

Public  
Oversight  
Board  
*Annual Report*  
1984-1985

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## Public Oversight Board

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ARTHUR M. WOOD, *Chairman*

A. A. SOMMER, JR., *Vice Chairman*

JOHN D. HARPER

MELVIN R. LAIRD

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JOHN D. HARPER  
April 6, 1910-July 26, 1985

*With the death of John D. Harper on July 26, 1985, the Public Oversight Board and the accounting profession lost a staunch supporter of self-regulation.*

*As a charter member of the Board, Mr. Harper's extensive executive abilities were especially useful to the Board in its formative years as it established its program of oversight of the accounting profession's bold experiment at self-regulation.*

*His perspective of the accounting profession, based on his broad experience as an executive, director, and especially as a member of corporate audit committees, helped the Board resolve many complex policy and procedural issues.*

*The Board wishes to record its deep sense of personal loss at the passing of a friend and colleague and its appreciation for the contributions John Harper made during his seven years as a valued Board member.*

# PUBLIC OVERSIGHT BOARD

SEC Practice Section • AICPA

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

June 30, 1985

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

It is my pleasure to transmit this seventh annual report of the Public Oversight Board.

The 1984-85 year was one in which continued progress was made by the accounting profession in its self-regulatory program. The successful peer review program was further strengthened through modification of standards and procedures. More significantly, the Section offered the SEC access through the offices of the Board to information on cases closed by the Special Investigations Committee. While details have not been completed, the Board hopes that such access will provide the SEC a basis to form an independent opinion and endorse the special investigative process in much the same way as it has endorsed the peer review process.

The past year, however, also saw a significant increase in the number of allegations of failure in audits, especially in audits of financial institutions. These highly publicized cases were in large part responsible for the initiation of Congressional hearings regarding the credibility of financial statements and the auditor's report thereon. The Board does not believe that additional federal regulation of the accounting profession is necessary and so testified during those hearings.

Nevertheless, the events of the past year suggest that the profession cannot become complacent with the success the self-regulatory program has achieved to date but must closely examine all aspects of the program in the light of recent events. Our report includes a number of suggestions which we have communicated to the Section, including the need to increase public awareness of the program and to educate the public regarding the difference between a business failure and an audit failure. The Board has full confidence, based on the commitment to self-regulation already evidenced by the Section and its members, that whatever is necessary to be done to strengthen the program will in fact be done.

Very truly yours,



ARTHUR M. WOOD  
Chairman

Public Oversight Board

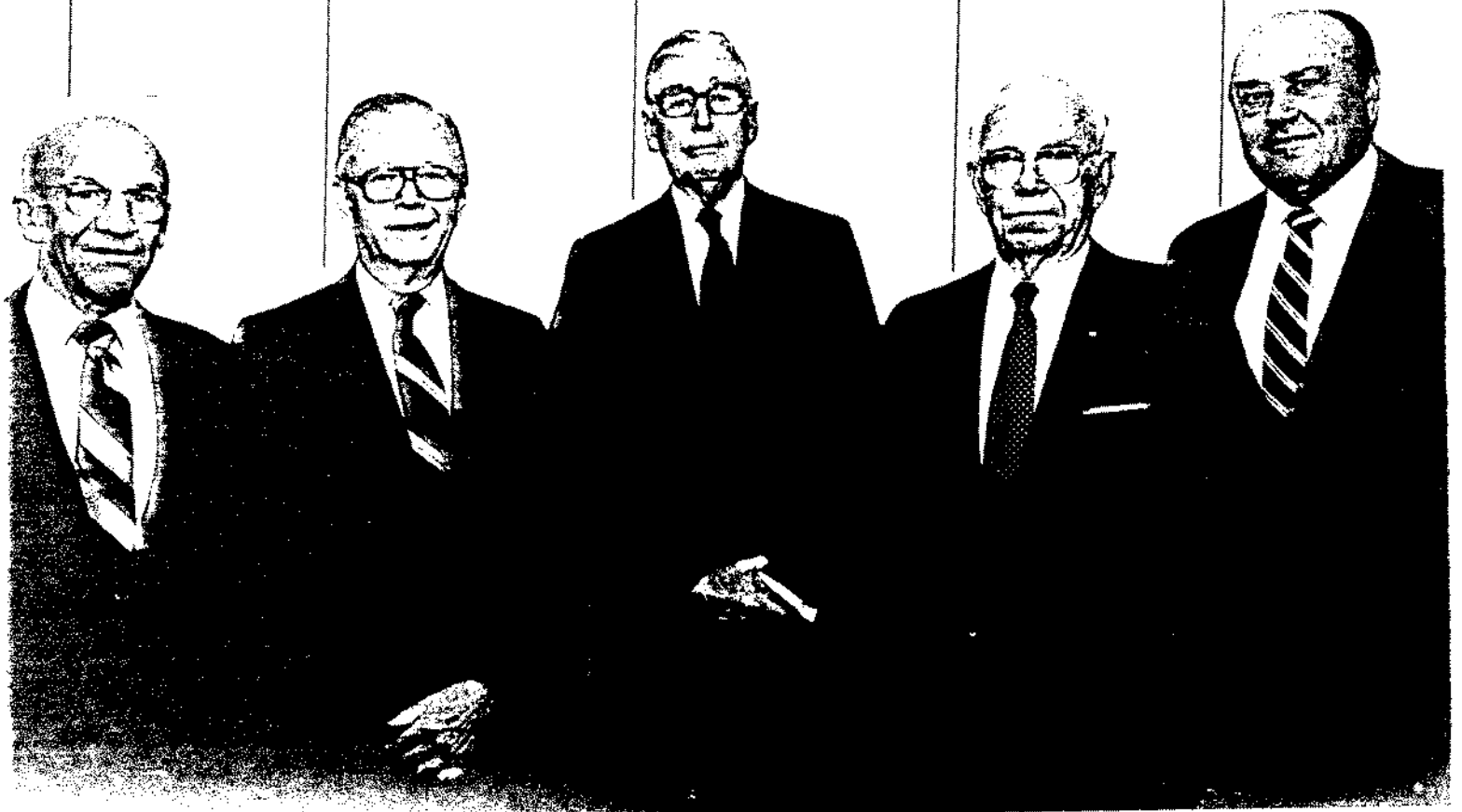
ROBERT K. MAUTZ

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MELVIN R. LAIRD



## Table of Contents

	Page
<b>Report on the Board's 1984-85 Oversight Activities</b>	6
Responsibilities and Functions	6
Role of the Board	6
Activities of the Board	6
Congressional Hearings	7
Oversight of the Peer Review Process	8
Oversight of the Special Investigative Process	9
Summary	9
<b>Peer Review Activity</b>	11
Types of Reports Issued	11
Types of Reviewers	13
Substandard Performance on Individual Engagements	13
Additional Requirements Imposed by the Committee	15
Monitoring of MAS Engagements	15
Continuing Modification of Peer Review Standards and Procedures	16
SEC Oversight of the Process	16
<b>Activities of the Special Investigations Committee</b>	17
Cases Reported	17
Special Reviews	17
Corrective Actions of Firms	18
Policy in Closing Cases	19
Other Actions Initiated by the Committee	19
SEC Oversight of the Process	19
<b>Membership Data</b>	20
Auditors of Publicly-traded Companies	21
Changes in Membership Requirements	21
The Division's Public Information Program	22
<b>Board Conclusions and Commentary</b>	24
Price Competition and MAS	24
Opinion Shopping	25
Proxy Statement Disclosure re: Auditing Firm	25
<b>An Introduction to Board Members</b>	26
<b>Exhibits</b>	
I. Report from the Public Oversight Board. An Address by Board Chairman Wood to AICPA Council, May 15, 1985	30
II. SEC Practice Section Committees	32

# Report on the Board's 1984-85 Oversight Activities

In setting up its self-regulatory program for accounting firms—described briefly in the accompanying box entitled "The Accounting Profession's Self-Regulatory Program"—the American Institute of Certified Public Accountants (AICPA) and those with statutory oversight believed it essential that a process organized and administered by the profession be subjected to oversight and review by an independent body representing the public interest. Thus, provision was made for a board of five experienced and independent individuals not engaged in independent public accounting to oversee the operations of the SEC Practice Section (SECPS). Brief biographies of Board members appear on pages 26-29.

