. McCloy

October 19, 1982

PUBLIC OVERSIGHT BOARD

SEC Practice Section • AICPA

540 Madison Avenue • New York 10022 • (212) 486-2448

June 30, 1983

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

It is my pleasure to transmit this fifth annual report of the Public Oversight Board. The fifth anniversary of the commencement of the accounting profession's self-regulatory program seems an appropriate time to present the Board's assessment of the program's accomplishments to date and identify some challenges that may lie ahead. Accordingly, this report summarizes not only the activities of the SEC Practice Section for the year ended June 30, 1983, but also the major events of the first five years of the program.

The past five years have constituted a learning experience for all who have been actively involved in the program. Among other things, we have gained an increased awareness of the sharp differences between governmental regulation and self-regulation. The accompanying report seeks to identify these differences and to comment on the proper objectives for the section's self-regulatory program.

The Board believes that the accounting profession deserves credit for the effective program which it now has in place. It will, of course, require constant refinement and attention to maintain and improve its quality and effectiveness.

Very truly yours,

John J. McCloy
Chairman

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ANNUAL REPORT

1982-1983

The SEC Practice Section and the Private Companies Practice Section constitute the Division for CPA Firms of the American Institute of Certified Public Accountants. The division was created in the fall of 1977 in response to a perceived need for a more effective self-regulatory program for the accounting profession. The Public Oversight Board was formed in 1978 to oversee the activities of the SEC Practice Section.

At the invitation of the Council of the Institute, John J. McCloy, Chairman of the Board, reported informally at the Council meeting on May 9, 1983 in Phoenix, Arizona, on the first five years of progress of the SEC section. The text of his address is set forth in Exhibit I.

This fifth annual report of the Public Oversight Board describes the activities of the SEC section during the period July 1, 1982 to June 30, 1983 and supplements Mr. McCloy's report by summarizing the section's accomplishments during its first five years.

OVERVIEW OF THE PROGRAM

The Role of the Board

The past five years have been a learning experience for all who have been actively involved in the operation of the self-regulatory program—an interesting, exciting and, at times, difficult but nevertheless productive experience. Three persons have served as Board members throughout this period—John J. McCloy as chairman, and Arthur M. Wood and John D. Harper as members. Mr. Wood currently serves as vice-chairman. The Board benefitted greatly from the contributions of two former SEC chairmen—Ray Garrett, Jr. and William L. Cary—who were charter members of the Board. Mr. Garrett died in 1980 while a member and Mr. Cary died in 1982 shortly after resigning because of illness. Robert K. Mautz, the first accountant to be appointed a member, joined the Board in 1981, and A. A. Sommer, Jr., a former SEC commissioner, was appointed in 1983. The current composition of the Board and its staff are shown in Exhibit II. Estimated expenses of the Board for the year ended July 31, 1983 are shown in Exhibit III.

The Board's primary function is to monitor and comment on the section's activities. From the beginning, the Board has taken the position that if the self-regulatory program is to be successful, all authority must be vested in the profession itself. The Board does not have line authority and desires none.

The Board discharges its responsibilities by meeting regularly with officials and committees responsible for the various components of the program, observing and reviewing the results of the peer review and special investigative processes, and periodically conferring with the commissioners and staff of the Securities and Exchange Commission. The SEC, charged by Congress with overseeing the practice of accountants before the commission, interacts with the accounting profession's self-regulatory program. The profession's self-regulatory program

supplements and complements the SEC's oversight program and must be viewed in concert with the other regulatory mechanisms in our society. The first five years of the program provided numerous opportunities for the section and the SEC to work together to coordinate their efforts and make their respective programs more efficient. As a result of the experience gained, both the section and the SEC have a clearer understanding today of what the program can reasonably be expected to accomplish.

The SEC has actively monitored and encouraged the self-regulatory program of the accounting profession. As indicated in its 1982 report to Congress (SEC Report), the SEC is placing increased reliance on the profession's program.[1] An excerpt of its 1982 report is set forth in Exhibit IV.

Differences Between Self-Regulation and Government Regulation

Perhaps the most valuable experience gained during the initial period has been a recognition that self-regulation is not a substitute for governmental regulation. The methods and objectives of a self-regulatory program are markedly different from those of a governmental regulatory agency. Recently, these differences were articulated by Board member Robert K. Mautz, whose article on the subject appeared in the *Journal of Accountancy* for May 1983 and is reproduced as Exhibit V.

Many persons, including some members of the profession and some governmental officials, equate self-regulation with governmental regulation or perceive self-regulation as a substitute for governmental regulation. Dr. Mautz points out that there is a general misunderstanding of what self-regulation entails and that such misunderstanding may be a significant impediment to the program in achieving the credibility it deserves. The effectiveness of a self-regulatory program should be measured by the merit of its objectives and the extent to which it achieves them, not by the extent to which it emulates governmental regulation. Governmental regulation emphasizes the deterrent effects of punishment and sanctions in dealing with inadequate performance. The accounting profession's self-regulatory program, particularly through the preventative measures of its peer review and special investigative processes, emphasizes corrective action to minimize the recurrence of inadequate performance and uses sanctions only to compel the undertaking of corrective action deemed necessary to protect the public interest. Some critics of self-regulation question its effectiveness and are likely to continue to do so as long as they expect it to emulate the governmental regulatory model. The profession should disabuse these critics of their unrealistic expectations.

Major Committees of the Section

The important work of the section is administered through its three major committees, the executive committee, peer review committee, and special investigations committee, whose membership is set forth in Exhibit VI.

[1] Securities and Exchange Commission, Annual Report, 1982, U.S. Government Accounting Office, Washington, D.C.

PEER REVIEW PROCESS

History of Peer Reviews

The peer review process is the foundation of the section's self-regulatory program. Through this process, the section determines whether member firms have, and are complying with, an appropriate quality control system in the performance of accounting and auditing engagements in a manner that gives reasonable assurance that professional standards are being met. By subjecting their accounting and auditing practices to peer review, member firms demonstrate their dedication to achieving and maintaining high quality professional practices.

In the relatively short period of five years since its inception, the section has developed an impressive peer review process and over four hundred SEC section firms have undergone one or two peer reviews.

The Board and its staff closely monitor the peer review process and believe that its emphasis on improving the quality control systems of members has produced results that are in the public's and the profession's best interests. Every peer review includes an examination of a reasonable cross-section of the reviewed firm's accounting and auditing engagements and, in multioffice firms, a representative number of practice offices. Peer review has assisted member firms in improving the quality of their accounting and auditing practices, thereby reducing the possibility of future audit failure. It must be noted, however, that peer reviewers examine only a sample of the firm's engagements and thus an unqualified peer review report is not to be construed as a guarantee that the firm has performed all engagements, and will perform all future engagements, in accordance with professional standards.

The SEC recognizes the positive impact that the peer review process has on the quality of audit practice. The SEC Report[2] comments on the efficacy of peer review as follows: "If and when audit failures occur, the commission expects they will be due to isolated breakdowns or 'people problems,' and not to inherent deficiencies in firms' systems of quality control."

Improvements in Quality of Practice by Member Firms

Most firms are determined by peer reviewers to have effective systems of quality control. However, many reviewers identify areas where improvements are suggested and, in some cases, required. In those circumstances, in addition to the report on the peer review, the reviewer issues a letter of comments identifying areas that could be strengthened. The peer review committee reviews all reports, letters of comments, and the related corrective action plans filed by reviewed firms, and it evaluates each firm's corrective action plan to eliminate weaknesses in its controls or to assure greater compliance with its policies and procedures. The committee requires candor in reporting and aggressively pursues engagements deemed not to have been performed in accordance with professional standards. After the committee concludes that the review was performed and reported on in accordance with the section's standards and that appropriate actions are being taken by the firm, it places all these documents in a file available to the public on request. A summary of the types of reports issued during the first five years of the program is shown in Table 1.

[2] Securities and Exchange Commission, op. cit.

TABLE 1

SUMMARY OF TYPES OF PEER REVIEW REPORTS ISSUED DURING FIRST FIVE YEARS OF THE PROGRAM

	Total	Review Year 1982	1981	1980	1979	1978
Firms receiving unqualified report without letter of comments	34	5	16	9	2	2
Firms receiving unqualified report and letter of comments	360	63	152	109	28	8
Firms receiving modified report*	63	3	27	24	8	1
Firms receiving adverse report*	13	–	8	3	2	–
	470	71	203	145	40	11

* Thirty-five reports were adverse or modified for more than one reason. The reasons cited were:

Inadequate documentation or noncompliance in a designated area of quality control:	
Supervision	43
Inspection	41
Consultation	4
Independence	4
Advancement	4
Assignment of Personnel	1
	97
Noncompliance with other membership requirements:	
Concurring partner review	14
Continuing professional education	9
Liability insurance	6
Other	2
	31

Additional Requirements Imposed by Committee

The committee has the authority to recommend that the executive committee impose a sanction if a firm's quality control system cannot be relied on and the firm refuses to make the corrections deemed necessary. Although the committee has not as yet exercised this authority, it has required some firms to comply with rather severe additional requirements when their quality control systems were deemed to be materially deficient. Since these requirements were voluntarily agreed to by the firms, they have not been classified as sanctions, even though they achieved the same objective.

To date, the committee has required thirty firms to permit a revisit by the peer reviewer or an alternate to determine whether the firm had taken appropriate corrective action. Twenty-two firms agreed, as a condition of continued membership, to undergo an accelerated full scope peer review, i.e., a review in the next year or two rather than in the third year. To date, ten of the firms that previously received highly modified or adverse reports have had their revised quality control systems subjected to peer review. These subsequent reviews ascertained that each of these firms improved its practice substantially, eight to such an extent that they received unqualified reports. Twelve firms were allowed sufficient time to implement corrective action and accordingly their reviews are scheduled for the latter half of 1983. Two firms withdrew rather than undergo an accelerated review. In all these situations, correspondence between the committee and reviewed firms detailing these additional requirements is placed in the public file. Table 2 provides additional information.

TABLE 2

SUMMARY OF COMMITTEE ACTIONS TO ASSURE QUALITY CONTROL IMPROVEMENTS IN CONNECTION WITH PEER REVIEWS DURING THE FIVE YEARS ENDED JUNE 30, 1983

Type of Report/Action of the Committee	Review Year					
	Total	1982	1981	1980	1979	1978
Firms receiving adverse report						
Accelerated peer review	12	–	7	3	2	–
Revisit by peer reviewer	1	–	1	–	–	–
Firms receiving modified report						
Accelerated peer review	13	1	6	5	1	–
Revisit by peer reviewer	9	–	5	4	–	–
Firms receiving unqualified report and letter of comments						
Revisit by peer reviewer	6	2	3	1	–	–
Total reviews where corrective actions were required as a condition of continued membership	41	3	22	13	3	–

The SEC Report commented on the committee's practice of imposing additional requirements as follows:

> "The commission concurs in the POB's belief that this informal process gives the SECPS the ability to act promptly and achieves the same result as the imposition of a sanction. The formal sanction process remains available and should be used when mandatory corrective measures are not undertaken promptly or where a member chooses not to cooperate."

