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Public Oversight Board

Annual Report 1983-1984

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

Public Oversight Board*

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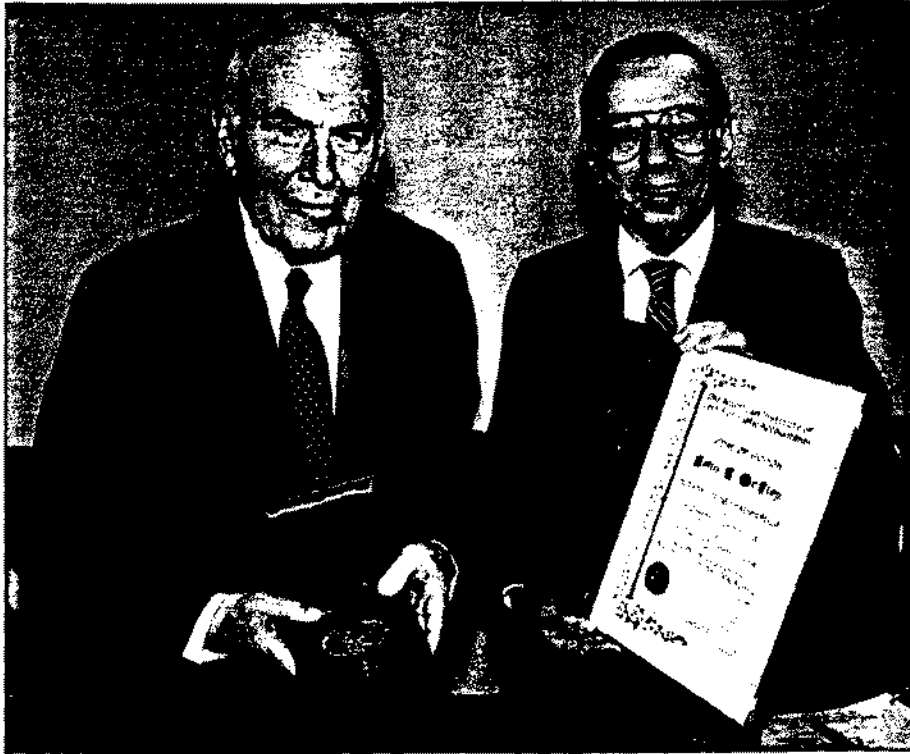
*In August 1984, Melvin R. Laird, former Secretary of Defense, was appointed to the Board to fill the vacancy created by the resignation of John J. McCloy.

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Dedication



John J. McCloy receiving Medal of Honor from AICPA Chairman B. Z. Lee.

John J. McCloy served as chairman of the Public Oversight Board from its inception in 1977 until his resignation in February 1984 for personal reasons.

His appointment as member and chairman of the Board brought immediate stature and credibility not only to the Board, but also to the accounting profession's enhanced program of self-regulation.

His leadership contributed materially to the Board's effectiveness. He played major guiding roles in formulating and articulating the Board's philosophy regarding self-regulation, in determining the Board's jurisdiction, and in formulating and implementing the Board's operating policies.

His lasting and significant contribution has made the accounting profession's innovative program of self-regulation effective in serving both the public interest and the profession.

Because of his leadership, wise counsel, and warm friendship, the members of the Public Oversight Board gratefully dedicate this report to him. We are all richer for having the opportunity to serve with him.

PUBLIC OVERSIGHT BOARD

SEC Practice Section • AICPA

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

June 30, 1984

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

It is my pleasure to transmit this sixth annual report of the Public Oversight Board. This report differs in some material respects from our previous reports.

As my predecessor remarked in his address of May 9, 1983 to the Council of the American Institute of Certified Public Accountants:

“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.”

We believe all users of financial statements should be aware of the accounting profession’s self-regulatory program and the success it has attained. We hope this report and the accompanying booklet entitled *Audit Quality: The Profession’s Program* will give readers a better understanding of how the program works and an appreciation of its objectives and accomplishments.

This year’s report is dedicated to John J. McCloy, who served as Board chairman from its inception until his resignation in February 1984. The AICPA acknowledged its gratitude by awarding him its Medal of Honor for his outstanding leadership as charter member and first chairman of the Public Oversight Board. Those of us who had the privilege of serving with him recognize that the award was richly deserved.

The Board believes that firms belonging to the SEC Practice Section continue to give evidence of strong commitment to self-regulation and the improvement of quality of services to their clients.

Very truly yours,



ARTHUR M. WOOD
Chairman

Highlights

Public Oversight Board Activities

■ Board and staff members actively monitored all activities of the Section during the past year by:

- Attendance at all committee meetings and a majority of meetings of task forces.
- Review of all peer reviews completed during the year.
- Review of all litigation alleging audit failures of SEC registrants.

■ The Board is convinced that the self-regulatory program of the profession is improving the quality of accounting and auditing practice of its member firms.

■ The Board has published simultaneously with the publication of this sixth annual report a booklet entitled *Audit Quality: The Profession's Program*. The booklet describes how the practice of public accounting is regulated at three distinct levels—by firms individually, by the profession, and by government; the elements of a quality control system of a CPA firm; and the peer review and special investigative processes of the SEC Practice Section, integral parts of the accounting profession's program of self-regulation. The Board's oversight extends primarily to the operation of the SEC Practice Section.

■ Members of the Board elected Arthur M. Wood to succeed John J. McCloy as chairman. The Board has not yet appointed a member to fill the vacancy created by the resignation of Mr. McCloy.

Peer Review Activities of the Section

■ One hundred forty-four firms were peer reviewed in 1983. The reports on all but three reviews were processed by the Peer Review Committee as of the date of this report. One hundred thirty-three of the reports processed were unqualified opinions, seven were qualified, and only one was adverse.

■ Twenty-three of the firms reviewed in 1983 had received a modified report on their initial review

in prior years; all but five of these firms received unqualified opinions on their reviews in 1983.

■ Only one firm received an adverse opinion on two successive reviews. The Peer Review Committee accepted the latter report on the condition that the firm agree to undertake significant corrective actions imposed by the Committee. Nevertheless, the Board expressed its concern to the Section regarding the extended period of time over which the firm's unsatisfactory performance had been permitted to continue without more decisive action being taken by the firm. In response, the Section has notified the firm that proceedings leading to the possible imposition of a sanction would begin unless the firm took immediate decisive action.

■ Reports on other peer reviews were accepted by the Peer Review Committee on the condition that the reviewed firms provide assurance that they were implementing appropriate corrective actions by:

- Allowing the reviewer or a Committee member to revisit the firm to assess the effectiveness of the improvements made.
- Requiring the firm to make available a copy of the report on the subsequent inspection of its quality control system.
- Requiring the firm to engage the services of a competent person from outside the firm to perform a preissuance review of all audit engagements.

■ The Board has suggested several improvements in the peer review process, which have been acted upon to the Board's satisfaction. Two that have been made recently and not yet acted upon are:

- A peer review report should make reference to the letter of comments when such letter is issued in conjunction with the report.
- Additional guidance should be provided to reviewers as to when noncompliance with the quality control element of inspection should result in the issuance of a modified report.

■ Several modifications of peer review standards and procedures were made during the year, some of them at the suggestion of the Board. The more important ones were:

□ A reviewer is now required to consider litigation alleging audit failure that is required to be reported to the Section's Special Investigations Committee by the firm as a factor in determining the scope of that firm's forthcoming peer review.

□ Procedures were established to resolve disagreements between a peer reviewer and the Peer Review Committee as to the type of report to be issued on a specific peer review.

□ To serve as a reviewer, a firm must have had its own quality control system peer reviewed.

□ Additional information was provided to reviewers regarding selection of engagements for review where the firm has received fees for performance of management advisory services (MAS) which exceeded fees for audit services.

□ A reviewed firm is now required to document the actions it plans to take when a peer review team concludes that the firm did not perform sufficient procedures to support an audit report issued.

Special Investigative Activities of the Section

■ Twenty-seven cases alleging failure with respect to the performance of an audit of the financial statements of an SEC registrant were reported by member firms during the year. At the beginning of the year, the Special Investigations Committee had open files on twenty-five cases reported in prior years.

■ The Special Investigations Committee determined that no case on its agenda warranted a special review of a firm's quality control system in the current year.

■ Files on all but twenty cases were closed; fourteen cases are still undergoing initial investigative

procedures and six are being monitored awaiting future developments.

■ The Special Investigations Committee requested technical committees of the AICPA to consider whether allegations in reported cases indicate a deficiency in professional standards or a need for additional guidance.

□ As a result of meetings with members of the Committee, the AICPA Banking Committee published additional information regarding appropriate bank auditing procedures and reassessed the adequacy of its recently published Bank Audit Guide.

□ The Committee conferred with representatives of the AICPA Insurance Committee to discuss issues raised in reported cases and urged the Accounting Standards Executive Committee to accelerate its consideration of income recognition issues of certain insurance industry transactions.

Other Section Activities

■ John W. Zick of Price Waterhouse was elected chairman of the Executive Committee succeeding Ray J. Groves of Ernst & Whinney.

■ A special committee—the SECPS Review Committee—was appointed by the chairman of the American Institute of Certified Public Accountants to review the structure, operations, and effectiveness of the Section. The Committee's report has been submitted to the AICPA Board of Directors for approval and clearance to publish.

■ Membership in the SEC Practice Section increased by sixteen firms in the year ended June 30, 1984.

■ Members of the Section audit 85 percent of the publicly-traded companies listed in the eleventh edition of *Who Audits America*; these companies account for over 98 percent of the combined sales of all publicly-traded companies.

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Introduction

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. This new innovative structure is concerned with the activities and conduct of accounting firms as opposed to those of individual accountants. The Public Oversight Board oversees the activities of the SEC Practice Section.

This sixth annual report of the Public Oversight Board describes the activities of the SEC Practice Section during the period July 1, 1983 to June 30, 1984.

Clearer Perspective of Self-Regulation

The creation of the Division for CPA Firms was a milestone in the history of regulation. No other profession has a self-regulatory program that is broader in scope or that has had as significant an impact on the quality of professional practice.

The program was adopted in part to forestall the possibility of increased government regulation arising from a series of significant business and alleged audit failures in the 1960s and 1970s. At congressional hearings, concern was expressed about the manner in which the accounting profession was being regulated and disciplined. Some congressional leaders suggested that Congress should enact legislation to create a regulatory organization for accountants similar to that governing the securities industry.¹

Because it was intended in part to preclude action by Congress, the self-regulatory program was initially considered by many both within and outside the profession to be a substitute for government regulation. However, experience with the program has convinced the Board that self-regulation is not and cannot be a substitute

for government regulation. Self-regulation, or perhaps more properly, peer regulation, is but one of three distinct levels of regulation of the activities of accountants in public practice. In addition to being regulated by peers, practicing public accountants are regulated by their firms and by various governmental agencies. The methods and objectives of these three levels of regulation governing the practice of public accounting are more fully described in an article authored by Board member Robert K. Mautz, which appeared in the April 1984 issue of the *Journal of Accountancy* and is reproduced as Exhibit I.