Initially, members of the Public Oversight Board (POB) were appointed by the Board of Directors of the AICPA and it was intended that their replacements would be so appointed. However, to further assure its independence, a change was made in 1978 to give the POB the right to appoint its own successors in consultation with and subject to the approval of the AICPA Board of Directors. After further consideration, in 1985, another change was made so that the POB now acts independently on its own appointments, compensation, and all other decisions. As Chairman Wood told the AICPA Council in May 1985,<sup>1</sup> however, the changes were not required because the Board and its individual members have always felt completely independent.

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## Responsibilities and Functions

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The Board is charged with the responsibility for monitoring and evaluating the activities and decisions of the Section's committees and conducting continuous oversight of all other activities of the Section. It also has responsibilities to make recommendations for improvement in

the operation of the Section and to publish an annual report and any such other reports as it may deem necessary with respect to its activities and those of the Section.

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## Role of the Board

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The role of the Board is to represent the public interest and to assure that this is not neglected when the Section sets standards, membership requirements, and rules and procedures.

The Board does not believe that its commitment to the public interest places it in conflict with the best interests of the accounting profession. The accounting profession serves the public interest in a particular manner—the enhancement of the credibility of financial statements which issuers and debtors prepare and which investors and creditors, as well as governmental authorities, rely upon. The Board, and the program which it oversees, exist to give additional assurance that the accounting profession performs, and is perceived to perform, the role which society accords it. Unless the accounting profession satisfies society that it is performing this role, society will seek other means of giving financial information the reliability needed in an economy which relies upon credit and private investors for its viability.

The Board does not have line authority. Nevertheless, the Board and its staff have played major roles in the development and refinement of the policies, standards, and operations of the Section. In addition, it has influenced the development of professional standards. Some of the Board's major contributions during the past year are identified in other sections of this report.

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## Activities of the Board

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The Board actively monitors all aspects of

<sup>1</sup> See Exhibit I for full text of Chairman Wood's address to the Spring Meeting of AICPA Council, Scottsdale, Arizona, May, 1985.

the self-regulatory program administered by the Section. The Board is assisted by a staff of four CPAs and two administrative personnel. Richard A. Stark, a partner in the New York law firm of Milbank, Tweed, Hadley & McCloy, has served as the Board's legal counsel since its inception.

The Board meets monthly to consider issues as they arise and to review events since the last meeting.

## Congressional Hearings

In February 1985, the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce, chaired by Representative John D. Dingell (D., Mich.) began a series of hearings on "Oversight of the Accounting Profession and the Securities and Exchange Commission: Effectiveness, Independence, and Regu-

## The Accounting Profession's Self-Regulatory Program

During the course of the Congressional hearings on the accounting profession in 1977 and 1978, concern was expressed about, among other things, the quality of the auditing services provided by public accounting firms in this country. In response to these concerns, in 1977 the American Institute of Certified Public Accountants created a new organization to improve the quality of service provided by these firms—a Division for CPA Firms consisting of two sections, an SEC Practice Section and a Private Companies Practice Section.<sup>2</sup>

■ **Membership Requirements.** Firms that join either section commit themselves to adhere to rigorous membership requirements, including peer review and continuing professional education. The SECPS also has requirements regarding partner rotation and second partner review on audits of public companies, the reporting to the Section of litigation and government action alleging failure in the conduct of an audit of a publicly-held company and the reporting of serious disagreements with management to the client company's board of directors.

A fundamental membership requirement of both sections is that firms commit themselves to adhere to quality control standards enunciated by the AICPA, which assure that member firms meet high professional standards in all aspects of their accounting and auditing practice.

■ **Levels of Regulation of Accountants.** The peer regulatory program administered by the Division for CPA Firms is but one facet of the overall regulatory program of the AICPA, which includes, among other activities, the setting of ethical, auditing, and quality control standards. Regulation of professional practice is applied at two other levels: by individual accounting firms and by government. These three levels of regulation use means commensurate with their differing purposes and powers to achieve their common goal of enhanced audit quality. Together, the three

provide a coordinated program of regulation of accountants and accounting.

Individual accounting firms provide the first line of defense against unsatisfactory audit practice. First, they establish internal systems of quality control designed to ensure compliance with professional standards and, if applicable, SEC rules and other legal requirements in the conduct of their accounting and auditing practice. Second, they establish programs of internal inspection to ascertain possible failures of compliance with their systems of quality control. Third, they take disciplinary and remedial steps against partners and staff members judged to be inadequate in performance of their professional responsibilities.

Regulation imposed by the government includes qualifying examinations, licensing provisions and other regulatory requirements to assure reliable service by accountants to the public. The government has the final authority to punish accountants who fail to comply with legal standards of performance and does so through imposition of punitive measures such as public censure, injunction, and temporary or permanent suspension from practice before the SEC or by state licensing boards. In addition, civil litigation pursued within the government's legal system may result in damage awards against auditors which are often substantial in amount.

In contrast to the roles played by government regulation and private regulation, peer regulation by the AICPA Division for CPA Firms is not directed to identifying, convicting, and punishing those who fail to meet established requirements; rather, it is preventive in nature. In line with its powers and authority, it focuses on strengthening systems of quality control and improving the effective performance of member firms through reviews to discover whether they comply with membership requirements, ethical standards, and professional standards.

2. The nature and scope of the accounting profession's self-regulatory program and the way in which the program combines with other regulatory efforts is

more fully described in *Audit Quality: The Profession's Program* published in 1984 by the Public Oversight Board.



lation of Corporate Audits.”

Board Chairman Wood and Board Vice Chairman Sommer presented written and oral testimony to the Committee in April, explaining the Section's self-regulatory program and the Board's oversight thereof.

The hearings are expected to continue at least until the fall of 1985. As Chairman Wood reported to the Committee: "We are observing closely your hearings. From them, we hope to gain further insights into the circumstances that have caused the perception in many quarters that there are deficiencies in the audit process in this country. Out of these insights we expect to develop new procedures and safeguards to further reduce the possibility of 'bad' audits occurring, notwithstanding the earnest efforts of us and so many members of the accounting profession to strengthen the quality of audits and the systems of quality control that have been welded together for many years, especially the last eight."<sup>3</sup>

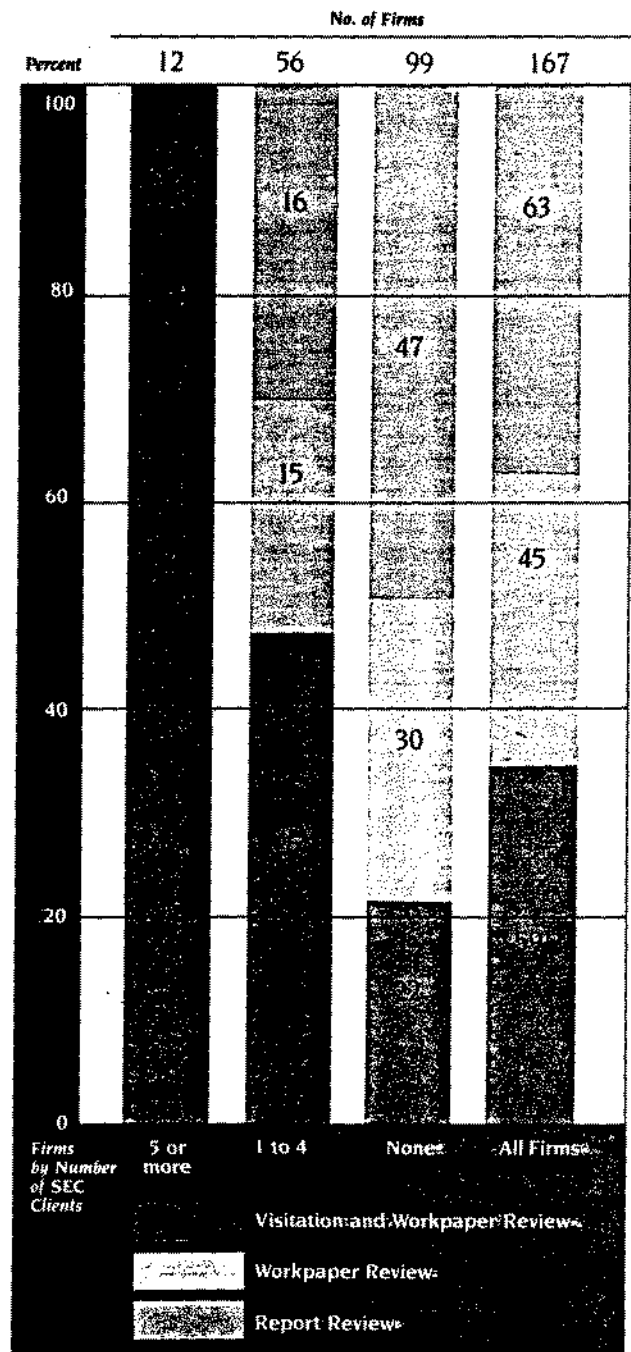
**Oversight of the Peer Review Process**