Substandard Performance on Individual Engagements

While the thrust of peer review is to identify and correct deficiencies in a firm's system of quality control, the process also deals with instances of substandard auditing or accounting performance on individual engagements, which are required to be reported promptly to the committee. During 1981 and 1982, peer reviewers reviewed the financial statements, reports, and workpapers for more than nineteen hundred audit engagements. Sixty-one of these engagements were deemed to be substandard in the application of generally accepted accounting principles (GAAP) or generally accepted auditing standards (GAAS). In approximately thirty-six percent of the cases in which the financial statements were not in accordance with GAAP, the reviewed firm immediately recalled its report, and the financial statements were reissued. The remaining cases generally involved reports given limited distribution and did not require immediate recall; however, the firms agreed to cause the deficiencies to be corrected in the subsequent year's report.

In each instance where the peer reviewers concluded that the audit had not been performed in accordance with GAAS, the firm either immediately performed the omitted procedures or agreed to perform the procedures in a subsequent imminent audit. Table 3 summarizes the actions taken by the firms in connection with engagements found not to have been performed in accordance with professional standards.

TABLE 3

SUBSTANDARD AUDIT ENGAGEMENTS IN PEER REVIEWS PERFORMED IN 1982 AND 1981

Corrective Action Required by Committee	Total	1982	1981
Audit report recalled and financial statements revised and reissued	14	4	10
Omitted auditing procedures performed	7	4	3
Cause of impairment of independence eliminated	3	–	3
GAAP and GAAS deficiencies not requiring immediate action to be corrected in subsequent year's audit	37	6	31
Number of audit engagements considered substandard by peer reviewers	61	14	47
Number of audit engagements reviewed	1,919	584	1,335
Percent	3.2%	2.4%	3.5%

Modification of Peer Review Standards and Procedures

The peer review process is being modified as experience is gained. The committee recently revised its manual and updated its codification of standards for performing and reporting on peer reviews.This codification incorporates many of the suggestions made by the POB staff and the SEC staff. For example, beginning with 1983 reviews, reviewers are given more specific guidance in selecting for review a representative sample of audit work performed by other offices under the supervision of the office primarily responsible for the overall engagement. If a firm has multioffice engagements, the reviewer must now review for at least one such engagement the workpapers prepared by the primary office and at least one other office performing a significant segment of that engagement.

New procedures were adopted to further expedite completion of peer reviews. As previously reported, during the initial years of the peer review process, many reviews were completed much later than planned. Each member firm is now required to submit to the peer review committee its peer review report, letter of comments and response no later than thirty days after issuance of the report and letter of comments. Failure to do so could lead to the imposition of a sanction. In addition, a reviewer failing to complete and report on a review in a timely, professional manner could be subject to disciplinary action. Review procedures also require reviewers to consult immediately with the committee when instances of materially substandard performance are identified, thereby expediting committee involvement and facilitating timely resolution of such matters. Vigorous enforcement of these procedures will improve the pace of processing reports and the timeliness of corrective action.

Experience has permitted other efficiencies in the process to be adopted. For example, standards now permit a reviewer, who after appropriate testing concludes that he can rely on the reviewed firm's inspection program, to use inspection findings along with peer review findings as a basis for his report. By so doing, the reviewer reduces the number of offices and the number of engagements he personally reviews, thus substantially reducing the cost of peer review.

Elimination of the Quality Control Review Panel

A peer review can be conducted by a team appointed by the section's peer review committee, by a team or firm appointed by an association whose plan for administering reviews has been approved by the peer review committee, or by another member firm selected by the firm to be reviewed.

Prior to 1982, at the insistence of the SEC, a panel was assigned to each peer review conducted by another firm or administered by an association of CPA firms. The panel's responsibility was to issue an independent opinion on the quality control system of the reviewed firm. The procedures and the report of the panel, in essence,duplicated those of the primary reviewer. Based on a study conducted by the Board's staff to evaluate the cost effectiveness of the panel, the Board recommended that the panel be eliminated. The section accepted and implemented the Board's recommendation and the SEC did not object.

The Board is confident that elimination of the panel has not impaired the effectiveness of the process. As a transitional procedure, members of the committee performed preissuance reviews on a sample of 1982 firm-on-firm and association reviews. Evaluation of the results of the transitional procedure indicated that preissuance review procedures were unnecessary,

primarily because they were duplicative of oversight procedures conducted by the Board's staff. Consequently, beginning with 1983 reviews, the committee performs preissuance review procedures only on a case-by-case basis upon recommendations of its chairman or staff. The Board concurs with this decision.

Oversight of the Process

Because of the importance of peer review in the overall self-regulatory program, the Board and its staff devote a significant amount of time to monitoring all aspects of the process. The staff attends all meetings of the committee and, at its discretion, attends most meetings of the committee's subcommittees and task forces. The Board's views are generally sought on all proposed changes in the peer review process and its comments on individual peer reviews are considered by the committee in deciding whether the review was performed in accordance with prescribed standards.

As in each of the preceding years, during 1982-83 the Board continued its policy of monitoring all reviews. It observed reviews in process on all firms with five or more SEC clients and, on a random sample basis, a number of other firms with fewer than five SEC clients and a representative number of firms with no SEC clients. Details are shown in Table 4.

TABLE 4
SCOPE OF BOARD OVERSIGHT OF 1982 PEER REVIEWS

	Number of Firms by Number of SEC Clients				
	30 or more	5 to 29	1 to 4	None	Total
Visitation and workpaper review	4	3	14	9	30
Workpaper review	–	–	8	24	32
Report review	–	–	–	12	12
Total	4	3	22	45	74

The SEC independently evaluates the peer review process including the effectiveness of Board oversight. The SEC conducts an independent inspection of a sample of peer reviewer workpapers and Board oversight workpapers under an arrangement agreed to by the section. All workpapers are masked so as not to reveal the identity of individual clients. Under a 1982 modification of that arrangement, workpapers relating to firms with fewer than ten SEC clients are masked to conceal the identity of the reviewed firm in order to reduce further the possibility of client identification.

The SEC continues to have a high level of interest in the program and has actively supported it by both constructive suggestions and public endorsement. Based on its inspection of 1982 peer review workpapers, as described above, the SEC has again expressed satisfaction with the peer review process and the effectiveness of the Board's oversight procedures. The SEC Report states that "the Commission has determined that it can rely to a great extent on the POB's oversight function in fulfilling its own oversight responsibilities."[3]

SPECIAL INVESTIGATIVE PROCESS

Member firms are required to report to the special investigations committee each litigation and proceeding (case) against them or members of their firms involving allegations of failure in the conduct of an audit of the financial statements of an SEC registrant. The committee determines whether such allegations indicate a need for improvements in the quality control systems of such firms or whether changes in professional standards are required.

Objectives of the Process

Investigation of a firm's quality control system supplements the peer review process as a means of protecting users of financial statements. Unlike governmental regulation, which focuses on an alleged audit failure as a matter deserving possible punitive action, the committee's investigative process focuses on reducing the possibility of future failures. It does so by (1) identifying deficiencies in the auditing firm's quality control system that may have permitted the alleged deficiency to occur and (2) causing such deficiencies to be corrected. The special investigative process protects the public by reducing the likelihood of a recurrence through remedy and improvement.

Operation of the Committee

One or two committee members are assigned to each reported case, and each case is subjected to one or more of four levels of examination: screening, monitoring, investigating certain aspects of the firm's quality control system, and investigating the specific alleged audit failure.

During screening, the committee considers whether the charges regarding possible audit failure appear to have substance. In some cases, a mere reading of the complaint and the financial statements to which it relates permit the committee to conclude that allegations are without merit. In other cases, the preliminary review needs to be supplemented by a discussion of the allegations with representatives of the auditing firm and a review of the findings of the firm's most recent peer review.

If the results of the screening process warrant, the committee monitors the case in order to follow and evaluate future developments. For example, a case may be monitored pending the results of a peer review in process, issuance of a bankruptcy trustee's report or further discussion with firm representatives.

[3] Securities and Exchange Commission, op. cit.

If the committee concludes that a failure in the firm's quality control system may have occurred and there is a reasonable possibility for a recurrence, it conducts an investigation of the relevant aspects of the firm's quality control system. If the findings of the investigation warrant, it requires the firm to amend its quality control policies and procedures accordingly.

Status of Reported Cases

Since the inception of the special investigative process in November 1979, sixty-six cases of alleged audit failure involving SEC registrants have been reported. In addition, the committee obtained the consent of the firms involved to add to its agenda two cases involving non-SEC registrants.

The committee has closed its files on forty-three cases. Of these, twenty-eight were closed after being screened, twelve after being monitored, and three after an investigation of the firm had been conducted. Of the remaining cases, thirteen are being screened, ten are being monitored, and two cases involving the same firm are being investigated. A summary of committee activity is shown in Table 5.

TABLE 5
SPECIAL INVESTIGATIONS COMMITTEE ACTIVITY FOR THE PERIOD FROM NOVEMBER 1, 1979 (INCEPTION) THROUGH JUNE 30, 1983

	Screening	Monitoring	Investigation of Firm
Cases reported by member firms	68		
Action taken:			
Determined that developments should be monitored	(25)	25	
Authorized an investigation	(2)	(3)	5*
Closed the case	(28)	(12)	(3)
Status of cases at June 30, 1983	13	10	2

* Two cases involve one firm.

Investigations of Firms

To date, the committee has conducted investigations of selected aspects of the quality control systems of four member firms. The committee dictated the scope of and supervised the conduct of each of the investigations that were performed either by the investigated firm's previous peer reviewer or by a special task force. These investigative teams generally examined other engagements supervised by personnel involved in the alleged failure and engagements in

similar industries and with similar accounting and auditing issues to those involved in the reported litigation. Findings of the investigations were reviewed by one or more committee members assigned to the investigation and discussed by the full committee. Three of the four investigations resulted in recommendations for improvement in the firm's quality control system or compliance therewith, all of which were voluntarily implemented by each of the firms. The files on three of the investigations have been closed, but the committee is keeping its file open on the fourth investigation pending the receipt of the findings of an ongoing review to determine whether the suggested improvements have in fact been implemented. None of the four investigations resulted in discovery of a deficiency in the firm's quality control system so major that the imposition of a sanction was warranted.