The Board has published a booklet *Audit Quality: The Profession's Program* which serves as a companion piece to this report. The booklet describes in greater detail the structure and principal activities of the organizations involved in the regulation of accountants, explains the elements of a quality control system of a firm in the practice of public accounting, and describes the SEC Practice Section's peer review and special investigative processes.

Activities of the Board

As its name implies, the Board oversees the activities of the SEC Practice Section. The Board and its staff represent the public interest in the Section's peer regulatory program and actively monitor all aspects of the program. The Board does not have line authority and has never sought such, for it believes that by so doing, it would violate the spirit of self-regulation. Notwithstanding the fact that the Board's role is one of oversight only, it has had considerable influence on the policy decisions made by the Section, on the effectiveness of its operations, and on the accomplishment of its objectives.

The SEC Practice Section has three major committees: the Executive Committee, the Peer Review Committee, and the Special Investigations Committee. Individual Board members are assigned liaison responsibilities for each major committee. Representatives of the Board attend as observers all committee meetings and the preponderance of meetings of subcommittees and

¹ On June 16, 1978, HR 13175, *A Bill to Establish a National Organization of Securities and Exchange Accounting Commission*, was proposed but not enacted.

task forces. All activities and decisions of the Section are reported and discussed at Board meetings, which are held monthly or more frequently as needed.

The major activity of the Section is administering the peer review program. Each member firm is required at least triennially to submit its quality control system for its accounting and auditing practice to an independent review by peers. The findings of such review are formally reported upon and the report placed in a public file. Reports are either unqualified or modified. Every peer review report, and some or all of the reviewers' workpapers, are critically examined by the Board's staff. A copy of each modified report is sent to Board members and discussed at Board meetings. In addition, any significant differences the staff has with respect to the appropriateness of a given report are reported and discussed at Board meetings. The Board's procedures for monitoring the peer review process are described in another section of this report.

Every litigation matter reported to the Special Investigations Committee is reviewed in detail by the Board's staff. Summaries of the issues in the case, prepared by the Committee's staff, are sent to all Board members and serve as a basis for discussion at Board meetings.

Because of its active involvement in monitoring the program, the Board on several occasions has made suggestions for improvement in various aspects of the program. It does not hesitate to express its dissatisfaction with a decision or pro-

posed decision on a particular matter, such as the type of report accepted by the Peer Review Committee. The Board is satisfied that, on those occasions when it has offered another perspective on an issue, serious attention has been accorded the Board's views.

Composition of the Board

The Board is a five-member, autonomous group with the right to elect its own members and chairman, subject to consultation with and concurrence by the AICPA Board of Directors. At a special meeting in February 1984, John J. McCloy announced his resignation as chairman and member of the Public Oversight Board for personal reasons. The Board accepted Mr. McCloy's decision with sincere regret. Arthur M. Wood, formerly vice chairman, was elected chairman.

As of June 30, 1984, efforts are continuing to find a qualified person to fill the vacancy created by Mr. McCloy's resignation. The current composition of the Board and its staff is shown in Exhibit II. [EDITOR'S NOTE: In August 1984, Melvin R. Laird, former Secretary of Defense, was appointed to the Board to fill the vacancy created by the resignation of Mr. McCloy.]

SEC Practice Section

Organization of the Section

The important work of the Section is conducted by its three committees—the Executive Committee, the Peer Review Committee, and the Special Investigations Committee—whose composition is set forth in Exhibit III.

The Executive Committee

The Executive Committee's major responsibilities include establishing general policies for the Section, administering and monitoring all its activities, determining membership requirements, and imposing sanctions, either on its own initiative or on recommendation of the Peer Review or Special Investigations Committees.

The Committee currently consists of twenty-one members elected by the AICPA Council for three-year terms. The organizational document of the Section provides that the Committee shall at all times include representatives of all member firms that audit financial statements of thirty or more registrants under section 12 of the Securities and Exchange Act of 1934. Currently, fourteen member firms qualify for permanent Committee representation.

During the year, John W. Zick of Price Waterhouse succeeded Ray J. Groves of Ernst & Whinney as Executive Committee chairman.

The Peer Review Committee

The Peer Review Committee's major responsibilities include establishing standards for performing and reporting on peer reviews, administering the peer review program, and taking whatever measures it considers necessary to assure that member firms are taking appropriate corrective actions as a result of peer review findings.

The Committee can recommend that the Executive Committee impose a sanction on a firm for failing to take corrective action deemed necessary by the Committee. It has not found it necessary to do so to date. In every such case, the firm agreed to correct quality control system or compliance deficiencies and demonstrate appropriate corrective action to the Committee as requested. Some actions were extensive in nature, precipitating the requirement that the firm demonstrate implementation of its corrective action plan by undergoing another full scope peer review the

following year. Corrective actions required by the Committee are detailed in a later section of this report.

The Committee consists of fifteen individuals from member firms, appointed by the Executive Committee. All Committee members have extensive experience in the audit, review, or quality control functions within their firms.

The Special Investigations Committee

The Special Investigations Committee's major responsibility is to perform such investigatory procedures as it considers necessary to determine whether facts relating to audit failures alleged in litigation or formal proceedings and involving audits of SEC registrants indicate (1) a possible need for corrective action by the member firm in question with respect to its quality control policies and procedures or compliance with them, or (2) that changes in generally accepted auditing standards, generally accepted accounting principles, or quality control standards need to be considered.

The Committee consists of nine active or former partners of member firms appointed by the Executive Committee. Initial appointment is for a three-year term, and members are eligible for reappointment for a maximum of three additional one-year terms. All members have extensive experience in the audits of SEC registrants.

The SECPS Review Committee

In February 1983, the chairman of the AICPA appointed the SECPS Review Committee, an ad hoc committee to review the structure, operations, and effectiveness of the SEC Practice Section. The objectives of the Committee were to evaluate the activities of the Section and to determine whether it is accomplishing its mission of improving the quality of practice before the Securities and Exchange Commission. The Board met with the Committee and expressed its views and recommendations. The Board has read the Committee's report of findings and concurs with its recommendations which should enhance the effectiveness of the Section and a better understanding by the public of its objectives and the means used to attain those objectives. The Committee's report has been submitted to the AICPA Board of Directors for approval and clearance to publish.

The Peer Review Program

Each member firm is required to design and implement a quality control system for its accounting and auditing practice, as defined in Statement on Quality Control Standards No. 1, *System of Quality Control for a CPA Firm*, issued by the AICPA Quality Control Standards Committee. The elements of a quality control system are described in the Board's companion publication entitled *Audit Quality: The Profession's Program*. In addition, the Section has established membership requirements that obligate firms to implement practices that go far beyond professional standards.

A key membership requirement is that once every three years a member firm must have the quality control system for its accounting and auditing practice reviewed and reported on by an independent third party. The review may be conducted, at the option of the member firm, by another member firm, by a team appointed by the Peer Review Committee, by a team assembled by an association of CPA firms to which the member belongs, or by a team assembled by a state CPA society. To qualify to administer peer reviews for its members, an association or a state society must have its administrative plan approved by the Peer Review Committee and have any common quality control items such as manuals and educational programs reviewed by an independent third party. Currently, nine associations and one state CPA society are authorized to administer peer reviews for Section members.

Peer Reviews in 1983

In 1983, 144 firms were required to undergo a peer review; 119 of these were reviews of firms that had previously undergone review and 25 were initial reviews. Ten of the reviews were full scope reviews performed prior to the normal triennial requirement, pursuant to conditions imposed by the Peer Review Committee because

of its concern that the earlier reviews had disclosed the need for extensive corrective action to eliminate serious system deficiencies. All but three of the 144 peer review reports were accepted by the Committee as of June 30, 1984.

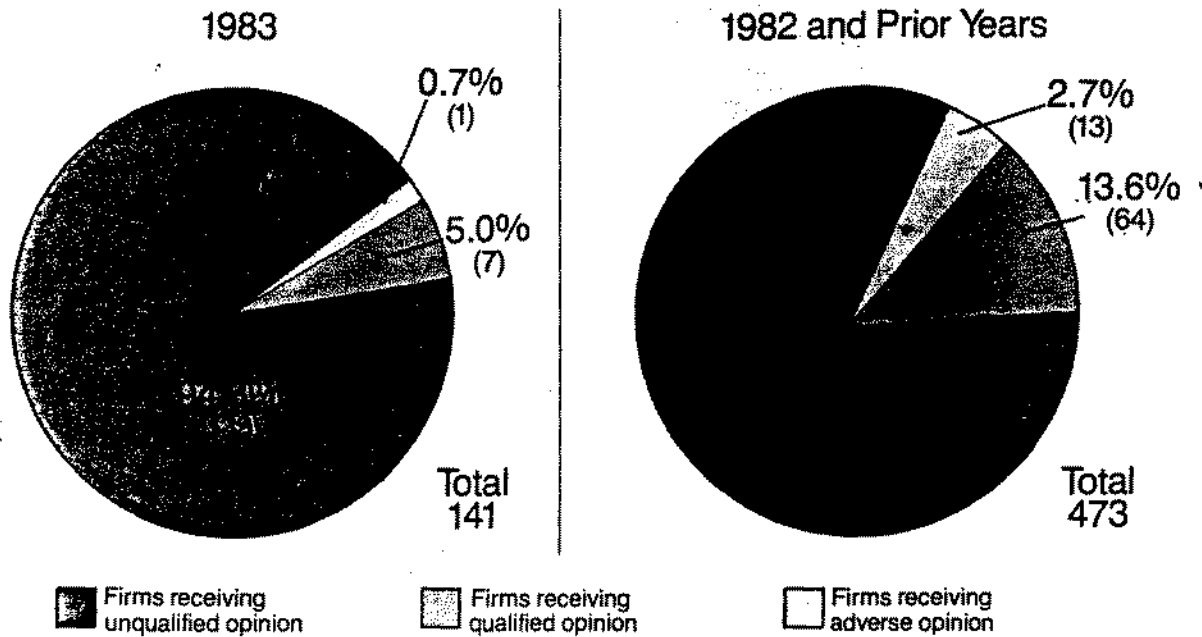
An unqualified report is issued when the review discloses that the firm's quality control system met the objectives of quality control standards and was being complied with to provide the firm with reasonable assurance of conforming with professional standards. As indicated in Chart A, over 94 percent of the firms reviewed in 1983 received an unqualified opinion, representing an increase in excess of 10 percentage points over firms receiving such reports in prior years.