The Board monitors the activities of the Peer Review Committee, including reports on individual peer reviews as well as the setting of, revisions to, and enforcement of standards. Members of the Board and its staff attended each of the seven full-day meetings held by the Committee, eight meetings of its Evaluations and Recommendations Subcommittee, and seven full-day meetings held by its various task forces. In addition, the Board's staff reviews every peer review performed; it attends many of the exit conferences—the meeting at the conclusion of a peer review when the reviewers report their findings and recommendations to management of the reviewed firm—and members of the Board also periodically attend such meetings. Any problem the staff has with the conduct of a review or a report—if they think it is too harsh or too lenient—is brought to the attention of the Board. While the Board does not have the power to overrule a decision of the authorities in the Section, the Board's experience has been that the Section reconsiders its decision when the Board makes its views known. The Section often adopts the Board's recommendations. In other cases, the Board accepts the logic of the position taken by

the Section.

Each review is subjected to one of three levels of Board oversight: (1) observing the performance of the field work, attending the exit conference and reviewing the review team's workpapers, report, letter of comments, and the reviewed firm's letter of response; (2) reviewing

**CHART A. Scope of Board Oversight of 1984 Peer Reviews Classified by Number of SEC Clients of Reviewed Firms**



<sup>3</sup> Testimony on Behalf of the Public Oversight Board before the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce, March 6, 1985.

the review team's workpapers, the report, and the letters issued; or (3) reviewing selected reviewers' workpapers, the report, and the letters issued. During the past year, the Board observed reviews in process for all 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 A 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 opportunity to express their views and to receive responses to such expressions. The Board is convinced that the peer review program is functioning effectively and accomplishing the purposes for which intended.

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### **Oversight of the Special Investigative Process**

The other major element of the Section's program is the special investigative process. A member firm is obligated to report promptly to the Special Investigations Committee (SIC) litigation and governmental proceedings directed against it that allege deficiencies in the conduct of an audit of a client in which there is a significant public interest, defined, generally speaking, as a client that files financial statements with the SEC or certain other federal regulatory agencies in connection with the sale or trading of its securities.

As with the peer review activity of the Section, the Board and its staff actively monitor all activities of the Special Investigations Committee and its task forces. The Board has unrestricted access to all Committee meetings and files. Members of the Board's staff read, for each reported case, all pertinent financial statements, other public documents, related correspondence, and relevant professional literature. For each reported case, Board members receive a copy of a summary of the allegations, which identifies the accounting, auditing, and quality control issues involved and applicable professional standards, as well as information and comments developed by the Board's staff in carrying out its oversight functions. These papers serve as the basis for questions and

discussion at Board meetings.

Members of the Board and its staff attended each of the seven full-day meetings held by the Committee during the year and attended most of the 30 meetings held by SIC task forces with firm representatives to discuss allegations in reported cases or with peer reviewers to discuss peer review findings that may have been relevant to allegations made in reported cases. Additionally, during 1984-85, the Board's staff evaluated the activities of the two SIC task forces and review teams that performed special reviews. The staff also visited the offices of the two member firms being reviewed during the course of the special reviews, reviewed the workpapers prepared in connection therewith, discussed the findings and their quality control implications with appropriate parties, and attended meetings at which the findings of the review team were communicated to representatives of the reviewed firm.

Based on its extensive monitoring, the Board concludes that the Committee has effective operational procedures, and that the Committee's decisions are well-reasoned and in the interest of the public and the profession.

The Board is concerned that the special investigative process has not yet achieved credibility equal to that attained by the peer review process. This is largely due to the confidentiality of the Committee's activities rather than to any weakness in its purpose or procedures. Because of concern for possible prejudice to both plaintiffs and defendants in private and governmental proceedings, the Section determined that details of the Committee's proceedings and conclusions on individual cases would not be publicly disclosed. Consistent with the Section's concerns, the Board only reports aggregate information about the activities of this Committee.

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### **Summary**

The Public Oversight Board was established by the American Institute of Certified Public Accountants as a means of giving further assurance that the quality control requirements imposed by it on firms which voluntarily chose to subject themselves to those requirements were met. The Board, consisting of five members, none of whom is engaged in the practice of accounting

and three of whom have had no professional association with the accounting profession, has established a program to oversee the quality control efforts of the Section. The Board believes that this program is effectively designed to accomplish its purpose. Based upon its oversight of the work done under that program, the Board has concluded that during the 1985 fiscal year the quality control program was effectively implemented and that it provided significant assurance that firms participating in the program had in place, and complied with, quality control systems which provide reasonable assurance that audits would be done in accordance with generally accepted auditing standards.

This is not to say, of course, that a program less than a decade old cannot be improved. As indicated in what follows, the Board and others have identified improvements which should be considered. We are confident that those responsible for the implementation of the program will make the changes that are necessary to strengthen the program and provide even greater assurance that the audits of publicly-held companies and other companies of public concern are conducted in accordance with the highest practicable standards.



Board members discussing annual report for 1984-85. Left to right: Vice Chairman A. A. Sommer, Jr., Robert K. Mautz, Board counsel Richard A. Stark, Chairman Arthur M. Wood, John D. Harper, and Melvin R. Laird.

# Peer Review Activity

In calendar 1984, 167 member firms were required to undergo a peer review; of these, 136 were firms that had previously been peer reviewed and 31 were firms that submitted their quality control system to peer review for the first time. One review was a full-scope review performed prior to the expiration of the affected firm's normal three-year cycle, because the previous review had disclosed quality control system deficiencies requiring extensive corrective action by the firm. One hundred fifty-three peer review reports were accepted by the Committee as of June 30, 1985. Processing of the reports on the remaining 14 reviews was deferred pending resolution of certain matters to the satisfaction of the Committee or its staff.

The peer review process is detailed in the box on page 12.