Investigations of Alleged Audit Failures

Although the committee's charter document provides that it may, with prior executive committee approval, investigate a specific alleged audit failure prior to completion of litigation, the conduct of such an investigation has not yet occurred and it is expected that such an investigation rarely will be necessary. The Board believes that the committee's authority to investigate a specific alleged audit failure should continue. However, this action should be reserved for limited situations such as ascertaining whether there is a deficiency in a firm's quality control system or in generally accepted auditing standards that cannot be ascertained by other means.

Certain practical limitations affect the committee's ability to conduct an investigation of a specific alleged failure. In fact, the capacity of the committee to conduct an investigation is far more limited than that of private litigants or the SEC. For example, it cannot take testimony of witnesses under oath and it cannot subpoena documents or witnesses. It must rely on the willingness of the audit firm to supply evidence. Hence, were it to pass judgment on a firm or an individual in connection with an alleged audit failure, it would not have as firm a basis for that judgment as would the SEC or a court. The danger of an unfair result would be significant. Compounding the problem is the fact that private litigants might then use this conclusion, founded on an insufficient record, as evidence in civil litigation.

Since the primary objective of the special investigative process is preventive and not punitive, the committee can accomplish its objective effectively by conducting an investigation of the firm's quality control system without the risks inherent in an investigation of the specific alleged audit failure.

The Board believes that the special investigative process has no need to duplicate the work of the SEC or the civil courts. Rather, the committee's responsibility is (1) to determine whether charges in litigation or other proceedings involving audit performance indicate that there are insufficiencies in auditing standards or the quality controls of the auditing firm that require remedial action and (2) to ascertain that such remedial action is taken so that whatever gave rise to the charges should not again be the source of problems.

Procedures

During its entire three-year existence, the committee has continuously improved its operational procedures. In a typical case, committee members read the complaint and other

publicly available materials. In addition, committee members routinely interview firm representatives with respect to the allegations, quality controls in areas of the alleged audit failure, the present responsibilities of the personnel involved in the litigation and the date of the last peer review or internal inspection of the office and partner involved in the litigation. The committee members may also interview the firm's most recent peer reviewer and examine peer review workpapers and reports to gain a better understanding of the firm's quality control policies and procedures and general compliance therewith.

The committee, with the cooperation of the firms involved, has actively pursued the quality control implications of each reported alleged audit failure. In this connection, during the past year the committee members (1) met with firm representatives on twenty-one cases to discuss the allegations and the firm's relevant quality control policies and procedures, (2) read peer review reports and selected workpapers on all firms involved in litigation, made an extensive review of workpapers on five occasions, and met with the firm's peer reviewer on three occasions, (3) obtained advice on accounting and auditing issues from authoritative sources within the Institute, and (4) reviewed reports of investigations concerning reported cases conducted by public bodies.

Before the committee authorizes an investigation of a firm or recommends an investigation of a specific alleged audit failure, the firm's representatives are invited to appear before the committee to present their views on the matter and respond to committee questions.

The committee uses internal guidelines to provide a consistent basis for reviewing and deciding upon action to be taken with regard to reported litigation. These guidelines are not rules that are rigidly followed, but they assist the committee in its decision-making process and reflect the practices that have evolved during the committee's three-year existence.

Confidentiality of Committee Actions

The Board and its staff believe the committee's actions to date constitute an aggressive self-regulation effort of which, unfortunately, the public is largely unaware. However, rules require that the committee conduct its affairs in privacy, beyond the glare of publicity and without public disclosure, except in extreme and unusual cases. This requirement of privacy is not to shield members of the profession or deny the public information it is entitled to have. The section considers privacy essential to allow the committee to operate effectively and to avoid prejudicing a member firm while litigation is in process. The Board is not insensitive to suggestions that means be found to ease the restraints of privacy now surrounding the committee's activities. The Board, however, opposes any such action that would unfairly prejudice the rights of any firm or deny any firm the opportunity to answer charges in the forum provided by law, which permits them as well as their adversaries full access to the evidence necessary to assure that justice is done.

Board Oversight of 1982-83 Activities

Since the Board's last report, the committee has held nine meetings, and committee members assigned to specific cases under investigation have each held several meetings with personnel of the firms involved. Members of the Board and its staff attended most of these meetings.

The Board has complete access to all committee files and actively monitors the committee's decisions on individual cases. The Board's staff reads the pertinent court documents, financial information, and correspondence related to reported cases, and it attends, at its discretion, meetings between firm representatives and committee members. In addition, the staff reviews the committee's workpapers on all investigations.

The Board concurs with the direction and thrust of the special investigative process and believes the process is functioning effectively.

Board Liaison with the SEC

The Board and its staff meet periodically with the chairman and staff members of the SEC to discuss the various aspects of the self-regulatory program. In these meetings, operating under the privacy requirement imposed on the special investigative process, the section and the Board have attempted to provide sufficient information to the SEC so as to permit it to have confidence in the effectiveness of the process and the Board's oversight thereof. However, the SEC believes that it needs additional information to reach an independent conclusion regarding the special investigative process. Exploratory discussions between the section, the SEC, and the Board are continuing; in the long run, the Board hopes to persuade the SEC to rely to a large degree upon the Board's oversight of the special investigative process.

SECTION MEMBERSHIP

Almost 1,700 firms belong to the division for CPA firms; 426 belong to both the private companies and SEC sections and 1,259 belong only to the private companies section. Member firms represent approximately 3,800 practice units, 16,500 partners, and 100,000 professional staff members. While the number of member firms decreased during the past year, the number of SEC clients audited by member firms and the number of professionals employed by member firms both increased during the past year. Details are shown in Table 6.

TABLE 6
ANALYSIS OF MEMBERSHIP IN THE DIVISION FOR CPA FIRMS JUNE 30, 1982 AND JUNE 30, 1983

	Both Sections			SEC Section		
Classification	1982	1983	Increase (Decrease)	1982	1983	Increase (Decrease)
Number of firms	1,882	1,685	(197)	428	426	(2)
Number of SEC clients	9,865	10,330	465	9,618	10,147	529
Number of practice units	3,986	3,771	(215)	1,941	1,957	16
Number of professionals	99,398	100,024	626	79,548	83,925	4,377

Auditors of Publicly-traded Companies

Firms that are members of the division continue to have a significant impact on the quality of audits of publicly-traded companies. Three hundred eleven member firms audit 87 percent of all public companies listed in the ninth edition of *Who Audits America.*[4] As shown in Table 7, these companies account for over 98 percent of the combined sales volume of all publicly-traded companies.

TABLE 7

ANALYSIS OF FIRMS THAT AUDIT PUBLICLY-TRADED COMPANIES* LISTED IN THE NINTH EDITION OF WHO AUDITS AMERICA

	SEC Registrants		Annual Sales** (Millions)	
	Number	Percent	Dollar	Percent
Companies audited by members of the division for CPA Firms				
By the eight largest firms	5,959	70.0%	$3,568,045	96.1%
By other firms	1,265	14.9	92,316	2.5
By firms that are members only of PCPS	148	1.7	2,135	.1
Total	7,372	86.6%	$3,662,496	98.7%
Companies audited by foreign firms	64	.7	34,957	.9
Companies whose auditors are not identified	154	1.8	4,917	.1
Companies audited by U.S. firms not members of the division	924	10.9	11,710	.3
	8,514	100%	$3,714,080	100%

* Does not include the following types of companies filing with the SEC: limited partnerships, employee stock option plans, smaller companies in various stages of bankruptcy, etc.

** Annual sales of less than $1 million are not reported in *Who Audits America.* Sales of each such company are estimated at $500 thousand in the above analysis.

[4] *Who Audits America*, 9th ed. (Menlo Park, Calif.: Data Financial Press, 1982.)

Members of the division audit all but three of the U.S. companies whose stocks are listed on the New York Stock Exchange and all but twenty-four of the U.S. companies listed on the American Stock Exchange.

Membership Promotion

While the statistics cited above are impressive, a broader base of membership is needed to provide the public with the full benefits of the self-regulatory program. Division membership now stands at 1,685 firms, down from a high of 2,200 firms in 1980. SEC section membership is 426 firms, down from a high of 579 firms in 1979. While membership in the SEC section remained relatively constant during the twelve months ended June 30, 1983, membership in the private companies section decreased by 195. Table 8 presents an analysis of membership as of June 30, 1983, and changes in membership for the year then ended. It should be noted that mergers among member firms account for a decrease of thirty-nine member firms.

TABLE 8

ANALYSIS OF MEMBERSHIP IN THE DIVISION FOP CPA FIRMS BY NUMBER OF SEC CLIENTS AND BY SECTION JUNE 30, 1982 TO JUNE 30, 1983

Number of Firms by Number of SEC Clients	June 30, 1982	New Members	Resignations	Mergers	Terminations	Classification Changes—Net	June 30, 1983
Five or more SEC clients							
Both sections or SECPS only	45	–	–	(1)	–	(1)	43
PCPS only	1	–	–	–	–	2	3
One to four SEC clients							
Both sections or SECPS only	160	12	(13)	(6)	–	1	154
PCPS only	115	25	(22)	(1)	(2)	1	116
No SEC clients							
Both sections or SECPS only	223	41	(28)	(6)	(1)	–	229
PCPS only	1,338	153	(278)	(25)	(45)	(3)	1,140
Totals							
Both sections or SECPS only	428	53	(41)	(13)	(1)	–	426
PCPS only	1,454	178	(300)	(26)	(47)	–	1,259
Grand Totals	1,882	231	(341)	(39)	(48)	–	1,685

While the self-regulatory objectives of both sections are similar, the SEC section has an additional goal, i.e., to improve the quality of practice before the Securities and Exchange Commission. Consistent with that goal, the section has established certain additional membership requirements.

One hundred nineteen firms that audit SEC clients are members of the private companies section only; these firms audit 183 SEC registrants. The Board believes that every firm that audits one or more SEC clients should join the SEC section and the SEC in its 1982 report expressed the same view.

Impediments to Increasing Membership

The Board believes it is important that the division identify and eliminate to the greatest extent possible the causes for attrition and the impediments to attracting new members. In 1982, the division engaged a research firm to determine the attitudes of members and nonmembers about the division and the factors that might motivate members to join either or both sections. That study revealed that the overwhelming majority of members and nonmembers support the division, seeing it as "a forward step for the profession and an opportunity to minimize government interference and regulation."[5]

While the survey indicated satisfaction with the improvement in the quality of practice of member firms resulting from the peer review process, it revealed several perceived impediments to membership. The reasons most frequently cited by nonmember firms were that the cost of peer review is not offset by commensurate benefits and services and that the accomplishments of the division are virtually unknown outside the profession.