A substantial majority of firms receiving unqualified reports also receive letters of comments which report (1) deficiencies noted in the quality control system or in compliance by the firm's personnel with its quality control policies and procedures and (2) recommendations for corrective action. While such corrective action would result in substantial improvement in the firm's quality control system or in compliance with its quality control policies and procedures, the identified deficiencies are not so serious as to negate the conclusion that the reviewed system provides the firm with reasonable assurance of compliance with professional standards. Only 12 percent of the firms reviewed in 1983 (and 7 percent of the firms reviewed in prior years) did not receive a letter of comments. In most instances, firms receiving an unqualified opinion without a letter of comments were single-office firms.

Reviewed firms are required to respond in writing to each item in the letter of comments stating whether they have taken or intend to take the suggested action to correct the deficiencies or their reasons for not doing so.

A qualified report is issued when the review discloses significant deficiencies in the firm's quality

CHART A Comparison of Types of Reports Issued on Reviews of SEC Practice Section Member Firms in 1983 and in Prior Years



control policies and procedures, a significant lack of compliance with such policies and procedures, and/or a significant lack of compliance with other membership requirements. Only 5 percent of the firms reviewed in 1983 received a qualified opinion, a significant drop from 13 percent in prior years.

An adverse report is issued when the review discloses that the firm's quality control system is not sufficiently comprehensive or not being complied with in a manner that provides the firm with reasonable assurance that it is complying with professional standards. Only one of the 141 reports processed on 1983 reviews was adverse, whereas 13 of 473 or 2.7 percent of the reports issued on reviews conducted in 1982 and prior years were adverse. As indicated, reports on three 1983 reviews remain unprocessed by the Committee as of June 30, 1984, for various technical reasons.

The percentage decrease in the number of qualified and adverse opinions is, in the opinion of the Board, direct evidence that the peer review process is improving the quality of practice of member firms. As previously noted, 119 firms reviewed in 1983 had undergone a prior review.

The Committee reviews the findings and the report issued on each review to ascertain whether peer review standards have been observed and

whether the firm is responsive to the reviewer's findings and recommendations. If satisfied with the report, letter of comments and response, the Committee places these documents in a file maintained by the Section for public inspection.

Improvement in Quality of Practice by Member Firms

Most firms are found by peer reviewers to have effective systems of quality control. However, a few of the systems reviewed are found to have serious deficiencies, which the firms agree to remedy. Results obtained on subsequent peer reviews provide convincing evidence of the serious commitment Section members have made to improve the quality of their accounting and auditing services.

Twenty-three of the firms reviewed in 1983 had received a modified opinion on their initial review. Ten of the firms were undergoing an accelerated review, pursuant to a condition imposed by the Committee when it accepted the report on the firm's initial review. Of the twenty-three modified opinions, eighteen were qualified and five were adverse.

On the subsequent review, sixteen of the eighteen firms receiving a qualified opinion on

their initial review received an unqualified opinion on their 1983 review. Two of the five firms receiving an adverse opinion on their initial review received an unqualified opinion on their 1983 review, two received qualified opinions, and one received another adverse opinion.

The report of the firm again receiving an adverse opinion was accepted by the Committee with the condition that the firm agree to some extremely stringent corrective actions, including, among other things, the engaging of a qualified reviewer from outside the firm to perform pre-issuance reviews of all audit reports and related workpapers. The Board has expressed its concern to the Section's Executive Committee regarding the extended period of time over which the firm's unsatisfactory performance had been permitted to continue without more decisive action being taken. Accordingly, the Peer Review Committee has formally notified the firm that failure to take the required corrective actions immediately will cause it to begin proceedings leading to the possible imposition of a sanction.

Another case illustrates the success the Peer Review Committee has had working with a firm that was highly motivated to overcome its serious quality control deficiencies. The firm received an adverse opinion on its initial peer review in 1980. As a result, the firm was reviewed again in 1982. The results indicated that the firm had made some improvement but not enough to warrant the issuance of an unqualified opinion. The Committee assigned one of its members to revisit the firm periodically to assess the effectiveness of the firm's corrective action plan. The Committee member reports that the firm has significantly improved the quality of its accounting and auditing services.

The Board especially commends this firm and the eighteen firms that received modified reports and then made such significant progress in improving their quality control systems as to warrant unqualified reports on their subsequent reviews.

Additional Requirements Imposed on Firms by the Committee

During the year, the Committee took various actions to assure that firms were effectively implementing corrective action plans in situations where the peer review had surfaced serious quality control deficiencies. Committee actions included:

- Revisits by the peer reviewer or a Committee member (Board staff participated in selected revisits) to assess improvements.
- Obtaining copies of the report of the firm's inspection program and, in the case of multioffice firms, copies of the inspection reports on individual office practice units to assess appropriateness of corrective action plans.

Type of Reviewer

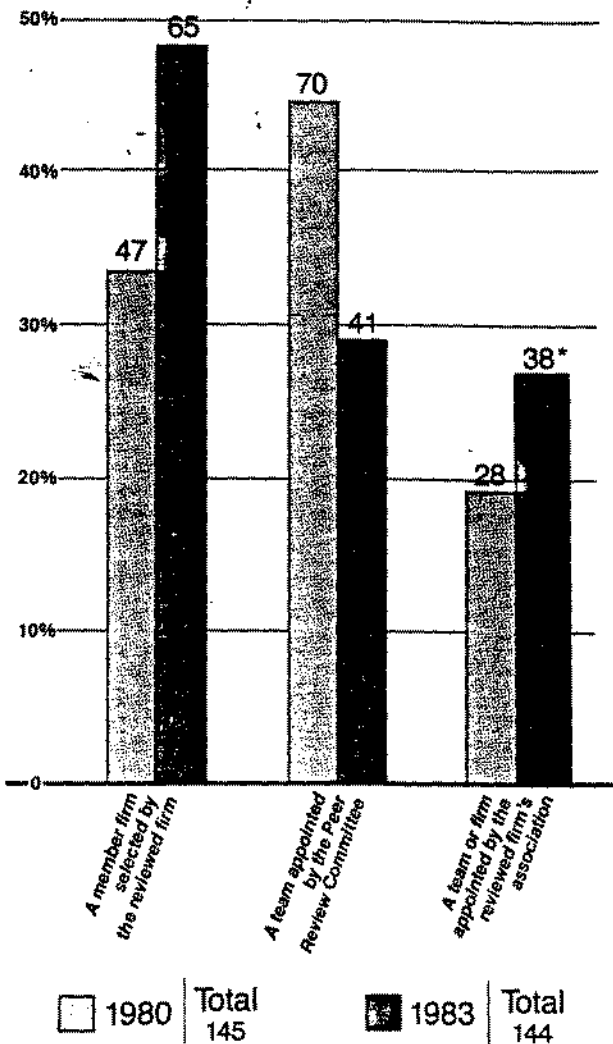
Firms that were reviewed in 1980 were again peer reviewed in 1983. A comparison of the types of reviewers in 1980 and 1983 shows a definite trend of firms selecting another firm to perform the review rather than ask the Committee to appoint a review team. Almost one-half of the firms — 70 of 145 — were reviewed by committee-appointed-review-teams (CARTs) in 1980; the percentage of firms using CARTs decreased by 19 percentage points in 1983 — to 41 of 144 firms. The types of reviewers used in 1980 and 1983 are shown in Chart B.

One possible reason for the greater use of CARTs in 1980 was that use of other types of reviewers then required the Committee to appoint a quality control review panel for each such review, which increased the cost to the reviewed firm. The panel was eliminated by the Section in 1982, upon recommendation of the Board. A study by the Board had revealed that the quality control review panel could not be cost justified because, in general, the panel duplicated the work of the primary reviewer and contributed little that was not being provided by oversight procedures of the Committee and the Board.

The quality of reviews performed by firms and associations of firms generally compares favorably with the quality of work performed by CARTs. However, both the Committee's staff and the Board's staff have noted instances where team captains appointed by firms (firm-on-firm reviews) or associations (association-administered reviews) have not had sufficient experience and/or have not adequately planned or participated in and supervised the review. As a result, the Committee has had to defer acceptance of several reports of firm-on-firm and association-administered reviews and require that:

- Additional work be performed because the scope of the review did not test a reasonable cross-section of the firm's accounting and auditing practice.
- Reconsideration be given to achieving greater correlation between the review findings and the type of

CHART B Comparison of Types of Reviewers in 1980 and 1983 Peer Reviews



*Includes one review team appointed by a state CPA society authorized by the Peer Review Committee to administer such a program.

report issued and the items included in the letter of comments.

- "Open question" be resolved concerning the reviewed firm's possible noncompliance with professional standards on some of its accounting and auditing engagements.

The Committee has dealt effectively with these types of substandard peer review performance. For example, one firm has been asked and agreed to subject future peer review reports to a preissuance review by another partner experi-

enced in quality control systems. One association with a number of troublesome reviews has been required to submit all future reviews to on-site oversight by a Committee member and to reimburse such member for expenses incurred.

Performance by CARTs was generally of high quality. A reviewer whose performance is graded as unsatisfactory is not appointed to another CART. Also, eligibility for appointment to a CART ordinarily requires attendance at a peer review training program. The Committee presented such programs again in 1984. The Board's staff reviewed and suggested refinements in the training materials and acted as course instructors as well.

Continuing Modification of Standards and Procedures

The peer review process is well past the experimental stage, yet it is still evolving. The evolutionary development of the process is continuing at a healthy rate as is evidenced by the changes that took place during the past year. Many of the changes resulted from suggestions made by the Board, the Executive Committee, the Special Investigations Committee, and the SEC staff. Included among the more important changes are the following:

Consideration of Litigation Alleging Audit Failure

Peer review guidelines were silent as to whether a reviewer had to consider pending litigation alleging audit failure as a factor in setting the scope of a peer review. A reviewer is now required to consider whether litigation alleging audit failure that is required to be reported to the Special Investigations Committee by the firm should be considered in determining the scope of that firm's forthcoming peer review. Such consideration may suggest that specific offices, personnel, audits in a particular industry, certain quality control elements, or accounting issues may require special attention. This modification of the peer review guidelines does not diminish in any way the important work of the Special Investigations Committee, which is discussed in a later section of this report.

Qualifications of Reviewers

The only qualification for a firm to serve as a peer reviewer in the early years was that it be a member of the Section. To be eligible to conduct peer reviews, a firm must now itself have been peer reviewed. While it is not expected that firms

receiving a modified or an adverse report will be selected to conduct another firm's peer review, the Board has noted that the Peer Review Committee of the Private Companies Practice Section requires that a firm must have received an unqualified opinion on its own review to be eligible to serve as a reviewer. The Board believes that the SEC Practice Section should consider adopting a similar rule.