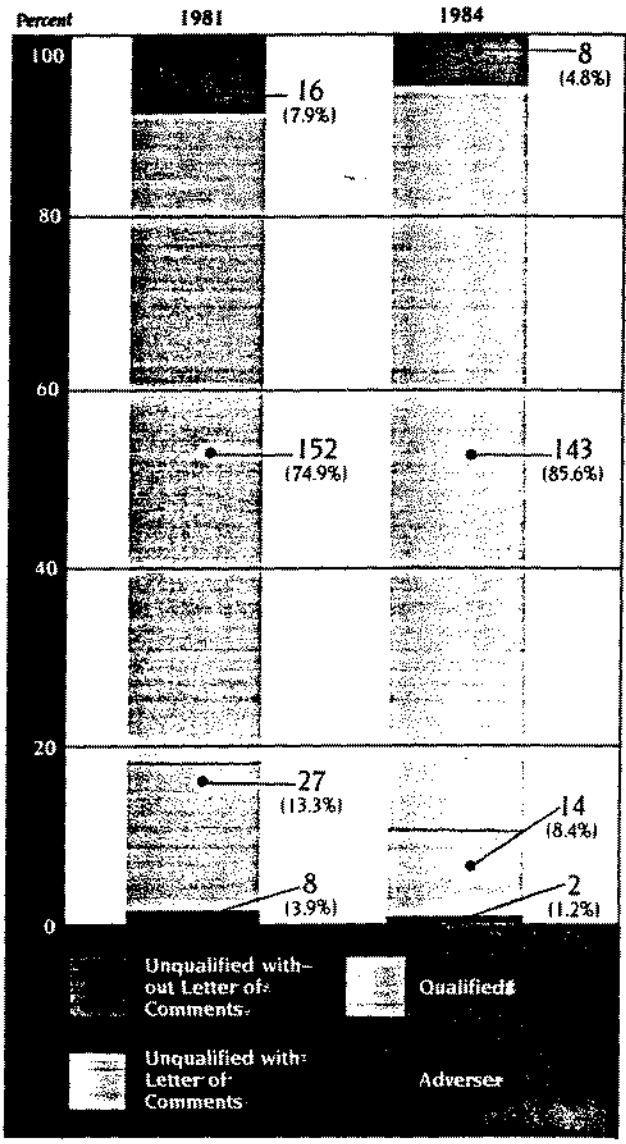
### Types of Reports Issued

As indicated in Chart B, over 90 percent of the firms reviewed in 1984 received an unqualified opinion, the majority of which were accompanied by a letter of comments. As in past years, firms receiving an unqualified opinion without a letter of comments are firms with a limited accounting and auditing practice for which a relatively simple system of quality control is appropriate. Approximately 8 percent of the firms reviewed in 1984 received qualified opinions and two of the reports issued on 1984 reviews were adverse. Reports on all reviews completed in 1984 are included in Chart B classified by the type of report issued by the reviewer and/or based upon the preliminary evaluation made by the Committee's and POB's staffs of the peer reviewer's findings.

The majority of firms reviewed in 1984 were also reviewed in 1981 under the three-year rotation policy. As indicated in Chart B, results of reviews performed in 1984 indicated a substantial

improvement over results of reviews performed in 1981.

**CHART B. Types of Reports Issued on 203 Peer Reviews Performed in 1981 and on 167 Peer Reviews Performed in 1984**



An analysis of the types of reports received by the 136 firms peer reviewed in both 1981 and 1984 shows that 115 firms received the same

type of report in 1984 as they did in 1981, 15 firms received a better report, and six firms received a more critical report in 1984. Comparison of the letters of comments for 1981 and 1984 indicates that most, if not all, of the firms that received unqualified reports both in 1981 and 1984 also had improved their quality control systems in the three-year period. The number, nature, and frequency of deficiencies reported in 1984 letters of comments were considerably less than those reported in 1981. However, it is our belief, based on our oversight program, that reviewers have gradually increased the rigor of their examinations over

the years. Details are shown in Table 1.

The one firm that received adverse opinions on its 1981 and 1984 reviews was requested by the Committee to take specified corrective actions in 1984, including the engaging of a qualified person, acceptable to the Committee, to perform preissuance reviews of audit workpapers and reports. The firm has refused to do so, and the Committee has initiated proceedings to impose formal sanctions on the firm.

In another case, a firm initially refused to undergo an accelerated review as a condition of continued membership in the Section and steps

### The Peer Review Process

Peer review is the cornerstone of the profession's self-regulatory program. Once every three years a member firm must have the quality control system for its accounting and auditing practice reviewed and publicly reported on by an independent third party. The public report on an accounting firm's system of quality control may be unqualified, qualified, or adverse.

The review may be conducted 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 reviewed member firm belongs, or by a team assembled by a state CPA society. To qualify to administer peer reviews for its members, an association 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. Similarly, a state CPA society must have its administrative plan approved by the Committee. Currently, 10 associations and one state CPA society are authorized to administer peer reviews for members belonging to the SEC Practice Section.

A review covers the operations of a firm's accounting and auditing practice over a one-year period. An unqualified report is issued when the reviewer concludes that the firm's quality control system is sufficiently comprehensive and suitably designed to meet the objectives of quality control standards and that its quality control policies and procedures were complied with during the year, thus providing the firm with reasonable assurance of conforming with professional standards.

A qualified report is issued when the reviewer concludes that there are significant deficiencies in the design of the firm's quality control system, a significant lack of compliance with its quality control policies and procedures, or a significant lack of compliance with membership requirements of the Section.

An adverse report is issued when the reviewer concludes that the firm's quality control system is not sufficiently comprehensive or that its policies and procedures are not being complied with in a manner that provides the firm with reasonable assurance that it is complying with professional standards.

A substantial majority of firms receiving unqualified reports and all firms receiving qualified or adverse reports also receive letters of comments which report (1) deficiencies noted in the firm's quality control system or in compliance by the firm's personnel with its quality control policies and procedures and (2) recommendations for corrective action. The recommended corrective actions in a letter of comments issued with an unqualified report are intended to improve the effectiveness of the firm's quality control system or compliance by its personnel with its quality control policies and procedures, but the identified deficiencies are not considered to be so serious as to negate the conclusion that the firm's system provides it with reasonable assurance of complying with professional standards in the performance of its accounting and auditing engagements.

A firm is required to respond in writing to each item in the letter of comments stating the specific actions the firm has taken or intends to take with respect to each item listed or giving its reason for not doing so.

The Committee reviews the findings and the report issued on each review to ascertain whether the review was performed and reported on in accordance with standards and whether the reviewed firm is responsive to the reviewer's findings and recommendations. If the Committee is satisfied with the report and the letters of comments and response, the report is accepted and it and the letters are placed in a file available for public inspection.

**TABLE 1** Comparison of Reports Received by Firms Peer Reviewed Both in 1981 and 1984

Number of Firms by Type of Report Received in 1981	Number of Firms by Type of Report Received in 1984		
	Unqualified	Qualified	Adverse
Unqualified . . . . . 117	111	6	—
Qualified . . . . . 16	13	3	—
Adverse . . . . . 3	1	1	1
136	125	10	1

leading to the possible imposition of a sanction were initiated. Such plans were cancelled when the firm in question submitted to the accelerated review mandated by the Committee. The report issued on the mandated review was unqualified since the firm had made the required improvements in its quality control system.

As in past years, the Committee and its staff vigorously and equitably enforced the rigorous standards for performing and reporting on peer reviews. In this connection, the Committee deferred acceptance of 45 reports upon initial consideration. The primary reasons for deferral of action were:

- The sample of engagements reviewed did not represent a reasonable cross-section of the firm's accounting and auditing practice; the reviewer was required to revisit the firm and review additional engagements.
- The type of report and letter of comments issued were not consistent with the deficiencies noted in the course of the review; the reviewer was asked to change the report and/or letter or to justify the type of report and letter issued.
- Questions were unresolved as to whether one or more of the auditing engagements reviewed had been performed in compliance with professional standards; the reviewed firm was required to resolve such matters as a condition precedent to the processing of the report by the Committee.

### Types of Reviewers

A firm can request that its review be performed by a team assembled by the Committee,

another member firm, or an association or state CPA society authorized by the Committee to do so. A comparison of the types of review teams in 1984 and 1981 indicates a trend toward selecting a member firm to perform a review rather than to request the Committee to appoint a team to do so. Over 61 percent of the firms undergoing reviews in 1981 were reviewed by a committee-appointed review team (CART), whereas only 26 percent of 1984 reviews were performed by CARTs. Forty-five percent of 1984 reviews were performed by member firms as shown in Chart C.