Cost of Peer Review

The cost/benefit of peer review has received a great deal of attention since the inception of the program. While it is difficult to generalize because of the wide differences in size and profile of practices among member firms, the cost of most peer reviews is generally less than one percent of one year's accounting and auditing fees. This is an expense incurred only once every three years. When the benefits of peer review in terms of improved professional competence and performance are balanced against cost figures of this sort, the Board questions whether cost is the real issue.

One commentator, knowledgeable about the program, recently cited fear of not passing peer review as a key impediment to the growth in membership.[6] If that is the case, and the Board suspects it may be, it should be made clear to nonmember firms that the primary purpose of peer review is to help firms improve their performance. Commenting on the value of peer review, the SEC Report observes: "In a sense, peer reviews 'should pay for themselves' by reducing auditors' risks of liability to those who rely on their audits."

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[5] Hill and Knowlton. *Member Services Assessment: Findings and Observations* (Confidential and Proprietary Study Performed for the AICPA, September 1982).

[6] Clint Romig, "Peer Review Key to Continuing Professional Standards Says Louisiana CPA," *Public Accounting Report*, vol. VI, no. 4, April 1983.

Nevertheless, the Board recognizes that cost of peer review may be perceived as exceeding its benefits and thus may be a deterrent to membership. The Board continues to support any reasonable means to reduce the cost of peer review, provided they do not dilute or appear to dilute the effectiveness of the process.

Over the course of the past five years, many suggestions have been made to reduce the cost of peer review. Some have been implemented, including the elimination of the quality control review panel and reliance on a firm's inspection program to reduce the scope of its peer review, both of which have been discussed previously. Other cost reduction suggestions have been rejected, notably that the three-year peer review cycle be extended and that an alternating cycle of full-scope/limited-scope review be adopted. The Board concurs with the section's rejection of these two proposals because it believes that they would have decreased, or would have been perceived to have decreased, the effectiveness of the process.

Need for a Public Relations Program

During 1982, the division published its first directory of member firms. While this was an important first step in public relations, the Board believes that the subject of education and public relations merits urgent attention.

As an independent study revealed, both member and nonmember firms believe that the public has not been made aware of the importance or meaning of membership in the division.[7] Consequently, nonmember firms experience little, if any, external or internal pressure to join.

As Chairman McCloy stated in his address to the Institute's Council, the Board believes that bankers, financial analysts, and businessmen in general are not sufficiently aware of the self-regulatory program.[8] They do not know what the peer review process is about or what it has accomplished. In the past, it seemed premature to advertise a program while it was still being developed. Now that both the peer review and special investigative processes are operational, it seems apparent that the program has reached a stage at which it can be presented with pride as an accomplished fact.

Efforts to inform users of financial statements and others about this program appear to offer many rewards. Not only would such efforts improve the credibility of the profession, but they might also increase membership. If public awareness were increased, some firms that now are unwilling to incur peer review costs and meet other membership requirements would likely find it in their best interests to do so. This in turn would increase the effectiveness of the program.

It should also be possible to educate nonmembers and the public about the differences between self-regulation and governmental regulation, and point out that self-regulation emphasizes preventive and corrective rather than punitive action.

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[7] Hill and Knowlton, op. cit.

[8] See Exhibit I.

There have been suggestions that the SEC might require disclosure in proxy statements regarding whether the registrant's auditor is a member of the division or is otherwise subject to peer review.[9] This might be effective in increasing membership, but it is a step away from self-regulation, since it depends on action by a government agency. Also it would only affect auditors of SEC registrants. The Board would prefer to see the profession address its membership problem by means other than seeking government action.

Performance of MAS Engagements for SEC Audit Clients

At the request of the executive committee, in May 1978, the Board undertook a major study of the "scope of services" issue. A variety of views were received in comment letters and in testimony at a two-day public hearing on the question of whether an auditor who provides management advisory services (MAS) to an audit client impairs his ability to render an independent opinion on the fairness of that client's financial statements. In June 1978, the SEC released Accounting Series Release no. 250 which required disclosure in proxy statements of all non-audit services furnished by a registrant's auditor and of the percentage relationship of such fees to audit fees.

The Board reported its findings in June 1979[10] and recommended, among other things, that peer reviewers review MAS engagements performed for audit clients to test for compliance with independence standards, and that members annually report to the section selected information about fees for MAS and tax services for SEC clients. The executive committee implemented all of the Board's recommendations.

When the SEC rescinded ASR no. 250 in January 1982, member firms were required to report to the section additional information regarding management advisory services engagements performed for SEC registrants that are also audit clients of the firm. The Board monitors the information so reported.

The Board continues to believe that audit committees and boards of directors should review and determine what effect the performance of MAS engagements has on the independence of their auditors. Section members are required to provide audit committees or boards of directors of their SEC clients information concerning MAS services notwithstanding rescission of ASR no. 250. Based on its oversight of peer reviews, the Board is satisfied that member firms are complying with the requirements. Furthermore, MAS engagements performed for SEC registrants are considered by peer reviewers in selection of audit engagements to be reviewed, and peer reviewers also ascertain whether the role played by the firm in the performance of MAS engagements impairs its independence as an auditor. The Board has seen no evidence to cause it to believe that the magnitude or the nature of MAS engagements being performed is impairing the independence of member firms.

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[9] Harold M. Williams, *The 1980s: The Future of the Accounting Profession*, An address before the AICPA Seventh National Conference on Current SEC Developments, January 3, 1980, Washington, D.C.

[10] Public Oversight Board, *Scope of Services by CPA Firms*, (New York: AICPA, 1979).

CONCLUSIONS

The division deserves to be commended for its accomplishments in fostering the highest quality of auditing and accounting practice by its member firms. Yet, those accomplishments are virtually unknown by either the public that benefits most from them or significant segments of the profession itself.

The public is not aware that the peer review and special investigative processes materially reduce the potential for audit failure. In the opinion of the Board, these two important aspects of the program have in fact reduced the number of audit failures by fostering and improving quality control systems of firms belonging to the division. The Board believes that those who doubt the objectivity of the section's peer review and special investigative processes would be favorably impressed if they were made more aware of how these processes operate and what they have accomplished. The accounting profession needs to dispel the erroneous assumption held by some segments of the public and by some in government that every business failure is also an audit failure. An education program should serve to heighten public confidence in the accounting profession at a time when business failures have triggered litigation against auditors who reported on financial statements of businesses that subsequently failed.

A final note. While the profession can be justly proud of the significant progress it has made in the short span of five years, it must guard against a spirit of complacency and a human tendency to backslide. As Chairman McCloy stated in his address to the 1983 spring meeting of Council of the AICPA:

> "The accounting profession's self-regulatory program has made a promising start—indeed a rather spectacular one. I believe the POB is justified in placing real confidence in it. Confidence-inspiring features lie mainly in the vigor and motivation with which its progress has been marked.
>
> But, the program has not yet won laurels on which it can confidently rest or be complacent. There is a need for constant reexamination of the program's objectives and the profession's dedication to their achievement."

EXHIBITS

Address by Public Oversight Board Chairman John J. McCloy to AICPA Council, May 9, 1983.

Accomplishments of the SECPS: the POB's assessment

Over five years have passed since the first meeting of the public oversight board (POB), which took place in March 1978. The POB oversees the SEC practice section (SECPS) of the American Institute of CPAs division for CPA firms. In this adaptation of POB Chairman John J. McCloy's *address at the AICPA council meeting in Phoenix, Arizona, last May, McCloy reports on the achievements to date of the SECPS's self-regulatory program and the challenges that lie ahead.*

The public oversight board (POB) was created to do what its name implies—oversee the self-regulatory program of the SEC practice section (SECPS) of the American Institute of CPAs division for CPA firms. It was to be composed of five individuals whose backgrounds, experience and judgment would enable them to bring objectivity to the accounting profession's self-regulatory program. The conduct of the program is the responsibility of the profession itself, but this independent board, composed mainly of nonaccountants, represents the interests of the public, i.e., the users of financial statements, and at the same time assists the profession in seeking to achieve a constantly improving quality of professional services.

First, a few words about the composition of the POB. Three of us have been members of the board since the inception of the program. Besides myself, two former chief executives of major companies, Arthur M. Wood and John D. Harper, have completed five years of service. I am a lawyer and former chief executive of a bank. Two former Securities and Exchange Commission chairmen, Ray Garrett, Jr., and William L. Cary, completed our initial five-man board. Ray Garrett and Bill Cary made outstanding contributions not only in the formation of the board's initial policies and procedures but also in formulating practical means for overcoming some of its early problems. For example, Ray Garrett chaired the two-day public hearing the board held on the scope of services question and was the chief author of the board's report on the subject.[1] Unfortunately, both of these distinguished and experienced men have since died. They were replaced in 1981 by Robert K. Mautz, a member of the accounting profession and a recipient of the Institute's gold medal, and in 1983 by A. A. Sommer, Jr., a lawyer, a former SEC commissioner and a former member of the Institute's board of directors. The POB is capably assisted by Louis Matusiak, who has been our executive director since the beginning, and three full-time CPA staff members as well as a number of part-time retired accountants who assist in monitoring the peer review process.

The board does not have and does not wish to exert line responsibility.

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The program would not be self-regulatory if it did. From the beginning we have subscribed to the view that all authority must be vested in the profession. We can oversee, comment, suggest and point out; we cannot order or demand.

The board and its staff are actively involved, however, in all aspects of the self-regulatory program. We try to attend all meetings of every committee of the section; we also consult on request with the SECPS executive committee on emerging issues, review every peer review of a member firm, attend exit conferences held at the conclusion of peer reviews, review the work of investigative teams appointed by the section's special investigations committee (SIC) and periodically confer with the commissioners and staff of the SEC. On one occasion we testified before a congressional committee.

I am pleased to report that the SEC supports the section's program. Chairman John S. R. Shad, like his predecessor, Harold M. Williams, has publicly complimented the program, and Chief Accountant A. Clarence Sampson's constructive suggestions have helped the section find solutions to some of its more difficult problems. In the early stages there was apprehension in some quarters of the profession that the SEC might seek to impose itself on the section in a harmful way. To the credit of the leadership of both the SEC and the section, this hasn't happened. There exists now a healthy liaison, in part through section officers and Institute staff members and in part through the POB, that I believe well serves the respective interests.

While the POB has oversight responsibility for only the SECPS, members of the board are kept informed of the major developments in the private companies practice section (PCPS) as well. We understand that the PCPS has objectives, requirements and a peer review process very similar to those of the SECPS. In our view, member firms of both sections deserve much credit for their commitment to the improvement of the quality of accounting and auditing practice.

Peer review

The foundation of the accounting profession's self-regulatory effort is the peer review process. The year 1983 marks the completion of the second three-year cycle of peer reviews in the SECPS—more than 400 member firms have undergone peer review. In addition, more than 1,100 firms that belong only to the PCPS will have been reviewed before this year is out.