Resolution of Disagreements

Until this year, there was no provision for resolving a disagreement between the Committee and a reviewer with respect to the type of report to be issued. Though such disagreements are few in number, the question sometimes arises as to whether a particular report should be unqualified or qualified. Such disagreements have eventually been resolved by the reviewers accepting the Committee's position or convincing the Committee of the merit of their judgment.

Under the new procedure, if a review team and the Committee should now disagree on the appropriateness of the report issued, the Committee, in certain circumstances, may appoint a special task force to perform an independent review and issue its own report which will be placed in the public file. Or, the review team's report may be placed in the public file together with a memorandum citing the reasons for the Committee's disagreement with that report.

Effect of MAS Engagements on Independence

The SEC and others have observed that the fees received for performance of management advisory services (MAS) may be perceived as an impairment of the independence of the auditor. Guidelines for testing compliance with the Section's membership requirements now require the reviewer to ascertain whether the firm performed MAS engagements for an SEC registrant for which the MAS fees exceeded the audit fees. Reviewers are required to consider this information when selecting MAS engagements for testing compliance with the independence requirements. The Board believes that audit engagements performed for such clients (i.e., those for whom the firm also performed MAS engagements) should be included in the sample of audit engagements to be reviewed, especially if MAS fees exceeded audit fees for three consecutive years.

Non-GAAS Audits

Professional literature prior to September 1983 was silent as to what an auditor was required

to do when he learned that he had not performed all audit procedures considered necessary for the issuance of an audit report he had already released. In September 1983, the Auditing Standards Board (ASB) issued Statement on Auditing Standards No. 46, *Consideration of Omitted Procedures After the Report Date*, which specifies actions that an auditor should take in such circumstances. This ASB pronouncement resulted from a concern expressed by the Board, and shared by the SEC, that auditors be given more definitive guidance in these matters.

When a peer review team reviews an engagement and concludes that the firm did not perform sufficient procedures to support the audit report issued, the team is unable to ascertain whether the financial statements were prepared in accordance with generally accepted accounting principles. Under these conditions, the firm is required to document the actions it plans to take or its basis for concluding that no action is required. If the review team believes that the firm's decision is inappropriate, the matter is referred to the Peer Review Committee for action. Procedures for resolution of differences between the Committee and a member firm are now in place.

Timely Submission of Peer Review Reports

Some peer review reports were not being submitted to the Committee for processing on a timely basis. To expedite the reporting of review results, commencing with the reviews performed in 1983, team captains are now required to transmit the report and letter of comments to the reviewed firm within thirty days of completing the review or face the possibility of sanctions. The reviewed firm is then required to forward the report, letter of comments, and its response to the Committee within thirty days after receipt of the report and letter of comments or face the possibility of sanctions. The new policy has improved the timeliness of submission of peer review reports.

During the past year, Committee task forces have become involved in the resolution of complex problems on several peer reviews, including two of the three unprocessed reviews at June 30, 1984. The resolution of complex problems understandably is a time-consuming process, and the Board recognizes the time and effort that various members of the Committee have expended this year in problem resolution.

Areas for Improvement

The Board believes there are areas where further improvement can be effected. Uniformity in the reporting of peer review findings is one of

these. The determination of whether deficiencies uncovered in a peer review are sufficiently significant to warrant issuing a modified report is a highly qualitative, judgmental matter. In several instances, reviewers have issued unqualified opinions in circumstances in which the Board believes other reviewers faced with the same set of facts would issue modified reports. In these cases, deficiencies have been reported in the letter of comments as areas for substantial improvement and the letter of comments is placed in the public file. However, since a reviewed firm may distribute its report to clients or prospective clients without the attendant letter of comments, a firm receiving an unqualified report without a letter of comments may have a comparative advantage over the firm receiving an unqualified report with a letter of comments. Accordingly, the Board believes that a reference should be placed in each report, where appropriate, to the effect that a letter of comments was issued in conjunction with the issuance of the report.

A second matter that requires reconsideration—and additional guidance—is when a report should be modified because the firm did not perform an annual inspection as required by quality control standards. During the year, the Peer Review Committee, while concluding that an annual inspection is an important activity for all firms, nevertheless agreed that the peer review report of firms with fewer than twenty professionals need not be modified for lack of timely performance of inspection during the intervening years between peer reviews, provided no other significant deficiencies were noted during the review. Noncompliance with the inspection requirement, however, is required to be reported in the letter of comments.

The Board recognizes that the rule on the size of firm was an arbitrary one and does not question the Committee's judgment on that matter. However, the Board notes that the Committee applied the concept underlying the rule to the review of a larger firm. The Board has informed the Committee that the rule should be either enforced or eliminated, rather than applied in what the Board believes is an inconsistent manner.

Substandard Performance on Individual Engagements

The peer review process also deals with instances of substandard auditing or accounting performance on individual engagements, which are reported promptly to the Committee. During

1983, peer reviewers reviewed the financial statements, reports, and workpapers for 1,315 audit engagements. Thirty-three of these were deemed to be substandard in the application of generally accepted accounting principles (GAAP) or generally accepted auditing standards (GAAS). In two of fifteen cases in which the financial statements were not in accordance with GAAP, the 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.

The Board's staff found reviewers diligent in pursuing instances of noncompliance with GAAP or GAAS. The fact that two-and-one-half percent of the engagements reviewed were identified as substandard reflects the objectivity of the reviewers. 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 1 summarizes the actions taken by the firms in connection with engagements found not to have been performed in accordance with professional standards.

TABLE 1 *Corrective Action Required by Peer Review Committee with Respect to Substandard Audit Engagements Identified in Peer Reviews Performed in 1983*

Number of audit engagements reviewed	1,315
Number of audit engagements considered substandard by peer reviewers	33
	(2.5%)
Corrective Actions Required	
Audit report recalled and financial statements revised and reissued	2
Omitted auditing procedures performed	5
Omitted auditing procedures—firm has not yet informed Committee of actions to be taken*	3
Cause of impairment of independence eliminated	1
GAAP and GAAS deficiencies not requiring immediate action to be corrected in subsequent year's audit	22
Total	33

* Engagements identified in review processed by Committee in March 1984.

The fact that even a small percentage of engagements is deemed not to have been performed in accordance with professional standards

is disturbing. Nevertheless, it was concluded that these were not the result of systems deficiencies but generally because of what is sometimes referred to as "people problems." The Board takes comfort from the fact that, absent the peer review process, these instances of substandard performance may have gone undetected for a much longer period of time and could have eventuated in investor losses if it were not for timely discovery and correction.

Monitoring of MAS Engagements

Member firms are required to report certain information regarding fees received for management advisory services (MAS) engagements. Such information is included in the firm's annual report which is placed in the public file. Analysis of the MAS data reported by members of the Section indicates that almost 90 percent of member firms generate fees from performance of MAS engagements that are less than 20 percent of total fees. A recent analysis shows:

Number of Section Members	Percentage of MAS Fees to Total Fees				Total
	0-9%	10-19%	20-50%	Over 50%	
With SEC clients	123	57	15	1	196
With no SEC clients . .	118	80	36	2	236
Total	241	137	51	3	432
Percentage	55.8%	31.7%	11.8%	0.7%	100.0%

Section monitoring of MAS engagements is accomplished in two ways:

- Firms must report the number of SEC clients for which MAS fees are in excess of 100 percent of fees for audit services for three consecutive years.
- Tests are performed during the triennial peer review to determine whether the firm has:
 - Complied with the AICPA Code of Ethics and

Statements on Standards for Management Advisory Services dealing with independence in performing MAS engagements for SEC clients.

- Abstained from performing stipulated MAS engagements proscribed by the Section.
- Reported to the audit committee of board of directors of each SEC client the amount of MAS fees received and the services performed.

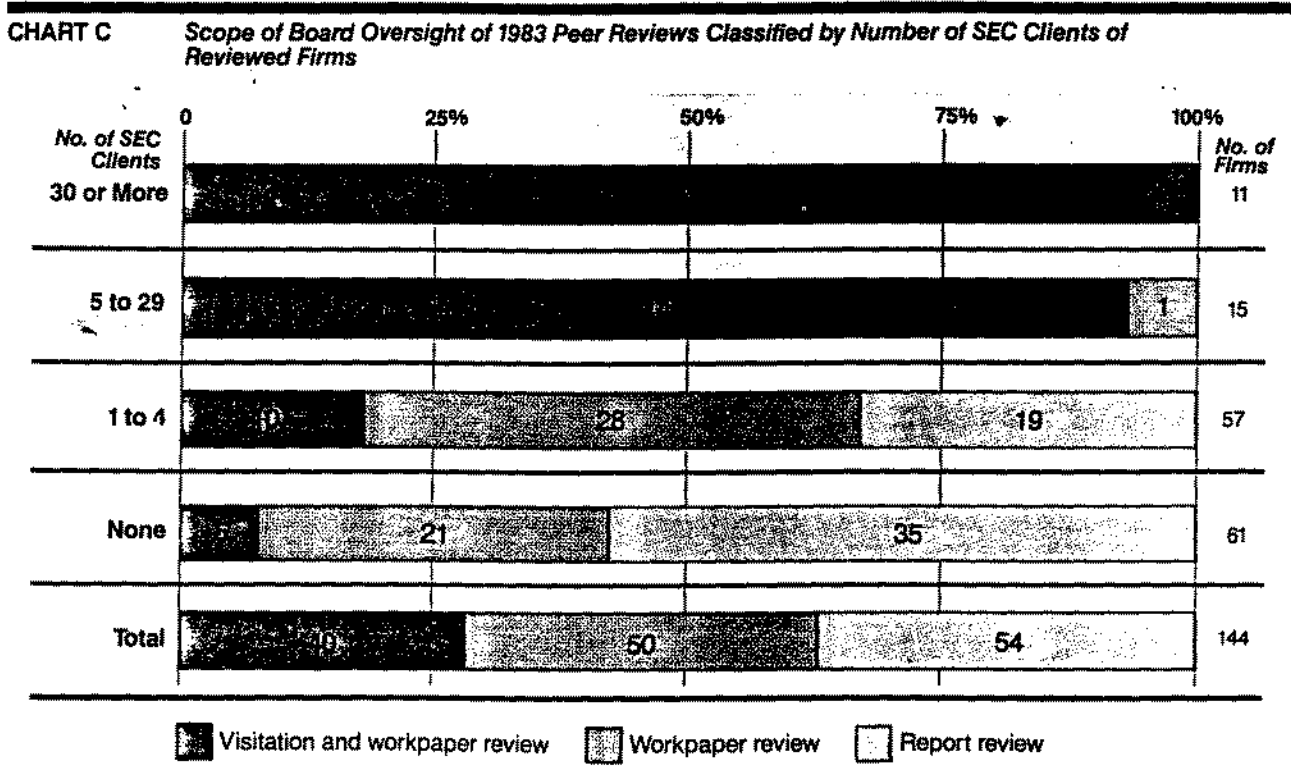
Peer review teams test compliance with these membership requirements by using special work programs designed by the Section's Peer Review Committee. These procedures have not surfaced any evidence that suggests that proscribed services have been performed or that performance of MAS by member firms has diluted the objectivity required in performance of the audit function.