### Substandard Performance on Individual Engagements

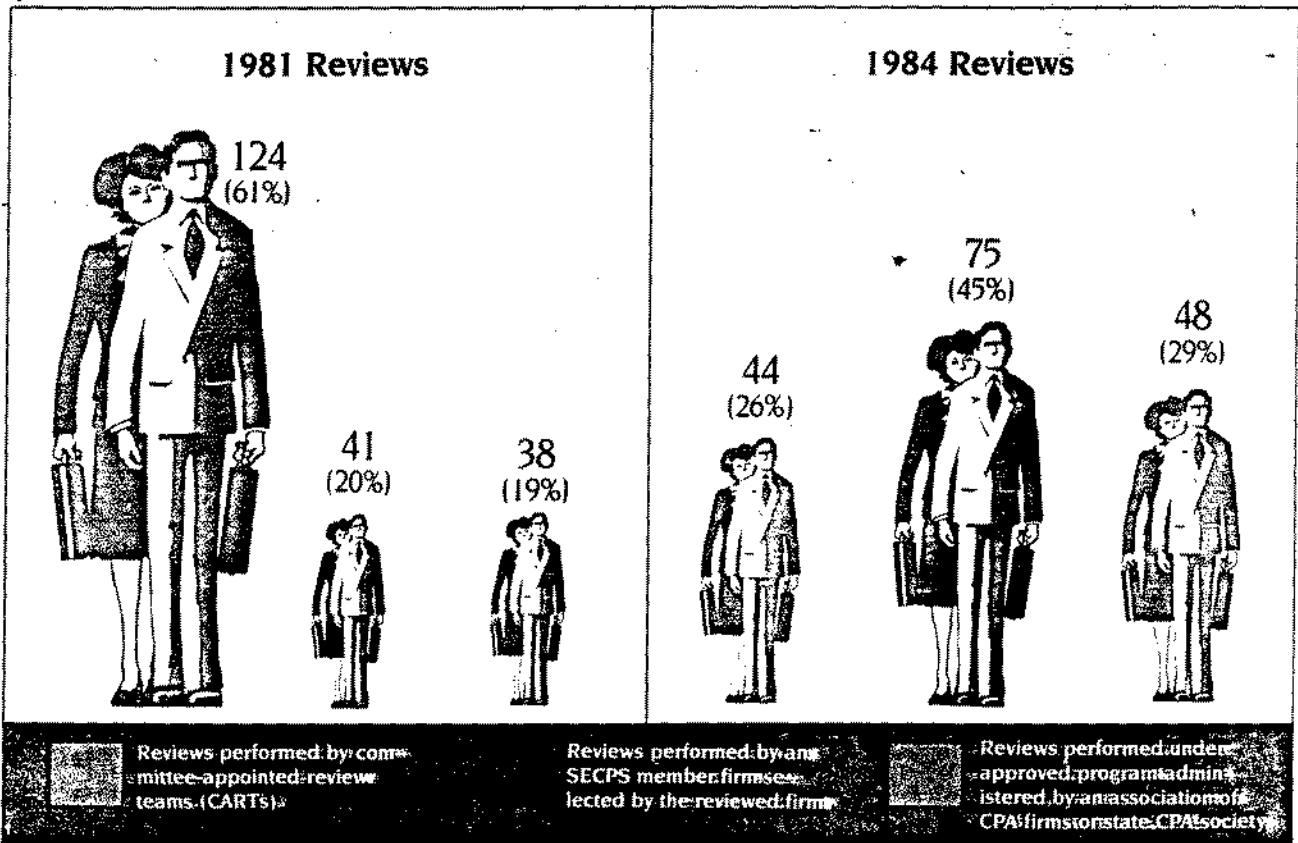
The Committee also deals with instances of substandard auditing and accounting performance discovered on individual engagements during the peer review process. These are reported promptly to the Committee. The Board's staff found reviewers diligent in pursuing instances of noncompliance with generally accepted accounting principles (GAAP) and generally accepted auditing standards (GAAS).

During 1984, peer reviewers reviewed the financial statements, reports, and workpapers for 1,162 audit engagements, including audits of 260 SEC registrants. Nineteen of these—or 1.6 percent of the number reviewed—were deemed to be substandard in the application of GAAP or GAAS; two of the nineteen were audits of SEC registrants.

In all five cases the financial statements were deemed not to have been prepared in accordance with GAAP, the auditing firm immediately recalled its report and the financial statements and/or auditor's report were reissued. None of these were SEC engagements.

In each instance where the peer reviewers concluded and the firm concurred that the audit had not been performed in accordance with GAAS, the firm either immediately performed the procedures that were considered necessary but not performed during the course of the audit or, because the next annual audit was imminent, agreed to perform such procedures in that audit. The unusually large number of non-GAAS engagements not yet resolved to the satisfaction of the Committee is due to unusual circumstances; three of the engagements were performed by the firm

**CHART C. Types of Reviewers in 1981 and 1984**



against which the Committee has initiated sanction proceedings and four were performed by a firm whose adverse peer review report has not yet been processed by the Committee. In addition, the firms involved are no longer engaged as auditor on three of these clients, including the SEC registrant. Details are shown in Table 2.

In each instance where substandard work was detected, the peer reviewer had to consider whether the firm's quality control system failed to include policies and procedures that should have prevented the substandard work (a system design deficiency) or whether the substandard work resulted from noncompliance with existing policies and procedures (a "people problem") and then recommend appropriate remedial measures in a letter of comments.

The 19 non-GAAP/non-GAAS engagements were performed by 10 different firms. Six of these firms received either a modified or adverse report because of the gravity of the deficiencies in their quality control systems. The four other firms received unqualified reports with a letter of com-

**TABLE 2 Corrective Action Required by SECPS Peer Review Committee with Respect to Substandard Audit Engagements Identified in Reviews Performed in 1984**

	Number of Engagements		
	Total	SEC	Non-SEC
Number of audit engagements reviewed . . .	1,162	260	902
Number of audit engagements considered substandard by peer reviewers . . . . .	19	2	17
	1.6%	0.8%	1.9%
<b>Corrective Actions Required</b>			
Audit report recalled and financial statements and/or report reissued . . . . .	5	0	5
Omitted auditing procedures performed . . . . .	7	1	6
Omitted auditing procedures—firm has not yet informed Committee of actions to be taken . . . . .	7	1	6

ments, because the reviewers concluded that the substandard work did not result from a system deficiency but rather from isolated noncompliance by the firm's personnel. The Board and its staff closely reviewed each such instance in order to obtain assurance that an unqualified report was appropriate in the circumstances.

#### Additional Requirements Imposed by the Committee

During the year, the Committee took various actions to obtain assurance that firms were effectively implementing corrective action plans in situations where the peer review had surfaced serious quality control deficiencies. Such actions required and monitored by the Committee consisted of:

- Revisits to 13 firms by the peer reviewer or a Committee member to assess the effectiveness of the firm's corrective actions.
- Obtaining copies from 16 firms of their annual inspection report and, in the case of three multi-office firms, copies of the reports issued in connection with inspection of certain of the firm's individual practice units to assess the effectiveness of the firm's corrective action plans.
- Requiring appointment, by each of three firms, of a qualified person acceptable to the Committee to direct the firm's quality control program and to have such director periodically report results to the Committee; additionally, one such consultant was to perform a preissuance review on each audit of a public interest client.

The Committee also dealt effectively with substandard performance by peer reviewers, including reviewing firms. As a case in point, the Committee concluded that review teams appointed by one firm for three peer reviews it was engaged to conduct did not perform the assigned reviews in accordance with standards. In response to being so advised by the Committee, the firm submitted a detailed plan for use by its personnel to assure that any future review engagements accepted by the firm would be performed and reported on in accordance with standards. The Committee accepted the plan subject to satisfactory implementation.

#### Monitoring of MAS Engagements

Member firms are required to report certain information regarding fees received for management advisory services (MAS) engagements, including MAS fees received from SEC registrants for whom the firm serves as auditor. Such information is reported in the firm's annual report which is placed in the firm's public file. Analysis of the data reveals that for 97 percent of the SEC registrants audited by member firms, the firm either did not perform an MAS engagement for the registrant in 1984, or, if it did so, the MAS fee was less than 26 percent of the audit fee. Details are shown in Table 3; additional analyses of MAS fees are shown on pages 24-25.