By subjecting their accounting and auditing practices to peer review, member firms demonstrate their dedication to achieving high-quality professional service. The board has established a comprehensive program for monitoring peer reviews, and this activity consumes the lion's share of the time of our staff and a significant amount of attention of board members. As I mentioned earlier, board members periodically attend peer review exit conferences. Having attended several of these, I can testify to the impression I received as a layman of the seriousness and penetration that characterized most of those conferences. As board member Mautz put it so pungently in his article in the May issue of the *Journal of Accountancy*: "Those cynics who see [peer review] as an exercise in mutual backscratching have no understanding of the effect of peer criticism on proud and sensitive professionals in a highly competitive activity."[2] Even though some of the discussions are heated, I can say that a uniform characteristic of the peer review process is that the reviewed

firm accepts and benefits from criticisms and suggestions made by peer reviewers.

The primary thrust of the peer review process is to identify weaknesses in a firm's quality control system and to insist, when appropriate, that the firm take corrective action. Formal sanctions are to be considered only in rare cases when the firm's quality control system can't be relied on and the firm refuses to make the corrections deemed necessary by the peer review committee.

The SECPS's peer review committee has imposed some rather severe additional requirements on firms whose quality control systems were deemed to be somewhat deficient. Since these requirements were voluntarily agreed to by the firms, they have not been classified as sanctions. Correspondence between the committee and the reviewed firms detailing such additional requirements are placed in the public file. To date, 20 firms—roughly 5 percent of the membership—have been required, as a condition of continued membership, to undergo an accelerated full-scope peer review, i.e., a review in the next year or two rather than every third year. An additional 15 firms have had to agree to a revisit by the peer reviewer to ascertain whether the firm has taken appropriate corrective action.

There is further evidence, I believe, that the peer review process is working in the public's and the profession's best interests. Occasionally, a peer reviewer will conclude that financial statements on which the member firm has opined were not prepared in all material respects in accordance with generally accepted accounting principles. In approximately 40 percent of such cases, the reviewed firm concurred with the judgment of the reviewer and recalled its report, and corrected financial statements were reissued. In the remaining cases, almost all of which involved financial statements of closely held companies, the firms were already performing or about to perform the subsequent year's audit and committed themselves to correct the deficiencies in the course of such audits.

The board believes that the peer review process has been well conceived, is being continually modified and improved with experience and now constitutes an efficient and key ingredient of the profession's self-regulatory program. Based on the POB's monitoring of the process over a period of several years, we are confident that fewer non-GAAP financial statements are being issued because of the peer review process.

As I will discuss later, membership in the division is declining. One of the most often cited causes for attrition in membership in the SECPS, and I understand in the PCPS as well, is the cost of peer review. In response, the SECPS has implemented a number of cost-saving measures, such as the elimination (at the board's suggestion) of the quality control review panel and placing reliance on a firm's inspection program to reduce the amount of work that peer reviewers personally perform. We believe these changes have not diluted the effectiveness of the process. We understand that the PCPS also has taken measures to reduce the cost of peer review.

This matter of the cost of peer review has been much discussed. While it is difficult to generalize because of the wide differences among firms, it would appear that the cost of most peer reviews is less than 1 percent of one year's accounting and auditing fees, and this

expense is incurred only once every three years. When the benefits of peer review in terms of improved professional competence and performance are balanced against cost figures of this sort, one must wonder whether the cost of peer review is the real issue. I was interested to read last month in the *Public Accounting Report* a statement by Clinton J. Romig, a former member of the AICPA council and currently a member of the peer review committee of the PCPS, that "fear [by firms] that they do not measure up to all of the required standards is the greatest deterrent to peer reviews."[3] This might be consistent with our experience that some firms withdraw from the SECPS as their time for peer review approaches. If Romig is correct, it could mean that a number of firms lack an understanding of peer review or that their quality controls are in fact inadequate. Of course, some firms may just be unwilling to be bothered with peer review irrespective of the adequacy of their controls. This would mean they are overlooking an opportunity for improvement. None of these alternatives seems very attractive in terms of overall quality standards of the profession and protection of the public. Perhaps I am guilty of oversimplification, but if there is any merit in these observations, the profession may wish to consider the need for a program of education and persuasion in order to improve the performance of the profession through the broadest possible acceptance of peer review.

The recently issued 1982 annual report of the SEC is bullish on peer review. The report observes that "peer reviews should 'pay for themselves' by reducing auditors' risks of liability to those who rely on their audits."[4]

As you know, the SECPS and the SEC have worked out an arrangement under which the SEC inspects POB oversight work papers and has access on a sampling basis to specified peer reviewers' work papers. As a result of this review, the SEC has indicated its satisfaction with the process. In its 1981 report to Congress, the SEC stated that the "standards for performing and reporting on peer reviews are appropriate . . . [and] are being meaningfully applied"[5] and, in its 1982 report, that it "can rely to a great extent on the POB's oversight function in fulfilling its own oversight responsibilities."[6]

In summary, the board believes that the peer review process has been very successful to date. While peer review can never be a guarantee against audit failures, we believe that the process has improved the quality of the audits performed by members of both sections.

Special investigations committee

One of the first matters considered by the POB was what action, if any, should be taken by the SECPS with respect to alleged or possible audit failures involving SEC clients of member firms. Because significant situations involving alleged audit failures are generally investigated by the SEC or result in private litigation, there was a question about whether the section should get involved at all. There was also the question of whether the section should defer any proceeding until the conclusion of litigation and governmental proceedings so as not to prejudice the firm involved. The board, keeping public interest in mind, recommended that when proceedings or litigation indicated possible audit failure, the section should ascertain whether such proceedings or litigation stemmed from a deficiency in the quality controls of the auditing firm or an insufficiency in auditing standards, requiring corrective action. The protec-

tion of the users of financial statements would be the paramount concern. Disciplinary procedures looking toward punishment of the auditing firm were thought to be less important; besides, the firm involved would most likely be facing actions by governmental and regulatory bodies and private litigants.

As a result of lengthy discussions between the board and the SECPS executive committee, the SIC was created by special resolution of the executive committee in 1979. At all stages in the development of these procedures, the balancing of the interests of the profession and the public received the most careful attention.

Members of the SECPS are required to report to the SIC any litigation or proceedings against them or members of their firms involving SEC registrants. The SIC screens and reviews such cases to the extent necessary to determine whether an investigation is warranted. To date, member firms have reported over 60 cases of litigation or other proceedings against them involving SEC registrants.

The committee has screened and closed a number of the reported cases. Others are being monitored for further developments and four investigations have been undertaken. To date, no investigation has resulted in discovery of a deficiency in the investigated firm's quality control system so important that the imposition of a sanction was warranted. In three instances, however, suggested improvements to the firm's quality control system were voluntarily implemented by the investigated firm. Incidentally, members of smaller firms will be interested to learn that all four investigations to date have involved larger firms.

The POB and its staff follow closely all of the SIC's activities and have full knowledge of all cases reported. One or more members of the board's staff have attended all SIC meetings and a board member has also attended most of them. Based on this observation, we believe that the SIC takes seriously its responsibilities and is equipped and disposed to make reasoned, well-founded decisions. It has already made some tough ones. Anyone who thinks the SIC is designed to gloss over the transgressions of fellow accountants would, I believe, seriously underestimate the quality of the process and the dedication of the members of the committee and of the section's executive committee to which it reports.

But the SIC poses a conundrum. One of the objectives of the SIC is to provide additional assurance to the public that member firms are complying with professional standards in the conduct of their SEC practices. However, the rules of the SECPS require that SIC proceedings be conducted in privacy to all but the POB, and this requirement is carefully observed by everyone. This is tantamount to asking the public and the SEC to accept on faith that the SIC is doing its job as intended or, at best, to take the POB's word for it. On this matter, the board doesn't have a solution because we understand and accept the need for privacy in proceedings of this character.

There is, unfortunately, a public expectation that the SIC should function in a manner similar to the governmental regulatory model. The public, including some people in government, do not seem to differentiate between governmental regulation and self-regulation. Many believe the SIC—and thus the entire self-regulatory program—will lack credibility unless sanctions are regularly imposed and publicized.

The Mautz article mentioned earlier highlights the sharp differences

between governmental regulation and self-regulation. Governmental regulation, the model best known to the public, treats audit failure as a matter deserving punitive action. Self-regulation, appropriately concerned with protecting the public, focuses on methods to prevent or reduce the possibility of future audit failures. The POB wholeheartedly endorses self-regulation and believes that a self-regulatory program does not have to emulate the governmental regulatory model to be effective. In essence, self-regulation is complementary to governmental regulation and deals with practical corrective measures which government is less well equipped to handle.

As I mentioned earlier, our board maintains liaison with the SEC on various aspects of the SECPS's activities. The nature of our liaison with respect to SIC matters is still being developed because of the difficulty of balancing the understandable desires of the section for confidentiality against the SEC staff's belief that it should have more information in order to evaluate this aspect of self-regulation. However, we hope to persuade the SEC to rely to a large degree on the POB's oversight of SIC activities.

For several years there was concern within the SECPS and the POB that the procedure for dealing with a cause célèbre audit failure was not firmly in place and that the self-regulatory program could suffer a serious setback if such a case arose and was poorly handled. The board believes this is no longer a serious concern. In the POB's view, the SIC program and procedures are well conceived, the committee is well established and it is performing its task diligently and effectively. The board believes that the SIC has already demonstrated its ability to deal with difficult cases with firmness and fairness. At the same time, the credibility problems resulting from the privacy requirement I mentioned earlier and the unrealistic expectations on the part of the public and some people in government are matters of continuing concern.

Membership

The division for firms has a significant impact on the quality of audits of publicly traded companies. As the POB reported in its last annual report, over 86 percent of such companies are audited by firms belonging to the division. Even more impressive is the fact that those companies account for over 98 percent of the sales volume of all publicly traded companies.

However, analysis of membership data reveals a disturbing trend. Membership in the division reached an all-time high of 2,200 firms in the fall of 1980. Currently, only 1,700 firms are members—a precipitous drop of 500 firms. There are undoubtedly a variety of reasons for this decline, some of which the division has little or no control over. I have already mentioned concern with peer review costs. It seems to us, though, that some actions could be taken to increase membership. While the division has embarked on several membership campaigns, little has been done to create external pressure to encourage nonmembers to join.

Public relations

The accounting profession's self-regulatory program is perhaps one of its best-kept secrets. Bankers, financial analysts, businessmen in general and perhaps even the majority of clients know very little about this constructive program on which the profession has embarked. Yet, I don't know of any article on this topic that has appeared in a nonaccounting publication.