Board Oversight of Peer Review Process

Representatives of the Board actively monitor the peer review process by attending all meetings of the Peer Review Committee and its Evaluation Subcommittee and by monitoring individual peer reviews. Each review is subjected to one of three types of Board oversight: (1) observing the performance of the field work, attending the exit conference where the results are reported to firm management, and reviewing the team's workpapers, report, and letter of comments, and the reviewed firm's letter of response; (2) reviewing the workpapers and the report and letters issued; or (3) reviewing selected reviewers' workpapers including the summary review memorandum and the report and letters issued. During the current year, the Board observed reviews in process of all but one of the firms with five or more SEC clients and, based on selected criteria, visited a number of firms with fewer than five SEC clients and a representative number of firms with no SEC clients. Chart C summarizes this phase of the Board's oversight.

The Board finds its access to the peer review activities of the Section entirely satisfactory for discharge of its oversight responsibilities. Discussion at Committee meetings is free and frank, and Board members and its staff have adequate oppor-

tunity to express their views and to receive response to such expressions. The Board is convinced that this aspect of the self-regulatory process is functioning effectively and accomplishing the purposes for which intended.



Special Investigative Process

Member firms are required to report to the Special Investigations Committee each litigation or 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. This requirement became effective for litigation or proceedings initiated on or after November 1, 1979. The Committee determines whether the allegations of audit failure indicate a need for improvements in the quality control systems of the reporting firms or compliance with them or whether changes in professional standards are required.

Objectives of the Process

The activities of the Special Investigations Committee supplement the peer review process as a means of protecting users of financial statements. The Committee's investigative process focuses on reducing the possibility of future failures by (1) identifying deficiencies in the firm's quality control system that may have permitted the alleged deficiency to occur and (2) causing such deficiencies to be corrected.

Operation of the Committee

For each reported case, the member firm is required to provide copies of the complaint, relevant financial statements, SEC or other regulatory filings, and, if requested, other relevant public documents. The staff of the Committee prepares a summary of the submitted data, identifying the accounting, auditing, and quality control issues involved. Copies of all documents and the staff summary are sent to all Committee members.

One or two Committee members are assigned as a task force to study the issues in each reported case and to make recommendations to the Com-

mittee as to the action that should be taken. Each case is subjected to prescribed initial investigative procedures, during which the task force considers the nature of the allegations and their implications. In some cases, analysis of the complaint and the financial statements to which it relates permit the Committee to conclude that the allegations are without merit. In other cases, the procedures are supplemented by a discussion of the allegations between representatives of the task force and the firm and a review of the findings of the firm's most recent peer review.

If the results of the initial investigative procedures warrant, the case is monitored in order to follow and evaluate future developments, such as the issuance of a report of a peer review in process or the issuance of a bankruptcy trustee's report.

If the allegations appear to indicate that there may be serious deficiencies in, or compliance with, the firm's quality control system, the Committee will order a special review of those aspects of the firm's system that, if effective, ordinarily should prevent or detect deficiencies of the type alleged to have occurred. Such a review involves application of procedures identical to those used in peer review. The Section has adopted a policy which requires cost of the special review to be borne by the firm.

Files are closed on cases when the Committee concludes that the allegations appear not to have merit, do not indicate a deficiency in the firm's quality control system, or if a deficiency may have existed, that appropriate corrective action has been taken to guard against the possibility of future failure.

Activity During the Year

At July 1, 1983, the Committee had open files on fifteen cases. Twenty-seven cases were

added to the Committee's agenda during the year. A summary of the year's activity is shown in Table 2.

TABLE 2 Special Investigations Committee Activity for the Year Ended June 30, 1984

	Cases Undergoing Initial Investigative Procedures	Cases Being Monitored	Cases Resulting in a Special Review of the Firm's Quality Control System
Status of cases at July 1, 1983	13	10	2
Activity during the year:			
Cases added	27		
Cases transferred to monitoring	[13]	13	
Cases moved from special review status to permit monitoring of firm's corrective action plan		2	[2]
Cases closed	[13]	[19]	—
Status of cases at June 30, 1984	<u>14</u>	<u>6</u>	<u>0</u>

As indicated, files on two cases involving special reviews were open at the beginning of the year. Those two cases were placed in monitoring status during the year, pending a determination of the effectiveness of the firm's action plan to correct deficiencies noted during the special review. Other cases are being monitored awaiting the outcome of expected future developments. No cases reported during the year resulted in the Committee's requiring a member firm to undergo a special review. In some cases, the need for a special review was obviated by actions initiated by the firm involved, where the firm reported its action to the Committee and made documentation of such action available. Actions taken by firms ranged from transfer of personnel and attendant reassignment of specific responsibilities to an intensive review of selected aspects of the firm's quality control system.

A more detailed description of the operation of the Committee and its decision-making process is contained in the Board's publication entitled *Audit Quality: The Profession's Program*.

Files on ninety-five cases have been opened by the Committee since inception of the program

in November 1979. While most cases involve alleged audit failures involving SEC registrants, some non-SEC cases were voluntarily reported by member firms in response to a request by the Committee because of high public interest in the case. The Board believes that all such requests of the Committee were appropriate and believes that the affected firms are to be commended for their cooperation.

Since allegations of audit failure involving any entity may be indicative of a deficiency in the firm's quality control system or in generally accepted auditing standards, the SECPS Review Committee has recommended extending the litigation reporting requirement to include certain cases involving non-SEC registrants. The Board believes that the reporting requirement should be expanded to include allegations of audit failure of companies in which there is a high public interest.

Reevaluation of Professional Standards

In addition to assessing the quality control implications of allegations in litigation, the Committee considers whether the allegations indicate a deficiency in professional standards or a need for additional guidance.

Cases reported during the year prompted the Committee to take several such actions. For example, noting that similar allegations were made in several reported cases involving bank audits, the Committee became concerned that the allegations were lessening the confidence of users of audited financial statements of banks. As a result, the Committee asked the profession's audit standard-setters to reassess the effectiveness of current bank audit guidance in light of the allegations. Members of the Committee met with members of the AICPA's Banking Committee and the chairman of the AICPA's Auditing Standards Board. As a result, the Banking Committee published additional information regarding appropriate bank auditing procedures and reassessed the adequacy of its recently published Bank Audit Guide.

On other occasions in its brief history, the Committee (1) conferred with representatives of the AICPA's Insurance Committee to discuss issues raised in cases that may have implications on existing standards and (2) urged the AICPA's Accounting Standards Executive Committee to

accelerate its consideration of income recognition issues of certain insurance industry transactions.

Board Oversight of SIC Activities

The Board actively monitors the activities of the Committee and its task forces and has complete access to all Committee files. Members of the Board's staff read all the pertinent documents, financial information, correspondence related to individual cases, as well as the Committee-staff-prepared summaries and relevant professional literature. Board members are sent copies of each case summary, which serves as a basis for discussion at Board meetings. Members of the Board

and/or its staff attend all Committee meetings and, at its discretion, meetings of the Committee's task forces with firm representatives to discuss allegations in specific cases.

Activities of the Committee and its decisions on each case are reported on and discussed at Board meetings. Based on its extensive monitoring, the Board concludes that the Committee has effective operational procedures, that Committee members take their responsibilities seriously, and that the Committee's decisions are sound and in the interest of the public and the profession.

Membership in the Division

Almost 1,700 firms belong to the Division for CPA Firms: 417 belong to both the SEC Practice Section and Private Companies Practice Section, 13 belong only to the SEC Practice Section, and another 1,233 firms are members of only the Private Companies Practice Section.

Despite the "loss" of thirty-four members through merger, net membership in the Division increased by twelve firms — an increase of three SECPS-only firms, an increase of thirteen in both

sections, and a loss of four firms that belong only to the Private Companies Practice Section. Table 3 presents an analysis of changes in membership for the year ended June 30, 1984, with firms classified according to whether they do or do not audit at least one SEC registrant.

The impact that the Division has on the quality of accounting and auditing services cannot be judged solely by the number of member firms. Member firms audit over 11,500 SEC registrants,

TABLE 3 Analysis of Membership in the Division for CPA Firms by Number of SEC Clients and by Section—
July 1, 1983 to June 30, 1984

Number of firms classified by firms with and with no SEC clients	July 1, 1983	Mergers* July 1, 1983 to June 30, 1984	July 1, 1983 Restated	New Members	Intra Division Changes (net)	Resignations, Terminations, and Suspended Memberships	Changes in Classification of Firms	June 30, 1984
Firms with 1 or more SEC clients								
SECPS only	6	—	6	1	1	1	—	7
Both sections	190	7	183	11	[3]	6	4	189
PCPS only	119	2	117	13	2	15	[4]	113
Totals	315	9	306	25	—	22	—	309
Firms with no SEC clients								
SECPS only	4	—	4	2	—	—	—	6
Both sections	226	5	221	17	1	7	[4]	228
PCPS only	1,140	20	1,120	152	[1]	155	4	1,120
Totals	1,370	25	1,345	171	—	162	—	1,354
All firms								
SECPS only	10	—	10	3	1	1	—	13
Both sections	416	12	404	28	[2]	13	—	417
PCPS only	1,259	22	1,237	165	1	170	—	1,233
Totals	1,685	34	1,651	196	—	184	—	1,663

* All 12 firms that were members of both sections merged with other firms that are members of both sections. Of the 22 PCPS-only firms, 15 merged with firms that are members of both sections and the remaining 7 merged with other PCPS-only members.

TABLE 4 Analysis of Membership in the Division for CPA Firms — July 1, 1983 and June 30, 1984

Classification	Division for CPA Firms			SEC Section		
	July 1 1983*	June 30 1984	Increase (Decrease)	July 1 1983*	June 30 1984	Increase
Number of firms	1,651	1,663	8	414	430	16
Number of SEC clients	10,330	11,543	1,213	10,147	11,366	1,219
Number of practice units	3,771	3,742	(29)	1,957	1,974	17
Number of professionals	100,024	100,846	822	83,925	85,192	1,267

*Adjusted for mergers July 1, 1983 to June 30, 1984

operate over 3,700 practice units in the United States, and employ over 100,000 professionals. Details are shown in Table 4.