**TABLE 3** Analysis of Ratio of MAS Fees to Audit Fees Received in 1984 from SEC Registrants

Number of Firms Classified by Number of SEC Clients	Number of SEC Audit Clients Classified by Percent of MAS Fee to Audit Fee				Total
	0-25%*	26-50%	51-100%	Over 100%	
Firms (11) with 100 or more SEC audit clients . . . .	10,741	184	99	105	11,129
Firms (11) with 20 to 99 SEC audit clients . . . .	562	9	5	1	577
Firms (169) with fewer than 20 SEC audit clients	470	26	3	0	499
Totals	<u>11,773</u>	<u>219</u>	<u>106</u>	<u>107</u>	<u>12,205</u>
Percents	<u>96.5%</u>	<u>1.8%</u>	<u>0.9%</u>	<u>0.9%</u>	<u>100%</u>

\*The Board has suggested that 0% be made a discrete category in future annual reports filed by member firms to make future analyses of these data more useful and less subject to misinterpretation.

The Section has been sensitive to critics who allege that performance of MAS engagements impairs auditor independence. Peer review standards require a team reviewing a firm that performs both audit and MAS engagements for one or more SEC registrants to perform appropriate tests of whether the firm has:

- Made objective accounting, auditing, and reporting decisions in performing the audit.
- Complied with independence rules embodied in the AICPA Code of Ethics and its Statements on



Standards for Management Advisory Services when performing MAS engagements.

- Complied with the proscriptions relating to the performance of stipulated types of MAS engagements.
- Complied with the requirement to report to the audit committee or board of directors the amount of MAS fees received and the nature of services performed.

The performance of such procedures throughout the seven-year history of peer review has not brought forth any evidence (a) that serving in an MAS capacity has diluted a firm's objectivity in performance of the audit function, or (b) that proscribed services have been performed.

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#### **Continuing Modification of Peer Review Standards and Procedures**

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A number of improvements were made in the peer review process during the year, several in response to suggestions made by the Board. The changes, which are expected to further enhance the quality of peer review performance and reporting, include measures dealing with:

- The qualifications of reviewing firms and team captains.
- The reporting implications of deficient offices in a multioffice firm in which firm-wide compliance is otherwise acceptable.
- The resolution of disagreements between a review team and the Committee.
- The consideration that should be given to litigation

in selecting engagements for review.

- Increasing consistency in the evaluation of and reporting on deficiencies discovered in peer reviews.

In addition, the Board has recommended that peer review reports include a reference to related letters of comments, when these exist, and that additional consideration be given to clarifying the purpose and extent of second partner review and the responsibilities of those performing this function. Both of these matters are under consideration by the Section as of the date of this report.

A Joint Task Force on Uniformity of Reporting, consisting of members of the Peer Review Committees of both sections, has held several meetings, all of which have been attended by Board staff, and is in the process of developing proposals to the respective committees regarding revisions to and clarification of existing standards and guidelines.

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#### **SEC Oversight of the Process**

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The SEC independently evaluates the peer review process of the Section, including the effectiveness of Board oversight. The SEC staff has begun its inspection of the 1984 reviews but has not yet concluded its inspection since its sample of reviews selected for such inspection has not yet been fully processed by the Committee. The Board understands that the SEC staff has indicated that it is satisfied with both peer review and oversight performance on the reviews inspected to date.

# Activities of the Special Investigations Committee

**A**s a result of a recommendation emanating from an intensive review of the structure and operations of the Section by a special review committee of accountants and nonaccountants (the SECPS Special Review Committee), the Section published in May 1985 its first *Report on the Activities of the Special Investigations Committee of the SEC Practice Section of the AICPA Division for CPA Firms*. The Board believes this report increases the awareness of how the special investigative process operates—described in the accompanying box entitled "The Special Investigative Process"—and what that part of the profession's self-regulatory program has accomplished, and encourages the Section to publish comprehensive annual reports covering all its activities.

## Cases Reported

Member firms reported 46 new cases during the year ended June 30, 1985. In addition, the Committee reopened its files on one case previously closed because of new developments in the case. A summary of the Committee's activity during the year is shown in Table 4.

In April 1985, the Executive Committee amended the membership requirements so that member firms are now required to report litigation alleging failure in the conduct of an audit of selected non-SEC clients. Details are reported on pages 21 and 22.

## Special Reviews

Based upon its analysis of data gathered in the initial investigative stage, the Committee required two firms to submit to a special review. The review of each firm focused on engagements performed by the personnel involved in the reported case and on certain types of engagements per-

**TABLE 4** *Special Investigations Committee Activity During the Year Ended June 30, 1985*

	Number of Cases		
	Undergoing Initial Investigative Procedures	In Monitoring	Undergoing Special Review
Status of cases at July 1, 1984.....	14	6	0
Activity during the year:			
New cases added .....	46		
Case reopened .....	1		
Cases transferred to:			
Monitoring .....	(11)	11	
Special review .....	( 2)		2
Cases closed .....	(27)	( 7)	
Status of cases at June 30, 1985 .....	21	10	2

formed by that office for clients in the same industry.

On one of the special reviews, the Committee's task force appointed a review team composed of experienced professionals drawn from several member firms. On the other special review, the Committee's task force used the firm that had served as the peer reviewer for the subject firm. The scope of each review was determined by the Committee's assigned task force. The members of both review teams had extensive review experience within their individual firms, recent experience in the peer review process, expert knowledge of quality control systems, and expertise in the industries of the engagements selected for review. Both review teams performed under the direct on-site supervision of the task force assigned to the case. As of June 30, 1985, both special reviews were still in process.

## Corrective Actions of Firms

Typically, a firm which has been named as a

defendant in private or governmental litigation undertakes on its own initiative a review of the engagement alleged not to have been performed

### The Special Investigative Process

Member firms are required to report to the Special Investigations Committee each instance of 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 or a bank or other lending institution filing periodic reports with other federal regulatory agencies. The Committee reviews the allegations in each case and considers whether they may indicate a need for improvements in the quality control system of the reporting firm or improved compliance with its quality control policies and procedures. Additionally, the Committee analyzes reported cases to ascertain whether changes in professional standards are required.

■ **Investigative Phases.** The activities of the Committee consist of two distinct phases: an initial investigative phase and a special review phase. The initial investigative phase includes review of relevant public documents, discussions with appropriate representatives of the accounting firm named in the litigation and other activities necessary to assess the implications of the allegations for the firm's system of quality control. If future developments relating to the case are expected, such as the issuance of a report for a peer review in process, the issuance of a bankruptcy trustee's report, or an action by a regulatory enforcement agency, the files on the case are kept open in order to follow and evaluate such future developments.

A special review is a review of certain aspects of a firm's quality control system, such as audit engagements performed for clients in a given industry, or engagements performed by a particular office or individual, or a specific element of the firm's quality control system. Such a review involves application of procedures similar to those used in peer review. The Section requires that the cost of a special review be borne by the reviewed firm.

The objective of both phases is to reduce the possibility of future failure by (1) ascertaining whether deficiencies exist in the firm's quality control system as alleged and (2) if so, requiring the firm to take appropriate corrective action.

■ **Operation of the Committee.** For each reported case, the member firm is required to provide the Committee with 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 and evaluating the

accounting, auditing, and quality control issues involved. Copies of all documents are sent to members assigned to the case and the staff summary is sent to all Committee members.

One or more Committee members are assigned by the chairman as a task force to analyze the complaint and other relevant documents to determine whether the situation suggests that there might be a shortcoming in the quality control system of the firm and to make recommendations to the Committee as to the action that should be taken. The task force applies the relevant prescribed initial investigative procedures designed to assist it in considering the nature of the allegations and their implications. In some cases, analysis of the complaint and the financial statements to which it relates permits the task force and Committee to conclude that the allegations are without merit. Many complaints, while stating legitimate claims against issuers, fall short, for a number of reasons, of stating a reasonable claim against the auditor, most stemming from a misunderstanding of the scope of audit responsibility. In other cases, a discussion with representatives of the affected firm of the quality control implications of the allegations and a review of the findings of the firm's most recent peer review are sufficient to give the Committee assurance regarding the adequacy of the firm's quality control system.

If this investigation of the allegations indicates that there may be serious deficiencies in the design of, or in compliance with, the firm's quality control system, the Committee may order a special review of those aspects of the firm's system that, if operating effectively, ordinarily should prevent or detect deficiencies of the type alleged to have occurred. The Committee considers recent peer review and inspection findings in deciding whether there is a need for a special review. While it has not yet had the occasion to do so, the Committee can request authorization from the Executive Committee to review the audit workpapers of the specific alleged audit failure.