Very few persons outside the profession are aware of what the peer review process is about or what it

has accomplished. Several years have been spent getting the division's program in place and functioning. In the past it may have seemed premature to advertise a program still being developed. Now we believe the program has reached the stage at which it can be presented with pride as an accomplished fact. Accordingly, we believe the subject of education and public relations merits urgent attention. Efforts to inform users of financial statements and nonmembers of the division about this progam would seem to offer many rewards. Such efforts would improve the credibility of the profession as well as increase the desire of accounting firms to participate in the division's program, which in turn would increase the effectiveness of the program. If public awareness was increased, perhaps some firms that now aren't willing to spend the time and effort to undergo peer review and to meet other membership requirements would find it in their best interest to do so. Also, it should be possible to educate the public regarding the emphasis that self-regulation places on corrective action rather than on punitive action.

There have been suggestions that the SEC might require some disclosure in proxy statements on whether the registrant's auditor is a member of the division or is otherwise subject to peer review. This might be effective in increasing membership, but it is a step away from self-regulation, since it depends on action by a governmental agency. Also, it would affect only auditors of SEC registrants. Our board would prefer to see the profession address its membership problem by means other than seeking governmental action.

Conclusion

I recognize that this has been a rather sketchy summary of the program of the SECPS as I view it from the vantage point of the POB. The accounting profession can be justly proud of its program's accomplishments to date. I know of no other profession's self-regulatory program which can approximate the accounting profession's in imagination and scope.

I take considerable comfort from the fact that, although the POB is primarily composed of nonaccountants, we now have on the board an accountant whose point of view can constitute a valuable asset to the board as it attempts to help improve the profession's self-regulatory program.

As Bob Mautz pointed out in his article, there are a number of quite falsely entertained expectations about what the self-regulatory program of the accounting profession can or should be able to effect. There are quite enough reasonable expectations which the program can properly be called on to fulfill without compelling it to respond to a number of unjustified ones. No firm's quality control system is going to be perfect and audit failures, though hopefully diminished, will still occur. But this is no cause for unjust criticism or, much less, despair.

The accounting profession's self-regulatory program has made a promising start—indeed, a rather spectacular one. I believe we are justified in placing real confidence in it. Confidence-inspiring features lie mainly in the vigor and motivation with which its progress has been marked.

But the program has not yet won laurels on which it can confidently rest or be complacent. There is a need for constant reexamination of the program's objectives and the profession's dedication to their achievement. ■

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[1]*Public Oversight Board Report: Scope of Services by CPA Firms* (New York: AICPA, 1979).
[2]Robert K. Mautz, "Self-Regulation—Perils and Problems," JofA, May83, p.82.
[3]Clinton J. Romig, "Peer Review Key to Continuing Professional Standards Says Louisiana CPA," *Public Accounting Report*, April 1983, p.16.
[4]Securities and Exchange Commission, *Annual Report 1982* (Washington, D.C.: Government Printing Office, 1982), p.16.
[5]SEC *Annual Report 1981* (Washington, D.C.: GPO, 1981), p.28.
[6]SEC, *Annual Report 1982*, p.16.

COMPOSITION OF PUBLIC OVERSIGHT BOARD

Member	Term Expires December 31	Affiliation
John J. McCloy Chairman	1983	Partner, Milbank, Tweed, Hadley & McCloy, New York
Arthur M. Wood Vice Chairman	1985	Former chairman and chief executive officer of Sears, Roebuck & Co.
John D. Harper	1985	Former chairman of Communications Satellite Corporation and former chairman and chief executive officer of Aluminum Company of America
Robert K. Mautz	1984	Director of Paton Accounting Center and Professor of Accounting, University of Michigan
A. A. Sommer, Jr.	1984	Partner, Morgan, Lewis & Bockius and former SEC commissioner
Richard A. Stark	Legal Counsel to the Board	Partner, Milbank, Tweed, Hadley & McCloy, New York

Permanent Staff

Louis W. Matusiak	Executive Director and Secretary
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

Supplemental Staff

Sidney M. Braudy	Retired partner of Main Lafrentz & Co.
John W. Hawekotte	Retired partner of Arthur Andersen & Co.
John W. Nicholson	Retired partner of Arthur Young

PUBLIC OVERSIGHT BOARD
STATEMENT OF ESTIMATED EXPENSES
FOR THE YEAR ENDED JULY 31, 1983

Regular fees of Board members	$173,500
Reimbursement of expenses to Board members and their firms	16,700
Salaries of staff, including part-time reviewers	402,700
Personnel	58,200
Occupancy	81,600
Staff travel and related expenses	23,000
Printing and paper	12,300
Legal expenses*	68,000
General office expenses	29,600
Total expenses	$865,600

* Paid to Milbank, Tweed, Hadley & McCloy

Excerpt from 1982 SEC Report to Congress on Oversight of the Accounting Profession.

Accounting Matters

Oversight of the Accounting Profession—The Commission has historically monitored, relied on and encouraged initiatives in the standard-setting processes of the private sector, subject to Commission oversight, through frequent staff contact with the private sector standard-setting organizations, attendance at or participation in meetings, public hearings, and task forces, and review and comment during the standard setting process. Moreover, this contact speeds referral of emerging problems found in company filings to the right private group for resolution. Although the Commission will continue to seek to fulfill its statutory responsibility by close oversight of private sector initiatives, it will not hesitate to take appropriate regulatory action when necessary.

SEC Practice Section and Peer Review—As of June 30, 1982, 428 accounting firms had voluntarily become members of the Division for CPA Firms of the American Institute of Certified Public Accountants and particularly its SEC Practice Section (SECPS); these firms audit over 90% of all publicly held companies. Firms that are members of the SECPS are subject to certain requirements designed to improve the quality of their audit and accounting practice. Among these are the filing of an annual report, the maintenance of a system of quality control, and the testing of that system once every three years through an independent peer review process.

An independent Public Oversight Board (POB) oversees and annually reports on the SECPS. In its report dated June 30, 1982, the POB concluded that "the self-regulatory structure is sound and is functioning properly." [36]Based on its oversight of the 400 peer reviews which had been conducted, the POB concluded that "there is now considerable evidence that the peer review program is functioning as intended and that section members are taking actions needed to improve the quality of their practice." [37]

Although peer reviews provide no assurance that all audit failures will be identified or avoided in the future, any audit failures that occur should be due to isolated breakdowns or "people problems," and not to inherent deficiencies in firms' system of quality control. In a sense, peer reviews should "pay for themselves" by reducing auditors' risks of liability to those who rely on their audits.

(1) *Access Agreement*—Under the terms of an "access" arrangement agreed to by the SECPS and the Commission, for the first time the Commission's staff reviewed a sample of the working papers underlying reviews. Based on this review and the staff's review of the POB's oversight files, the Commission has determined that it can rely to a great extent on the POB's oversight function in fulfilling its own oversight responsibilities. Nevertheless, the Commission will continue to monitor the peer review process by reviewing certain working papers

pursuant to the access arrangement so that it can periodically evaluate this important self-regulatory initiative and the need for refinements in the process as a result of changing professional, economic and regulatory conditions.

(2) *Sanctions*—The true test of any voluntary self-regulatory organization is whether it appropriately sanctions members that do not meet its standards. There are two aspects to the SECP's disciplinary procedures. First, the SECPS may impose sanctions as a result of serious quality control deficiencies uncovered during peer reviews. While the SECPS has not imposed any "formal" sanctions to date, some peer reviewed firms have voluntarily agreed to take and report prompt appropriate corrective action. The Commission concurs with the POB's belief that this informal process gives the SECPS the ability to act promptly and achieves the same result as the imposition of a sanction. The formal sanction process remains available and should be used when satisfactory corrective measures are not undertaken promptly or where a member firm chooses not to cooperate. [38]

Pursuant to the second aspect of the SECP's disciplinary procedures, member firms are required to report to the Special Investigations Committee (SIC) litigation against them or their personnel and proceedings or investigations publicly announced by a regulatory agency that involve clients or former clients which are or were 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 considers whether these allegations indicate the need for corrective measures by such firms, changes in professional standards, and/or appropriate disciplinary measures. The POB believes that the SIC made significant progress during the past year and that, although the structure for imposing sanctions has not yet been tested, the SECPS will appropriately discipline member firms. [39]The Commission thus far has no basis for reaching any conclusion and believes that visible evidence as to specific SIC activity is critical to demonstrate to the public the effectiveness of this aspect of the profession's self-regulation.

The Commission continues to believe that all accounting firms which audit public companies should join the SECPS. During the past year, a number of changes were made to SECPS membership requirements which the SECPS believes will significantly reduce the costs of membership while maintaining an effective self-regulatory program. The principal change was the elimination of the requirement that a quality control review panel (QCRP) be appointed for peer reviews conducted by firms or administered by associations of firms. The Commission does not object to the SECP's determination to eliminate the QCRP. The Commission supports other initiatives designed to facilitate membership in the SECPS provided that they do not detract from the credibility of the self-regulatory program.

SELF-REGULATION — PERILS AND PROBLEMS

Changing unrealistic expectations about the self-regulatory process is a major task of the SECPS.

by Robert K. Mautz

Embarking on a program of self-regulation is anything but risk-free. An important and perhaps unrecognized risk is the danger that expectations about the program may not be met and that this could encourage unwise actions. Unfulfilled expectations may result from inadequate performance of the self-regulatory process or from unrealistic expectations. The profession's experience, to date, suggests that unrealistic expectations may be the greater danger.

Unrealistic expectations arise because critics of the self-regulatory process—and even some participants—fail to recognize that

- ☐ Self-regulation is unavoidably limited in scope, operating within the constraints imposed by an already existing and rigorous disciplinary system.
- ☐ Any regulatory activity, and self-regulation in particular, requires a difficult balancing of private rights and public good.
- ☐ Self-regulation differs from public regulation in motivation, method and purpose.

The Scope of Regulation

If one considers regulation in the broadest sense, the complexity of the total process is overwhelming. It includes, on the one hand, such considerations as the maintenance of an economic and legal environment conducive to the continued provision of professional services for those who desire them and, on the other hand, sufficient control of conditions so that competition in the provision of those services does not fail and a monopoly does not emerge to exploit society's needs. It involves acceptance of the fact that the contracting for and the performance of services will from time to time result in misunderstandings or disagreements about the cost or quality of the services performed. When this occurs, a system for adjudicating such disputes is needed, a system that is recognized as both authoritative and equitable to all parties.

When members of the public are unable to evaluate the quality of a service because of its technical nature, a licensing provision requiring practitioners to meet established qualifications, perhaps including examination, may be appropriate. In addition, standards of performance must be established together with some means of reviewing that performance to protect the lay public from substandard practice. Finally, on those relatively rare occasions when performance deviates so far from the norm that sanctions are in order, the authority to impose and enforce sanctions becomes a part of the regulatory process.