Auditors of Publicly-traded Companies

Firms that are members of the Division audit the financial statements of the vast majority of publicly-traded companies. Two hundred fifty-four member firms audit over 85 percent of all public companies listed in the eleventh edition of *Who Audits America*.² As shown in Chart D, these companies account for over 98 percent of the combined sales volume of all publicly-traded companies. It should be noted that over 79 percent of the number of companies are audited by firms that are entitled to a permanent seat on the Executive Committee of the SEC Practice Section; these companies account for 98 percent of the aggregate sales of all publicly-traded companies.

Members of the Division audit all but three of the companies whose stocks are listed on the New York Stock Exchange and all but twenty-eight of the companies listed on the American Stock Exchange; approximately one-third of these are audited by Canadian firms of chartered accountants that are affiliated with firms that are members of the Division.

Membership Promotion

While the statistics cited above are impressive, a broader base of membership is desirable to pro-

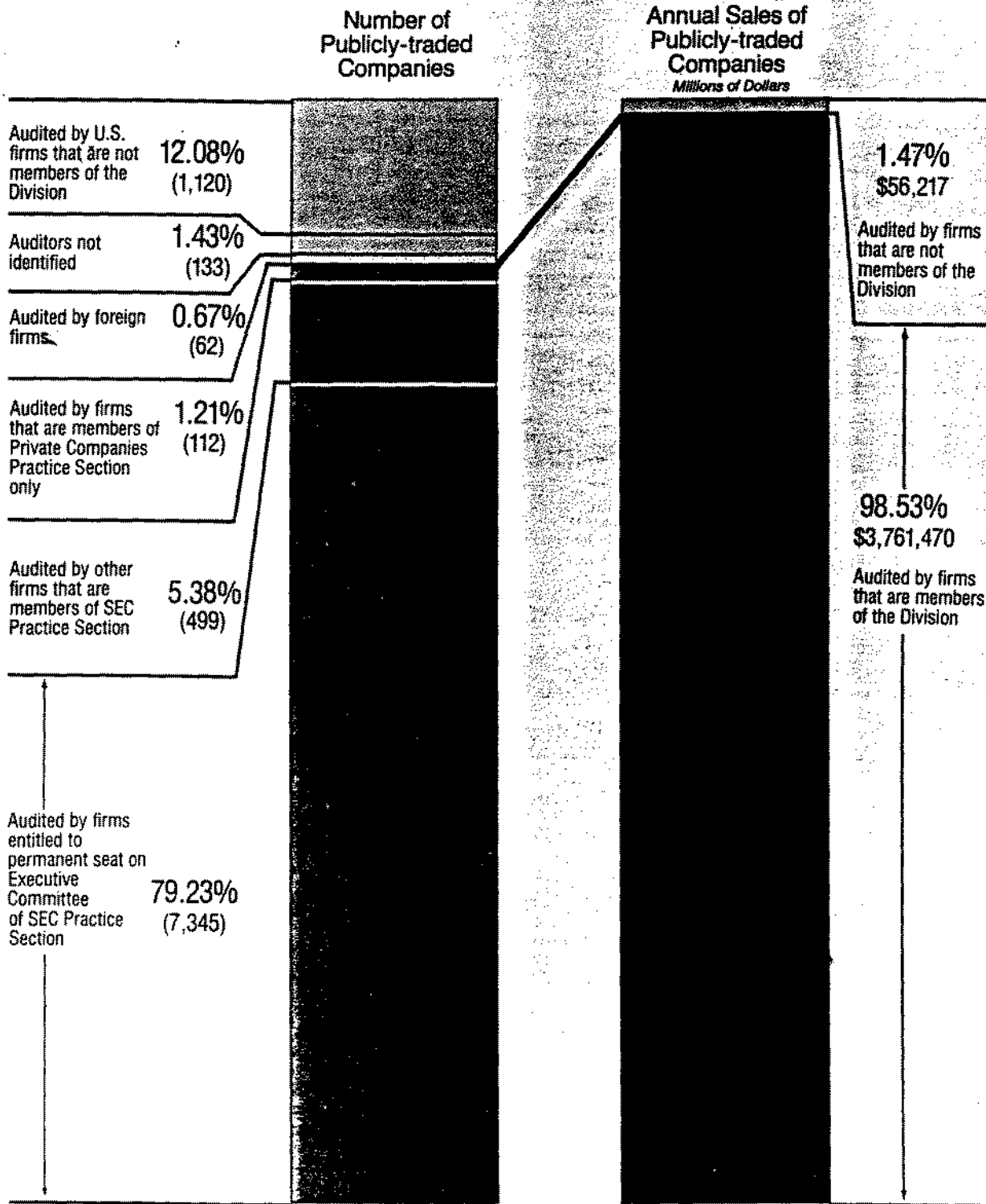
vide the public with the full benefits of the peer-regulatory program. The Board shares the view of the SEC as reported in its most recent report to Congress: "The Commission continues to believe that all accounting firms which audit public companies should join the SECPS."³

Efforts to increase membership should be intensified with special emphasis upon attracting auditors of SEC registrants to the SEC Practice Section. The Board is aware that the Division is giving serious consideration to initiating a multifaceted program intended to increase membership and better inform persons both within and outside the accounting profession about the program and the commitment to high quality service that membership in the Division represents. The Board urges the Division to implement such a program. The investing public would benefit from an increase in the number of firms committed to conduct their practices in accordance with the requirements of Division membership.

² *Who Audits America*, 11th ed., Menlo Park, Calif: Data Financial Press, 1984.

³ Securities and Exchange Commission, Annual Report, 1982, U.S. Government Printing Office, Washington, D.C.

CHART D Analysis of Firms That Audit Publicly-traded Companies
Listed in the Eleventh Edition of *Who Audits America*



SEC Oversight of the Program

The Board maintains a liaison relationship between the SEC and the SEC Practice Section. During the course of the past year, Board representatives met periodically with the SEC Chief Accountant and members of his staff to discuss various issues.

The SEC independently evaluates the peer review process of the SEC Practice Section, including the effectiveness of Board oversight. The SEC inspects a sample of peer review team workpapers of firms that audit SEC registrants 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 also in order to reduce further the possibility of client identification.

A continuing unresolved issue between the Section and the SEC is whether the SEC should be given direct access to the activities of the Special

Investigations Committee, or to evidence of those activities. Lacking the direct access it desires, the SEC asserts it has no basis for independently determining the effectiveness of the Committee's discharge of its responsibilities. The Section's position is that confidentiality is essential to the operation of the Committee; without it, member firms would not be as candid and forthright in responding to inquiries made by the Committee. Discussions between the Section and the SEC regarding this issue were deferred pending completion of the SECPS Review Committee's study, which includes study of this matter in depth.

Conclusion

The past six years have given all members of the Board a comprehensive understanding of the importance of and the difficulties with self-regulation. Our views of self-regulation have been affected by an increased understanding of the total professional regulatory scheme. The Board views regulation of the profession as a complex, inter-related disciplinary process at three distinct levels and involving a number of responsibilities. The purpose of professional regulation—continuing, satisfactory professional service at a competitive price—can be assured only if each of the three levels of regulation—private, peer, and public—fulfills its responsibility, and if each cooperates sufficiently and thus in combination constitute an integrated structure, uniform in expectations and consistent in requirements.

The Board has come to realize that perhaps the most substantial, and certainly the least recognized, force for improvement of professional performance is private regulation, the discipline imposed by management of individual firms as they strive to meet the demands of competition and to achieve professional standards.

Professional or peer-regulation also plays an integral role in the overall regulation of the accounting profession. The peer review and special investigative processes of the SEC Practice Section are especially vital and effective components of the profession's self-regulatory program.

Members of the Board are sometimes asked if it can provide measures of the success of the self-regulatory program in the accounting profession. Our response must be that we have no precise measurement, but we note considerable evidence provided by independent third parties that confirm our conclusion that the program is achieving its stated objectives. For example,

- L. Glenn Perry, Chief Accountant of the SEC's Division of Enforcement, finds that "...the accounting

profession is doing a good job. Its self-regulatory efforts have been successful, but they must continue. Audit performance has been significantly improved over the past decade. Additional quality controls have been implemented and they are working."⁴

- Several departments of the U.S. government, such as Energy, Labor, and Agriculture, now require accounting firms seeking to provide services to those departments to include in their proposals the date and results of their latest peer review.
- On more than one occasion, the SEC has required a firm, as part of a consent agreement following an enforcement action, to join the SEC Practice Section and submit its quality control system to peer review.
- A Regional Trial Board—an integral part of the Joint Ethics Enforcement Program of the AICPA and state CPA societies—recently found two members guilty of violating technical standards and will expel them from the state CPA society and the AICPA unless a peer review of their firm has been completed on a timely basis.
- The National Association of State Boards of Accountancy is encouraging state boards to implement positive enforcement programs to detect work not done in accordance with professional standards and to require firms doing such work to undergo a peer review.

The Division deserves to be commended again this year for continuing its efforts to strengthen the quality of auditing and accounting practice by its member firms. Nevertheless, its officers and members, like the members of the Board, recognize that there is progress yet to be made and such progress can be expected.

⁴ L. Glenn Perry, "The SEC's Enforcement Activities," *The CPA Journal*, The New York State Society of Certified Public Accountants, New York, New York (April 1984).

SELF-REGULATION— CRITICISMS AND A RESPONSE

How peer regulation works—and works well.

by Robert K. Mautz

Criticism is often irritating and sometimes helpful. Because of the possibility of helpfulness, wisdom requires that the criticism, however irritating, not be rejected out of hand. What, then, to do with it? Experience suggests that criticism should be examined to determine the point of view from which it is expressed, then that point of view should be analyzed to ascertain whether its perspective on the subject criticized is sufficiently appropriate that the criticism ought to be heeded.

In the year since I last spoke at the National Conference on Current SEC Developments, the public oversight board (POB) and the American Institute of CPAs self-regulatory program have been subjected to outspoken criticism. Four are cited here as examples:

"One CPA in jail would do more than all your peer reviews."

"Regulators seek out those who do wrong and punish them. That's what regulators do. If you don't do that, you may have a great system for improving professional practice, but you do not have self-regulation."

"Perhaps the most cynical aspect of the [AICPA] division for [CPA] firms is the

POB. This so-called public board is appointed by the executive committee of the division's SEC practice section [SECPS], which is controlled by the votes of the eight largest firms. To date, the POB hasn't censured, admonished or disciplined any accounting firm, especially those involved in the audit failures."

"I have pointed up legal proceeding after legal proceeding, SEC action after SEC action, against major firm after major firm, wherein such firms have been judged to have violated GAAP after GAAP and/or GAAS after GAAS. All these determinations notwithstanding, our disciplinary apparatus (in the AICPA, the POB and elsewhere) appears impotent to proceed against the miscreants who are entrenched within the Establishment."