■ **Basis for Closing Individual Files.** A file is closed on a case with respect to the individual firm when the Committee concludes either that the allegations do not indicate the likelihood of a deficiency in the firm's quality control system, or, if so, that the firm has taken appropriate action to correct such deficiencies so as to minimize the possibility of future failure.

If litigation suggests a problem with professional standards, the matter is referred to the appropriate standard-setting body of the AICPA.

in accordance with applicable standards. Such reviews are performed not only to evaluate the performance on the engagement in question but also to determine the effectiveness of the firm's quality control policies and procedures and to make such changes in them as appear appropriate. This latter objective parallels that of the Committee, namely, that a member firm modify any aspect of its quality control system if such modification would be expected to minimize the possibility of a future engagement not being performed in accordance with professional standards.

Corrective actions taken by member firms during 1984-85, either on their individual initiatives or after discussion with a Committee task force, included:

- Reassignment of firm personnel and responsibilities.
- Development and presentation of, or participation in, specified continuing professional education programs.
- Closer supervision of, or concurring preissuance review of, work performed by specified individuals.
- Performance of a special internal inspection of auditing and accounting assignments for clients in a given industry.

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### Policy in Closing Cases

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As indicated, the Committee closed its files on 34 cases during the year ended June 30, 1985. A file is closed when the Committee either (a) concludes that the allegations misstated the requirements of professional standards or did not indicate a need for changes in the firm's quality control system or (b) has obtained assurance that the firm has strengthened the quality control policies and procedures relevant to the issues in the case in litigation.

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### Other Actions Initiated by the Committee

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In addition to assessing the allegations in each case in terms of possible deficiencies in the reporting firm's quality control system, the Committee considers whether the cases, either individually or in the aggregate, indicate a deficiency

in professional standards or a need for additional guidance.

Several cases during the past year have prompted the Committee to refer specific matters to the profession's standard-setting authorities:

- The Auditing Standards Board was asked to reassess the adequacy of guidance regarding communications between successor and predecessor auditors, especially in situations where the successor auditor intends to issue an unqualified opinion on financial statements that contain material revisions to those opined on by the predecessor auditor.
- Several reported cases dealt with accounting for costs during construction of nuclear operating plants by public utilities. A Committee task force met with representatives of the AICPA Public Utilities Subcommittee to discuss the financial problems facing a number of utilities with such construction projects in progress and their implications for accounting and auditing standards.
- The Committee formally requested the AICPA Professional Ethics Executive Committee to issue a ruling as to whether an auditor's independence is impaired, in fact or in appearance, in a specific set of circumstances.

Several other issues were informally communicated at meetings held periodically between representatives of the Committee and the Auditing Standards Board.

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### SEC Oversight of the Process

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In May 1985, at the suggestion of the Board and others, the Section agreed that the activities of the Special Investigations Committee should be reported to the Securities and Exchange Commission through the offices of the Board. Although details of this access arrangement have not yet been finalized, the SEC is to be provided information about each closed case that will identify the company and firm in litigation, summarize the major allegations in the case, and relate the investigative procedures applied by the Committee, the results obtained therefrom, and the subsequent actions taken by the Committee and reasons therefor. The SEC staff will also have access to work programs prepared by the staff of the Board.

# Membership Data

One thousand five hundred forty-nine firms are members of the Division for CPA Firms: 393 belong to both the SEC Practice Section and the Private Companies Practice Section, 10 belong only to the SEC Practice Section and 1,146 belong only to the Private Companies Practice Section.

Membership in the Division continues to decline, a trend that has persisted since 1980 when membership reached an all-time high of over 2,200 firms. After adjustment for mergers between member firms, the number of firms with membership in both sections declined by 19 during the twelve months ended June 30, 1985, and the number of firms with membership in only the

Private Companies Practice Section declined by 66. Details are shown in Table 5.

The fact that 217 firms withdrew from the Division—or had their membership terminated for noncompliance with membership requirements—continues to be a matter of concern. The Board is pleased to note, however, that the number of firms auditing one or more SEC registrants declined by only six during the year ended June 30, 1985.

Analysis of membership records maintained by the Institute reveals that 103 firms that withdrew during the year had undergone one or more peer reviews during their term of membership. Eighty-eight of these firms (85%) had re-

**TABLE 5** Analysis of Membership in the Division for CPA Firms by Number of SEC Clients and by Section—July 1, 1984 to June 30, 1985

Number of Firms Classified by Firms with and with no SEC Clients	July 1, 1984	Mergers* July 1, 1984 to June 30, 1985	July 1, 1984 Reinstated	New Members	Intra Division Changes (Net)	Resignations, Terminations, and Suspended Memberships	Changes in Classification of Firms	June 30, 1985
	<b>Firms with one or more SEC clients</b>							
SECPS-only . . . . .	7	—	7	—	—	2	—	5
Both sections . . . . .	189	4	185	4	(4)	5	(5)	175
PCPS-only . . . . .	<u>113</u>	<u>1</u>	<u>112</u>	<u>12</u>	<u>4</u>	<u>14</u>	<u>4</u>	<u>118</u>
Totals . . . . .	309	5	304	16	—	21	(1)	298
<b>Firms with no SEC clients</b>								
SECPS-only . . . . .	6	—	6	1	—	2	—	5
Both sections . . . . .	228	1	227	4	—	18	5	218
PCPS-only . . . . .	<u>1,120</u>	<u>20</u>	<u>1,100</u>	<u>108</u>	<u>—</u>	<u>176</u>	<u>(4)</u>	<u>1,028</u>
Totals . . . . .	1,354	21	1,333	113	—	196	1	1,251
<b>All firms</b>								
SECPS-only . . . . .	13	—	13	1	—	4	—	10
Both sections . . . . .	417	5	412	8	(4)	23	—	393
PCPS-only . . . . .	<u>1,233</u>	<u>21</u>	<u>1,212</u>	<u>120</u>	<u>4</u>	<u>190</u>	<u>—</u>	<u>1,146</u>
Totals . . . . .	<u>1,663</u>	<u>26</u>	<u>1,637</u>	<u>129</u>	<u>—</u>	<u>217</u>	<u>—</u>	<u>1,549</u>

\*Of the five firms that were members of both sections, four merged with other firms that are members of both sections and one merged with a PCPS-only member. Of the 21 PCPS-only firms that merged, 19 merged with firms that are members of both sections and two merged with other PCPS-only members.

TABLE 6 Analysis of Membership in the Division for CPA Firms—July 1, 1984 to June 30, 1985

Classification	Division for CPA Firms			SEC Practice Section		
	July 1, 1984	June 30, 1985	Increase (Decrease)	July 1, 1984	June 30, 1985	Increase (Decrease)
No. of firms . . . . .	1,637*	1,549	(88)	425*	403	(22)
No. of SEC audit clients . . . . .	11,543	13,070	1,527	11,366	12,862	1,496
No. of practice units . . . . .	3,742	3,639	(103)	1,974	1,996	22
No. of professionals . . . . .	100,846	105,154	4,308	85,192	90,044	4,852

\*Adjusted for mergers between member firms July 1, 1984 to June 30, 1985.

ceived an unqualified report on their most recent peer review.

While membership in terms of the number of firms that belong to the Section declined during the year, the number of SEC registrants<sup>4</sup> audited by member firms and the number of professionals employed by member firms continue to increase. Details are shown in Table 6.

#### Auditors of Publicly-traded Companies

Firms that are members of the Division serve as auditors for the vast majority of companies whose stocks are publicly traded. Member firms audit over 85 percent of all public companies listed in the thirteenth edition of *Who Audits America*<sup>4</sup>. As shown in Chart D, these companies account for over 98 percent of the aggregate sales volume of all publicly-traded companies. The majority of these companies—78 percent—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 combined sales volume of all publicly-traded companies.

Members of the Division and their foreign affiliates audit all but two of the companies whose stocks are listed on the New York Stock Exchange, all but 19 of the companies whose stocks are listed on the American Stock Exchange, and approximately 82 percent of the companies whose stocks are traded "over the counter."