Given a fresh start and no limitations, one might invent a program of self-regulation that includes all the activities described. To do so might be interesting, but it would not be a very useful activity. Society has indicated no desire to free accounting, or any other profession, from all of the regulatory mechanisms now in place. Agencies with far greater pow-

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Author's note: Initially presented as my views in a talk prepared for the American Institute of CPAs tenth national conference on current SEC developments, this adaptation has since been reviewed by the public oversight board (POB) of the SEC practice section of the AICPA division for CPA firms and generally expresses the board's sentiments. The POB oversees the self-regulatory efforts of the SEC practice section. The conference was held in Washington, D.C., last January 11 and 12.

ROBERT K. MAUTZ, CPA, Ph.D., is a member of the public oversight board of the SEC practice section of the American Institute of CPAs division for CPA firms and is director of the Paton Accounting Center at the University of Michigan, Ann Arbor. A member of the Accounting Hall of Fame, Dr. Mautz is a past president of the American Accounting Association and a former editor of the *Accounting Review*; he also has served on the AICPA council and board of directors. In 1980 he was awarded the Gold Medal, the Institute's highest honor.

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ers than any possessed by the accounting profession police competition in the economy. An existing system of courts settles civil disputes. Licensing powers are reserved for the states. A multiplicity of federal and local policing organizations are constantly on the alert for criminal activity. The Securities and Exchange Commission has been assigned regulatory responsibilities that it shows no sign of relinquishing, and it couldn't relinquish these responsibilities even if it would.

Viewed realistically, self-regulation is but one element in a complex system of controls. Society entrusts to a self-regulating profession a limited set of privileges, among them the right and responsibility to develop, establish, review and refine standards of professional performance. Society does so at least partly because it believes the technical expertise and situational understanding of members of the profession qualify them to perform that role effectively. There is no reason, nor has accounting the ability, to challenge the other participants in the total regulatory structure. If accountants perform their role satisfactorily, the tasks of the others will all be eased. Accountants have a small niche in the total regulatory process but an important one.

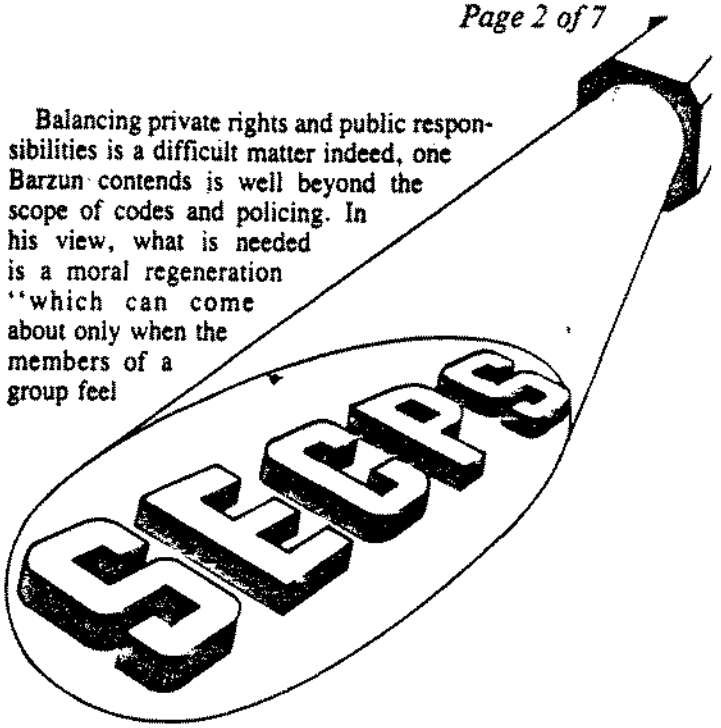
Private Rights and Public Responsibility

Establishing and maintaining appropriate standards of professional performance demand a proper balance of private rights and public responsibility. In a perceptive article entitled "The Professions Under Siege" Jacques Barzun takes note of the diminishing status of the professions, including accounting, the unavoidable conflict of interest between members of a profession and the lay public that uses its services, the vulnerability of the professions to public displeasure and the real dangers of public regulation.[1]

Professionals ask for special privileges, including the exclusion from practice of those who don't qualify. In return for privileges, society demands superior performance, high ethical behavior and very rare failures. Absent society's satisfaction, the profession's privileges are endangered.

[1]Jacques Barzun, "The Professions Under Siege," *Harper's*, October 1978, pp 61-68.

Balancing private rights and public responsibilities is a difficult matter indeed, one Barzun contends is well beyond the scope of codes and policing. In his view, what is needed is a moral regeneration "which can come about only when the members of a group feel



once more confident that ethical behavior is desirable, widely practiced, approved, and admired."[2] To establish and maintain such a condition should be part of the goal of self-regulation.

But how are such high-sounding goals to be achieved in the practical, down-to-earth, highly competitive world of accounting? Accomplishment is neither easy nor impossible, but the problems involved are gaining increasing attention in the profession where the spotlight has been focused on the American Institute of CPAs division for CPA firms, which includes the SEC practice section (SECPS) and the section's public oversight board (POB).

Public Regulation and Self-Regulation

However similar their goals, public regulation and self-regulation have important differences, not all of which are immediately apparent. Public regulation is conducted with the full power of the state in support of established requirements. Self-regulation has no equivalent authority. At most, it can exclude noncomplying members from whatever benefits group membership confers or impose whatever sanctions members have voluntarily agreed to accept. Such powers as the ability to subpoena records and witnesses are not available in self-regulation.

Public regulation is likely to emphasize punishment for transgressions; self-regulation

[2]Ibid., p.68.

will more likely emphasize remedies and the avoidance of future deficiencies. There are reasons for this. Public regulation is commonly employed only when the community has become aroused by what it considers improper conduct. The public wants that conduct stopped and finds punishment a useful deterrent. Self-regulation, however, often has a strong concern for equity to members of the group, which must somehow be balanced with service to the community. Members of the group and the community are both served more effectively by remedy than by punishment.

Self-regulatory processes accept the need for punishment in egregious cases, but sanctions are likely to have a positive purpose—to be aimed at improved service to society along with equitable treatment of the regulated. Public regulation tends to view infractions as willful violations deserving punishment. Self-regulation is concerned with establishing standards for proper conduct and eliminating the causes of unintentional and perhaps unrecognized failings as well as the rare refusal to meet professional standards.

Finally, public regulation offers opportunities not available to those engaged in self-regulation. Many a successful political career has been founded on the publicity and acclaim accorded a vigorous and resourceful prosecutor. Protecting the public, putting the rascals away and battling the wrongdoers earns recognition, gratitude and higher public office. There is no equivalent opportunity or reward in self-regulation.

Self-regulation, if it is justified at all, must rest on something more than the self-interest of those regulated. Generally, self-regulation is perceived as more equitable than public regulation because the standards to be met are established and enforced by fellow practitioners whose experience provides an understanding of the environment, the risks, the pressures and the possibilities of service that laymen neither comprehend nor understand. Self-regulation, if performed properly, also assures better service to the public because its emphasis is on remedy and improvement and because it is in closer touch with practice, more aware of changing needs, and more responsive to the wants of those who use the service than any other form of regulation can be.

Self-Regulation's Challenge

With this as backgound, let's consider the problems faced in the establishment and maintenance of any system of self-regulation. A major task of those involved in the process is one of establishing mutual trust. Many members of the regulated group accept self-regulation with considerable reservation, and then they accept it only because they consider it less undesirable than the public alternatives. Few people seek regulation for its own sake. Professionals seem to find any regulation particularly irksome, a slight to their professionalism and a potential threat should it get out of control.

Those who represent the public and have its best interests at heart are concerned that entrusting regulation to members of the profession is risky at best. They fear that self-interest and pressure from colleagues will discourage the establishment and maintenance of adequate standards. In addition, within the profession there will always be some who disagree with the self-regulatory process, no matter how it is conducted, and either refuse to cooperate or vigorously oppose what the majority of the group has accepted. These disparate views must somehow be brought together sufficiently to permit the program to function.

Another difficulty is found in reforming the erroneous expectations entertained by some who confuse self-regulation with public regulation. Those who have the point of view of public regulation expect a visibly impressive level of activity. They want unequivocal evidence that the process is working effectively. Without that evidence, they contend the process lacks credibility. In their minds, public regulation is the model, and unless self-regulation emulates that model it isn't as effective as they believe it should be. When their expectations aren't met, they become critics of the self-regulatory process.

At the other extreme are the expectations of the group subject to self-regulation. Within that group will be some—often too many—who really expect no change from their previously unregulated condition. They deny any need for regulation and, at least in their own minds, contest the right of anyone, even their professional colleagues, to impose requirements on them. Others will accept regulation

but only in those few cases in which there is great public interest that demands action if the profession is to avoid severe censure. To them, self-regulation means minimum interference with the status quo. Obviously, the expectations of all these interests cannot be met.

Finally, and because of these disparate views, there is the very real problem of maintaining satisfactory relationships between those engaged in self-regulation and those who have been entrusted with an oversight responsibility and would likely be charged with public regulation should the self-regulatory process not succeed. If the latter do not perform their oversight responsibility, they fail their own assignments. If they perform that oversight with excessive zeal, self-regulation is co-opted and becomes public regulation.

"The SEC, charged by Congress with an oversight responsibility, interacts with the section's self-regulatory effort in a number of ways."

Progress of the SECPS

Where is the profession now, insofar as the self-regulatory program for the SECPS is concerned? In a relatively short period of time, the section has made remarkable strides. It has adopted an impressive set of quality control standards and other requirements to be met by all members. A program of peer reviews has been established, reviewers have been trained, reporting mechanisms have been developed and a procedure by the peer review committee to evaluate the performance of completed peer reviews is in place and functioning. (This applies to the private companies practice section (PCPS) as well, although the PCPS is beyond the scope of this article.)

Recognizing that peer reviews, like audits, must be performed on a sampling basis, a special investigations committee (SIC) has been added to the SECPS to inquire into alleged audit failures charged by plaintiffs in litigation against any member firm. Such inquiries are designed to be no more burdensome on the member firm than necessary, but if circumstances suggest that there may be a need for important remedial measures investigation of part or even all of the subject firm's practice is likely to follow. In addition, at the completion of the investigation, a recommendation of sanctions, if considered necessary, will be made to the section's executive committee.

The SEC, charged by Congress with an oversight responsibility, interacts with the section's self-regulatory effort in a number of ways. It discharges its assigned responsibility in part by becoming familiar with and testing the work of the peer review committee, which constitutes the cornerstone of the self-regulatory program. It also seeks assurance that the SIC is performing satisfactorily and that the POB's oversight function is effective. To date, there has been no action on the part of the SEC that can be construed as a serious threat to the "self" designation of the section's regulatory process. At the same time, I must report no lack of interest or failure of diligence in the performance of the SEC's oversight function.