From what perspective do these comments come? Apparently, either from regulators or from those who believe the AICPA program should be judged by the standards of government regulators. Does that represent a point of view the POB should urge on the SECPS? I think not.

One interesting aspect of challenges and criticisms is that they need no support. Mere utterance gives them status. Responses to them, however, especially if they are disagreements, require justification to have any standing. What follows is the rationalization that has led to my disagreement with the criticisms cited.

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The Scope of Regulation

Regulation, as it is widely used in general conversation and as it was interpreted by the founders of the AICPA program, is a broad term. Regulation of the practice of accounting includes all measures intended to protect the public from exploitation and inadequate service by accountants. This comprehends a wide range of activities. Certainly it includes the activities of government regulators as they set standards for public practice, license those who qualify, establish laws and regulations, and seek out and punish wrongdoers. It also includes the efforts exerted within a CPA firm to avoid errors and mistakes; to provide reliable, satisfactory service; to train and supervise staff; to inspect the work of practice units; to insist on consultation when appropriate; to reward partners and employees who do well; to discipline those who fail to meet the firm's standards.

Regulation, as the AICPA program conceives of it, includes three distinct levels of control, which we can describe as government regulation, peer regulation and private regulation.

Government regulation. Government regulation of accounting includes the laws, regulations, licensing requirements, courts, legislatures, commissions and legal procedures designed to protect the public from fraud, gross negligence and breach of contract by accountants acting in their professional capacity. Note that government regulation concerns itself with activities below the level of social acceptability. Accountants and others who run afoul of the law have failed to meet the lowest standards acceptable to the community. Punishment of some kind, including possible loss of the privilege to practice, typically follows legal establishment of guilt.

The U.S. concept of justice strives to assure accountants charged with wrongdoing, as well as those who claim to have been injured, a fair trial in an adversary proceeding. Plaintiffs have the right of discovery; both parties are entitled to counsel and judicial propriety.

Government regulation is the most visible form of regulation. Few events are considered more newsworthy than the arrest and ultimate conviction of someone charged with breaking the law. This form of regulation is involuntary, is imposed with ultimate enforcement authority and is accomplished at considerable cost. Government regulation is primarily a deterrent. It is designed to prevent future occurrences of unacceptable behavior by persons found guilty. It is also designed to enforce

Author's note: Initially presented as my views in a talk prepared for the American Institute of CPAs 11th National Conference on Current SEC Developments, this adaptation has since been reviewed by the public oversight board (POB) of the SEC practice section (SECPS) of the AICPA division for CPA firms and generally expresses the board's sentiments. The POB oversees the self-regulatory efforts of the SECPS. The conference was held in Washington, D.C., on January 10 and 11, 1984.

minimum standards, not necessarily to improve the general level of service; nor is there necessarily any continuing effect of enforcement beyond the persons directly involved. Contrary to the thought expressed by the first critic cited, punishing the convicted has not proved to be a great deterrent to others for a great many types of unacceptable behavior. There is no available evidence that it is more successful for accountants.

Peer regulation. Compared with government regulation, peer regulation is almost invisible. It has minimum media appeal. It is a voluntary professional effort conducted by a professional organization to improve the quality of service provided by the members of the profession. Some members of the profession may work to influence the passage of laws and regulations. We do not think of that as peer regulation. We do include within that phrase the establishment of standards that the members of the organization agree to comply with, as well as the testing of compliance with those established standards.

Because membership in the professional organization is voluntary, there is little authority in support of peer regulation other than peer

"By establishing professional standards for quality control and then testing firms' compliance with those standards, peer regulation teaches the nature of quality control to all who are reviewed."

pressure and possibly some fear that failure to meet peer standards will become a competitive disadvantage.

Peer regulation must call for standards higher than the legal minimum accepted by the community or there is little reason for its existence. A professional organization calling for nothing more than conformity with the law would have little standing. If it called for anything less, it would be a conspiracy. Peer regulation thus differs from government regulation in a number of ways. It is positive in effect, calling for service of higher quality than is required under the law. It is also likely to have a continuing effect, especially if the compliance tests are rigorous and applied consistently. If the standards themselves are reviewed and updated periodically, the effect is both strengthened and lengthened. Finally, peer regulation reaches far more practitioners than does government regulation. All members of the profession are reached by the former; only those who fall below society's norm become involved with the latter.

Private regulation. Private regulation, for all intents and purposes, is invisible. What one does inside one's own organization is

rarely brought to the attention of others, and when it is, the interest tends to be minimal. Yet it is the most pervasive and probably the most productive of all types of regulation. Certainly it affects the most people. Most accountants have their first and perhaps only experience with regulation at the level of private regulation. It is here—emphasized in training classes, manuals and on-the-job experience—that the young accountant learns how professional standards are applied, what supervision and review of an audit engagement mean and what the consequences are when a supervisor's expectations are not met. Thus, private regulation has the broadest influence, is directed at improved service and can perform to standards as high as the personal pride of the partners or the demands of their competition and clients require. It is essentially constructive in nature, although the possibility of punishment is always present.

Private regulation is voluntary. As a firm's management seeks to meet the profession's standards, to provide service at least as good as that of competitors and to meet its own ideals of quality practice, the partners take measures they consider helpful. They do this with little fanfare but often at considerable cost and strain. The motivation for private regulation comes from within a firm; the regulatory measures are applied within the firm; the benefit from those measures flows directly to the firm and its clients. Private regulation—the personal response to a variety of stimuli—constitutes the ultimate means by which all constructive improvement is effected.

Interrelationship of the Levels of Regulation

The three levels of regulation are complementary rather than competitive. None can substitute for another: none is adequate by itself. Without the legal powers and authority of government regulation, peer or private regulation cannot seek out and punish wrongdoers with the effectiveness and justice of public regulation. Nor can government regulation provide the educational benefits of peer regulation or reach out to the numbers affected by private regulation. If those who use the services of public accountants are to have the full benefits of regulation in all its forms, all three levels of regulation must be encouraged and strengthened.

Some critics of the current system appear to argue that the most effective discipline is quick, sure and dramatic punishment. They believe that if failure to perform in accordance with requirements is discovered and punished, quality performance by other practitioners will result. I would not argue that crime should not be punished, but there is a great deal more to regulation than the punishment of crime. Do we want the practice of accounting to remain at the minimum level

that society will tolerate, or do we expect professional practice to be carried out at a much higher level of service? If the latter is the case, we must have the means to teach that requirement to all who are expected to meet it.

The Benefits of Peer Review

Those who believe so strongly in punishment should have the experience of sitting in on an exit conference following a peer review. Almost without fail there is an interesting exchange of useful ideas, as well as promises to forward copies of guides and checklists that the reviewing team has found helpful in its practice and that the reviewed firm is eager to receive and use. For every intentional law-breaker in accounting, there are thousands of dedicated practitioners eager to improve the quality of their work. Peer review, an aspect of peer regulation, is a remarkably successful educational process. By establishing professional standards for quality control and then testing firms' compliance with those standards, peer regulation teaches the nature of quality control to all who are reviewed. In addition, it carries to firm after firm word of what other firms are doing to measure up to those quality control standards as efficiently and effectively as possible.

In addition to the educational function of peer review, there is some highly desirable discipline. In anticipation of a peer review, a firm must document its quality control for the reviewers. Development of this document necessarily turns the firm's attention inward, toward its quality control policies and procedures. Management must ask, "Exactly what are we doing—and not doing—to maintain the quality of control over all aspects of our professional activities that our peers will expect of us?"

Members of the review team use this document in two ways. First, they ascertain whether the standards claimed meet the quality control standards of the profession. Second, they scrutinize evidential matter indicative of the firm's policies and the implementation of those policies to discover the extent to which the firm adheres to the quality control standards alleged to constitute its practice. The discovery by the reviewers of any material failure to perform in compliance with the firm's own quality control document results in a specific description of the failure. The facts of the description are cleared with the partner or the responsible staff member of the reviewed firm, and the description is included in the peer review work papers along with the firm's response to the charge of a deficiency in its quality control.

The Question of Sanctions

Now we come to the matter of sanctions, or punishments. The "Organizational Structure and Functions of the SEC Practice Section of

the AICPA Division for CPA Firms¹ grants to the executive committee the authority to impose sanctions on member firms following appropriate disciplinary proceedings.¹ These sanctions include

- "[Requiring] corrective measures by the firm including consideration by the firm of appropriate actions with respect to individual firm personnel.
- "Additional requirements for continuing professional education.
- "Accelerated or special peer reviews.
- "Admonishments, censures, or reprimands.
- "Monetary fines.
- "Suspension from membership.
- "Expulsion from membership."²

To date, no official sanction has been imposed by the executive committee on any member of the SECPS. This fact has caused some criticism by those who consider government regulation to be the model for all regulatory efforts.

Their views have been expressed to me in these general terms: "A regulatory program—call it self-regulation or whatever you will—that does not impose sanctions has no credibility. Not only must sanctions be imposed, their imposition must be a matter of public knowledge, and they must be sufficiently severe to be impressive. Your system must have teeth in it, or it will have no public

"Public accounting firms know a great deal about sanctions; they apply them on a private basis promptly, effectively and as often as needed."

standing." These are contentions that require consideration.

Although the executive committee is the only body that has the authority to impose sanctions officially, in fact the equivalent of sanctions is already being proposed by others at a number of points in the system and voluntarily accepted by the firms to which proposed.

When a peer review is completed, the formal report on the review, prepared by the team captain, is forwarded by the reviewed firm to the peer review committee for acceptance and inclusion with accompanying papers in the public file. With the formal report the peer review committee receives a copy of the letter of comment, which mentions all deficiencies in quality control not cleared during the review, as well as the firm's response to each of them. If the peer review committee is not satisfied with the report, the letter of com-

ment or the firm's responses, it will refuse to accept the report until an appropriate response or modification has been made. In some instances this "appropriate response," in the view of the peer review committee, is the equivalent of a sanction. Let me offer some examples:

In the 1980 peer review of firm A, two engagements were considered by the reviewers to be non-GAAS and the audit work papers were seriously deficient in documentation. Both engagements were in specialized industries. The engagement partner, who is also the firm's managing partner, was judged to be technically deficient in accounting and auditing matters. The peer review committee insisted that the firm adopt additional quality control procedures to monitor the performance of the managing partner when he served as an audit engagement partner. His partners concluded that another form of corrective action was preferable, and the peer review committee agreed. The firm relieved the managing partner of all engagement responsibilities; he is now concerned only with administrative matters.

In the course of the 1980 peer review of firm B, seriously deficient engagements were identified in a branch office managed by a manager without adequate partner oversight. In its letter of response the firm reported that the manager had been transferred to another office and a technically proficient partner had been assigned to manage the branch office in question. The peer review committee found these measures satisfactory.