The POB's Role

The POB, four of whose five members aren't accountants, occupies an interesting position in the total scheme, a position with multiple responsibilities. It represents the public, meeting with various elements of the self-regulatory program on a recurring basis to remind them of the public interest and the public viewpoint.

The POB has no line authority and desires none. From the beginning, it has taken the position that, if the process is to be one of self-regulation, all authority must be vested in members of the section. The POB can oversee, comment, suggest and point out; it cannot order or demand. The POB sees as its purpose the protection of the section's right to self-regulation. It can achieve that purpose most effectively by reminding the SECPS executive committee of how its decisions may be viewed by the public. Here's an example.

There is an understandable tendency on the part of member firms to object to any suggestion that technical membership rules be disregarded. They are quite within their legal rights in doing so. Some rules were specifically intended to limit the scope of members' responsibility, for example, a cut-off date before

which the SIC wouldn't be concerned with cases in litigation. The POB recognizes this but on at least one occasion recommended a contrary point of view. Relying on technical rules, however legal, to avoid inquiries into alleged audit failures may be regarded by the public as contrary to the spirit of self-regulation. If there has been an audit failure, the section needs to know what it is, assess its implications for future service and assure that any necessary remedial action is taken.

Furthermore, the public is unlikely to favor technicalities that appear to protect substandard practice at the expense of investors. The public isn't likely to be mollified with the statement, "Technically, the case can't be inquired into." It asks, "Do the facts in any way imply that current standards of audit performance are not being met?" and "Are the rules intended to protect the public or to aid firms in evading standards?" The POB serves the cause of self-regulation by pointing out the reasoning the public will apply.

"... peer review is effective in improving the general quality of audits performed by firms subject to it."

The POB staff serves as a reviewer of peer review workpapers and the peer review process in general. The POB also serves as a buffer and provides liaison between the SEC and the section's regulatory activities. In doing so, it must be able to understand and empathize with both but sympathize with neither. On some matters the views of these two parties are remarkably similar; on other matters they differ widely. The POB strives to explain each to the other and to seek a working reconciliation wherever possible.

How Good Is Peer Review?

Two questions have been asked often enough that they deserve comment:

1 Is peer review working?

2 As long as the profession has peer review, why does it need the SIC?

The two are closely linked. The first question is raised most frequently on the basis of reports of litigation in the financial press alleging accounting or audit failures. Why do these occur if peer review is effective?

There is no question in my mind that peer review is effective in improving the general quality of audits performed by firms subject to it. The POB receives and reads copies of all adverse and qualified opinions resulting from peer reviews; we sit in on some exit conferences; our staff reports to the board on letters of comment to the managements of reviewed firms and on such managements' responses to those comments. We observe in the peer review process an effectual and efficient combination of professional challenges and response, both in the performance of the review and in the reaction to it. Those cynics who see it as an exercise in mutual backscratching have no understanding of the effect of peer criticism on proud and sensitive professionals in a highly competitive activity.

If peer review is working so well, why is there so much litigation? The peer review process is systems oriented. It is directed at the reviewed firm's system of quality control. Litigation concerns specific cases. No system can assure that work performed by mortals will always be completely free of fault. Given the total number of audits required and the variety of conditions, distractions, pressures and personal problems faced by the auditors involved, some mistakes, lapses of judgment, oversights and misunderstandings are as inevitable as death and taxes. Perfect audits in all circumstances and situations are as unlikely as sustained perfection in any other human activity.

Does the Profession Need an SIC?

Allegations of audit failure sufficient to initiate litigation against accountants may imply a weakness in a firm's system of quality control. The fact that they may imply such a weakness requires attention. The SIC is charged with the responsibility of ascertaining the probability of substance in such charges. A preliminary review is made of the allegations and the financial statements in question to discover whether the charges have any apparent foundation in fact. In some instances, this is enough to establish that they are groundless and the case can be closed. In other cases, the preliminary review finds enough in the allegations to warrant a discussion with the firm's representatives and a review of recent peer review findings. In some instances, the circumstances are such that the SIC must

conclude that there is a possibility that a failure in the firm's system of quality control occurred and that it could happen again.

If so, an investigation is undertaken. The purpose of the investigation is to protect the public, not to try the case. The specific case is already in litigation; the court will determine the validity of the plaintiff's allegations. But the court will go no further. It is incumbent on the self-regulatory process to protect the public against quality control breakdowns. If, and I emphasize the word *if*, the firm's quality control process has failed in a specific case, the process may also have failed in other audits involving clients in the same industry or performed by the same personnel. A credible self-regulatory program must ascertain whether this is the fact and, if it is, take steps to see that the deficiency in the firm's system is remedied.

When the implications of an alleged audit failure are deemed sufficient to threaten the public interest, the SIC investigates the firm's system of quality control in terms much more specific than contemplated in recurring peer review. Peer review remains the cornerstone of the section's self-regulatory process. Yet, no matter how effective peer review is, there will always be instances of alleged audit failure, and all of these raise questions about the firm's quality controls. The SECPS needs the SIC to ascertain whether the potential for harm to the public exists and to demand remedial measures, if needed.

A Learning Experience

For all concerned, this is a learning experience, an interesting, exciting and difficult experience. Many of the things are being done for the first time, not only by those doing them but the first time for the profession. Unavoidably that means there will be some unhappy people. No one wants to be investigated or sanctioned. Neither does anyone in the process want to make the mistake of charging dereliction of duty without adequate support for the charge.

An interesting question has been raised about the type of people who should be appointed to the POB and to the SIC. Let me describe the current members of these units as I have come to know them through direct observation. All have carried important executive responsibilities; they are seasoned by long experience. They possess excellent personal reputations for integrity, dependability and diligence, reputations that they are unwilling to see sullied in any way. They are prudent, courageous, understanding and intent on getting the facts. They have high standards of professional and public responsibility, are aware of the pressures and temptations that beset mortal man and on occasion exhibit a strong sense of moral outrage. None of them is seeking to build a new reputation; their ambitions have been fulfilled. They can be trusted to take their public responsibilities seriously and to discharge them objectively.

At the AICPA's ninth national conference on current SEC developments in 1982, members of the POB were criticized as not being "movers and shakers." I expect that this is a fair description of their present activities, however vigorous their earlier careers may have been. I do not view such a description as pejorative in any sense, although it may have been so intended. My experience with movers and shakers is that they often leave a mess for someone else to clean up. Intent on fame and glory, they stride through life straightening out the affairs of lesser men whether or not such attention is needed. It is a good thing that some movers and shakers are part of the accounting profession. It is also a good thing that they aren't members of the POB or the SIC. One quakes at the mere thought of what a first-class mover and shaker could do in such a position.

> "Those who are now engaged in any way within the . . . self-regulatory process are seriously endeavoring to improve the quality of professional practice without placing undue burdens on anyone."

Some Future Prospects

So I would offer some suggestions. To those who criticize an apparent lack of exciting actions, I note that they may continue to be disappointed. The self-regulatory process works most effectively when it is not in the public press. Don't expect it to emulate public regulation; it should and does favor different methods and different goals. It will always favor investigations and sanctions directed at

the improvement of audit service over those directed at mere punishment.

To those who object to the current self-regulatory process as too onerous, one can only assert that self-regulation is, in fact, regulation. Society expects more and more each year from those who have the good fortune to be regarded and rewarded as professionals. Those who are now engaged in any way within the accounting profession's self-regulatory process are seriously endeavoring to improve the quality of professional practice without placing undue burdens on anyone. They appreciate, enjoy and take pride in the quality of their real world practice. Those who fail to meet satisfactory standards in their professional work will not be permitted to give the entire SECPS a bad reputation or to expose the self-regulatory process to undesirable risk.

I can also offer some assurances. Reconciliation of opposing influences within the section, and between the section and government, is no easy matter. Yet, it is progressing. Peer review and special investigations are proceeding. Liaison with the SEC is effective. The POB adds an essential public point of view, does not hesitate to make its views known and has been effective in causing reconsideration of decisions. Much has been done and there is much yet to do. All engaged in this effort are entitled to take some pride in current accomplishments as long as they do not rest on that record. The real record of self-regulation for accounting is yet to be made as the profession works its way through this period of economic stress and strain. The hard decisions are yet to come. ■

SEC PRACTICE SECTION

EXECUTIVE COMMITTEE

Representative	Firm Affiliation
Ray J. Groves, Chairman	*Ernst & Whinney
George L. Bernstein	*Laventhol & Horwath
T. Frank Booth	A. M. Pullen & Company
Robert M. Coffman	*Fox & Company
J. Michael Cook	*Deloitte Haskins & Sells
Mario J. Formichella	*Arthur Young
Howard Groveman	*Alexander Grant & Company
William D. Hall	*Arthur Andersen & Co.
Charles Kaiser, Jr.	Pannell Kerr Forster
William B. Keast	*Coopers & Lybrand
Charles E. Keller, III	Keller, Zanger & Company
Bernard Z. Lee	*Seidman & Seidman
J. Curt Mingle	Clifton Gunderson & Co.
J. David Moxley	*Touche Ross & Co.
Richard W. Paddock	Battelle & Battelle
Donald R. Sloan	*Peat, Marwick, Mitchell & Co.
John A. Thompson	*Main Hurdman
Jack C. Wahlig	*McGladrey, Hendrickson & Co.
Michael A. Walker	Mann Judd Landau
John W. Zick	*Price Waterhouse
Donald P. Zima	May Zima & Co.

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

PEER REVIEW COMMITTEE

Member	Firm Affiliation
Joseph X. Loftus, Chairman	Price Waterhouse
John F. Barna	Peat, Marwick, Mitchell & Co.
Clark C. Burritt	A. M. Pullen & Company
Paul B. Clark, Jr.	Main Hurdman
Robert W. Egner	Coopers & Lybrand
Arthur I. Farber	Altschuler, Melvoin & Glasser
Marvin Feller	Ernst & Whinney
Robert E. Fleming	Fleming, Tempas & Co.
John G. F. Knight	Purvis, Gray and Company
Daniel J. Moylan	Deloitte Haskins & Sells
Edward J. O'Grady	Laventhol & Horwath
Joseph A. Puglisi	Touche Ross & Co.
Robert H. Temkin	Arthur Young
Frank H. Whitehand	Arthur Andersen & Co.
Jerry E. Whitehorn	Whitehorn, Bradsher & Tankersley

SPECIAL INVESTIGATIONS COMMITTEE

Member	Firm Affiliation
Robert A. Mellin, Chairman	Hood and Strong
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
*John B. O'Hara	Price Waterhouse
*Leon P. Otkiss	Peat, Marwick, Mitchell & Co.
*David Wentworth	McGladrey, Hendrickson & Co.

* Retired