The 1981 peer review of firm C concluded that a construction-company audit engagement had been performed in a substandard way. The peer review committee agreed to accept the firm's peer review report on the condition that the firm agree to have a full-scope review of the engagement by someone with adequate knowledge of the industry before issuance of the report.

Firm D received an adverse report on its 1980 peer review. The peer review committee required the firm to undergo another full peer review within two years rather than the normal three-year term required by the membership rules. The 1982 report was a modified one. Serious engagement deficiencies were found in both the 1980 and 1982 reviews. The peer review committee required the firm to subject the specific engagements in question to an on-site review by a member of the peer review committee. The reviewing member recommended, and the full committee concurred, that, as a condition of continuing membership, the firm had to engage the services of an outside consultant (1) to perform reviews of all audits before issuance of audit reports and (2) to oversee the firm's annual inspection program. Correspondence on these matters is in the public file.

Similar activities are part of the work of the special investigations committee (SIC):

In one SIC investigation the review of an office found that, although no engagement was judged an audit failure, several sets of audit work papers were considered to be materially deficient in documentation. In the course of the investigation, and working in conjunction with selected members of the SIC, the firm developed a corrective action plan for that office. The plan contained three major provisions: (1) partners from another office will do a preissuance review of reports and audit work papers of all audit engagements (non-SEC engagements as well as SEC engagements) of the office in question, (2) the assigned preissuance reviewers will participate in the development and approval of the audit plan for each engagement and (3) several partners in the office were relieved of audit responsibilities.

In another case the SIC discovered, through inquiry, that the partner assigned to perform a preissuance review on an audit of an SEC client had not performed that review on a timely basis. As a result, the noncompliance of the offending partner was brought to the attention of the firm's top management, and the firm issued a strongly worded written reminder to all partners on the importance of complying with the firm's and the SECPS's requirements of a concurring partner preissuance review on all SEC engagements—an effective indirect, if not direct, reprimand.

The sanctions described are actual, yet they represent a small proportion of the total issued within the less visible portions of our entire regulatory effort. In participating in the reviews of some of the first investigations performed under the SIC's direction, the POB learned that by the time the SIC investigation had begun, the firms involved had already completed internal inquiries of their own and had taken action that sometimes included transferring partners and managers to less responsible positions and bringing in others to replace them.

Those who conceive of a public accounting firm as straining to protect an inept or dishonest partner or manager should think again. Self-interest on the part of the members of the firm demands that the incompetent, the careless and the venal be removed from any position in which they can expose the firm to harm. Public accounting firms know a great deal about sanctions; they apply them on a private basis promptly, effectively and as often as needed.

Consider the plight of a partner who has been terminated for reasons of unsatisfactory performance. He has been found inadequate by his most intimate peers. Accepted by them into professional partnership—with all that implies—he has been judged unworthy of that trust. His opportunity for finding employment

¹American Institute of CPAs Division for CPA Firms, SEC Practice Section, "Organizational Structure and Functions of the SEC Practice Section of the AICPA Division for CPA Firms" (sec. 1), *SECPS Manual*, rev. ed. (New York: AICPA, 1983).

²*Ibid.*, p. 1-15.

at anything like his previous compensation is slight, indeed. He may not be in jail, but he has been punished severely and is an object lesson to all who comprehend the nature and severity of his former partners' action.

Similar sanctions have been imposed at the level of private regulation as a direct result of peer review, without ever getting to the peer review committee or the SIC. The peer review process has brought home to member firms of all sizes the importance of quality control and the nature of the measures required to maintain it. In recent discussions with a peer review team leader who had performed a number of such reviews of small firms, he responded to the POB's questions by citing several cases in which reviewed firms had taken quick action to strengthen the quality of their organizations once deficiencies had been pointed out. One case involved the partner in charge of quality control in the reviewed firm. The peer review established that he had little understanding of, or respect for, quality control. When this fact was pointed out to the managing partner, together with data in support of that contention, the man was removed from his position immediately.

The partner who discussed this case noted several other examples, including some in his own firm. Peer review, in his judgment, which is based on direct experience in his own firm and elsewhere, is an effective force for improving the quality of professional practice in those firms that take advantage of it.

The Issue of Confidentiality

Some of the profession's critics would say that for all intents and purposes the illustrations provided thus far are nonpublic—that is, no one knows about them because they have not been publicized. They contend that sanctions must be publicized to carry the message that the AICPA self-regulatory program is credible. There is truth in the assertion that the discipline described gains little public attention: whether that denies its usefulness in establishing credibility is an assertion without supporting evidence.

There are reasons for confidentiality, but the issue of confidentiality is a complex one, involving private rights, the public interest, the litigious nature of our society and a widespread misunderstanding of the role, rights and responsibilities of independent accountants serving in their capacity as auditors. The resolution of so fundamental an issue, complicated as it is by so many factors, should not be attempted here.

My expectation is that, by the time the next POB annual report is issued, some means will have been found, either in that report or elsewhere, to disclose the extent and nature of the disciplinary actions imposed within the AICPA program.

The Public Image Problem

The public image of auditing suffers greatly from a combination of circumstances. The first is the tendency to believe the worst of our fellows, especially if there is litigation involving an alleged audit failure. Time after time, I have observed that the latest allegations published in the *Wall Street Journal* or elsewhere were being accepted at face value. Later developments supplied information that altered the conclusions substantially. Second is the equally human tendency to seek someone to blame for our mistakes. An investment that goes wrong must be the fault of someone else—hence the innumerable suits against auditors. It is no wonder that a technically proficient screening of such cases by the SIC finds so high a proportion of them to have no merit.

Third, few people understand the auditor's role with respect to financial statements and business success. They ask, "If an auditor says everything is all right, how could the company possibly fail?" But accountants know that, although a business failure may include an accounting failure, it seldom does. The profession should be prepared to make that point over and over. In today's economy a change in a company's fortune can have disastrous effects in a short time, often since the date of the most recent audit report.

As knowledgeable business people and accountants, we should be slow to charge audit deficiencies until all the evidence is in. When in the company of those who are quick to do so, we should point out the weakness of their position. With peer review working as it is, few if any auditors will commence or complete an engagement with the intention of doing unsatisfactory work. Our task is not to protect the guilty, but if accountants are interested in a satisfactory public image of their profession, they must be prepared to reserve judgment until all the facts are in and should encourage others to do the same.

Conclusion

Recently a member of the AICPA board of directors asked me whether the POB had any objective measurement of the success of the self-regulatory program. He had nothing specific in mind but was thinking in terms of a lessening of the number of cases litigated year after year since the program started. My answer had to be that we did not have such a measure and that I didn't believe we ever would. There are so many uncontrollable and perhaps even unknown factors impinging on the amount of litigation against accountants that I don't believe we can ever isolate and measure the specific impact of the AICPA program.

But that does not mean it has had no impact or will have no impact. Conceptually, the AICPA program is unique, far reaching and impressive. Practically, it is serving its purpose well. The practice of public accounting in this country is improved day by day as peers review the professional performance of practicing accountants, hold them to compliance with high standards, exchange views on additional improvements and report failures. It is still a young program and has a way to go before anyone will concede it is beyond improvement. The POB will continue to listen to critics and try to evaluate their comments. We will also take some modest pride in a program that is sound, in place and working well. ■

Exhibit II

Public Oversight Board

<i>Member</i>	<i>Term Expires December 31</i>	<i>Affiliation</i>
Arthur M. Wood <i>Chairman*</i>	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	Professor of Accounting, University of Michigan
A. A. Sommer, Jr.	1984	Partner, Morgan, Lewis & Bockius, Washington, D.C., 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*
Alan H. Feldman *Assistant Technical Director*
Marcia E. Brown *Administrative Assistant*
Miriam Freilich *Secretary*

* John J. McCloy, a partner in Milbank, Tweed, Hadley & McCloy served as chairman until his resignation for personal reasons in February 1984. In August 1984, Melvin R. Laird, former Secretary of Defense, was appointed to the Board to fill the vacancy created by Mr. McCloy's resignation.

Exhibit III

SEC Practice Section

Executive Committee

<i>Member</i>	<i>Firm Affiliation</i>
John W. Zick, Chairman	*Price Waterhouse
John D. Abernathy, III	*Seidman & Seidman
George L. Bernstein	*Laventhol & Horwath
Robert M. Coffman	*Fox & Company
J. Michael Cook	*Deloitte Haskins & Sells
Mario J. Formichella	*Arthur Young & Company
James D. Gläuser	Baird, Kurtz & Dobson
Clifford E. Graese	*Peat, Marwick, Mitchell & Co.
Howard Groveman	*Alexander Grant & Company
Charles Kaiser, Jr.	Pannell Kerr Forster
Robert L. May	*Arthur Andersen & Co.
J. Curt Mingle	Clifton Gunderson & Co.
J. David Moxley	*Touche Ross & Co.
Robert D. Neary	*Ernst & Whinney
Richard W. Paddock	Battelle & Battelle
James J. Quinn	*Coopers & Lybrand
Edward A. Reinerio	Johnson Grant & Co.
John A. Thompson	*Main Hurdman
Jack C. Wahlig	*McGladrey, Hendrickson & Pullen
Michael A. Walker	Mann Judd Landau
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

Edward J. O'Grady, Chairman	Laventhol & Horwath
Thomas E. Byrne, Sr.	Price Waterhouse
Michael L. Conway	Peat, Marwick, Mitchell & Co.
Arthur I. Farber	Altschuler, Melvoin & Glasser
Marvin Feller	Ernst & Whinney
Robert E. Fleming	Fleming, Tempas & Co.
Robert H. Haas	Coopers & Lybrand
John G. F. Knight	Purvis, Gray and Company
Daniel J. Moylan	Deloitte Haskins & Sells
David A. Nelson	McGladrey, Hendrickson & Pullen
Joseph A. Puglisi	Touche Ross & Co.
Robert H. Ternkin	Arthur Young & Company
Frank H. Whitehand	Arthur Andersen & Co.
Jerry E. Whitehorn	Whitehorn, Bradsher & Tankersley
Prentice N. Ursery	Pannell Kerr Forster

Special Investigations Committee

Robert A. Mellin, Chairman	Hood and Strong
Mark J. Feingold	Laventhol & Horwath
*Edwin P. Fisher	Arthur Andersen & Co.
*John J. Fox	Coopers & Lybrand
Gerald E. Gorans	Touche Ross & Co.
*Leroy Layton	Main Hurdman
*Leon P. Otkiss	Peat, Marwick, Mitchell & Co.
*David Wentworth	McGladrey, Hendrickson & Pullen
Joseph A. Zulfer	Ernst & Whinney

* Retired

Public Oversight Board
540 Madison Avenue
New York, N.Y. 10022