#### Changes in Membership Requirements

Public and Congressional interest in instances of litigation alleging audit failure involving

non-SEC registrants caused the Executive Committee to amend the Section's membership requirements.

■ **Litigation Reporting Requirement.** In April 1985, the requirement for reporting litigation and certain other proceedings to the Special Investigations Committee was significantly expanded. In addition to reporting cases alleging deficiencies in the conduct of an audit of an SEC registrant, a member firm is now required to report cases alleging deficiencies in the conduct of an audit of the following "public interest" clients.

A bank or other lending institution that files periodic reports with the Comptroller of the Currency, the Federal Reserve System, the Federal Deposit Insurance Corporation, or the Federal Home Loan Bank Board pursuant to section 12(i) of the Exchange Act.

A subsidiary or investee of an SEC registrant if the allegations relate to financial statements presented separately in parent and/or investor company reports.

A company whose financial statements appear in the annual report and/or proxy statement of an investment fund because it is a sponsor or manager of such fund but which is not itself a registrant required to file financial statements periodically with a federal regulatory agency.

■ **Other Requirements Applicable to Non-SEC "Public Interest" Audit Clients.** In June 1985, the Executive Committee further amended the membership requirements to make the following rules applicable to the types of clients now covered by the "expanded litigation reporting requirement," except for subsidiaries or investees:

- Closely-held oil/gas/real estate partnerships.
- Wholly owned "financial" subsidiaries.
- Employee stock plans.
- Foreign based companies.
- Companies in bankruptcy.

4. The number of SEC registrants reported by member firms is considerably larger than the number of publicly-held clients listed in *Who Audits America*, 13th ed. (Menlo Park, Calif.: Data Financial Press, 1985). The primary reason for the difference is that *Who Audits America* generally does not include the following entities:

- A partner can serve as audit partner in charge of such engagement for a maximum of seven consecutive years.
- A concurring review of the audit must be performed by a partner other than the engagement partner.
- Certain management advisory services may not be performed for such clients that are also audit clients.
- The following matters must be reported to the audit committee or board of directors of such clients:
  - The amount of fees received for management advisory services and the type of such services.
  - The nature of disagreements with the management of the client on financial accounting and reporting matters and auditing procedures, which, if not satisfactorily resolved, would have caused the issuance of a qualified auditor's report.

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#### **The Division's Public Information Program**

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In its 1983-84 annual report, the Board urged the Division to implement "a multi-faceted 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." Before the end of 1984, the Division—acting through the Joint

Coordinating Committee of the SEC and Private Companies Practice Sections—had engaged the public relations firm of Hill & Knowlton to assist in the development and implementation of a wide-ranging public information program.

Approximately 60 spokespersons have been identified and trained in presenting the Division's message. There are five basic points in that message:

- CPAs, as professionals, are committed to excellence.
- Peer review is proof of that commitment.
- Peer review reports are available to the public.
- The business community should know about the Division's program, ask firms if they belong, and review the firm's peer review results.
- Division members believe every firm that performs audits should have the effectiveness of its quality control system periodically subjected to an independent peer review.

Information packages have been developed for the media, advertisements have been run in the *Wall Street Journal* and the *American Banker*, brochures have been developed on the peer review process and the significance of membership, information on the Division has been sent to about 300 newspapers, editorial briefings have been conducted with media in major cities and numerous interviews, usually with articles resulting, have been held.

**CHART D. Analysis of Firms that Audit the 10,230 Publicly-traded Companies Listed in the Thirteenth Edition of *Who Audits America***

8,030 companies (78.50%) with aggregate sales of \$40,774.64 million (98.09%) are audited by firms with permanent seats on the SECPS Executive Committee.

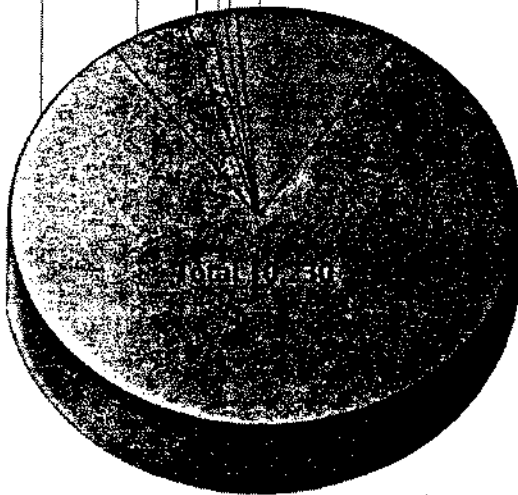
573 companies (5.60%) with aggregate sales of \$1,944.8 million (4.6%) are audited by other SECPS members.

179 companies (1.75%) with aggregate sales of \$218.6 million (0.5%) are audited by PCPS-only firms.

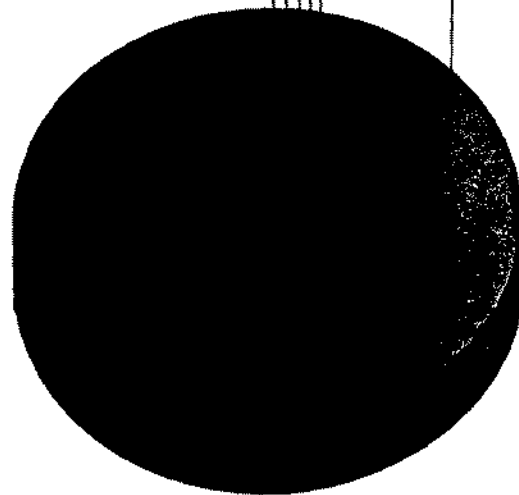
84 companies (0.82%) with aggregate sales of \$43,638 million (1.05%) are audited by foreign firms.

87 companies (0.85%) with aggregate sales of \$655.2 million (0.04%) are audited by firms not identified.

1,277 companies (12.48%) with aggregate sales of \$12,691 million (3.1%) are audited by U.S. firms not members of the Division.



**Number of Publicly-traded Companies**



**Annual Sales of Publicly-traded Companies (Millions of Dollars)**



## Board Conclusions and Commentary

**A**s indicated in earlier sections of this report, the Board concludes, based on its oversight activities, that both the peer review and special investigative processes are achieving their intended objectives. Both are upgrading the quality of accounting and auditing practice by reviewing the work of member firms, critiquing it, and compelling firms to strengthen their procedures where considered necessary. Both processes have benefitted by revision of standards and procedures suggested by reviewers, members of the Section's committees and their staffs, and Board members.

Testimony offered at the on-going Congressional hearings strongly indicates that the profession needs to increase the efforts to inform its various publics about the expanded self-regulatory program and to make clear the difference between a business failure and an audit failure. In addition, the hearings suggest that the Section should reevaluate the policies and procedures that cause misperceptions or whose objectives are being misinterpreted.

The profession must address itself to the problems caused by the changing environment, which were addressed by Chairman Wood in his recent address to AICPA Council (see Exhibit I), two of which are commented on below.

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### Price Competition and MAS

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The Board, through its oversight programs, has gained confidence that auditors perform audit assignments objectively. However, the increasing emphasis on management advisory services by member firms causes perception problems that demand the attention of the profession. The assertion is heard with increasing frequency that auditing is regarded as a commodity and that some CPA firms quote very low audit fees—i.e., use the audit as a "loss leader"—in order to gain new clients and reap the rewards of profitable

MAS engagements. Moreover, persistent and intensive price competition for audit services is interpreted by many as proof that the problem is more than one of perception.

An analysis of fee data reported by the 25 largest member firms reveals that:

- Four years ago, the range of MAS fees to total fees was 1 percent to 25 percent and the median percentage was 10 percent, i.e., half the firms received total MAS fees that were 10 percent or more of total fees.

- Currently, the range of MAS fees to total fees is 1 percent to 38 percent and the median is 13 percent, i.e., half the firms received total MAS fees that are 13 percent or more of total fees.

Thus, while fees for MAS engagements still represent a modest percentage of total fees, the trend of MAS fees is upward. The data reported does not permit a conclusion as to what portion of MAS fees are received from audit clients; it may be that a significant portion of MAS fees are for engagements performed for nonaudit clients. The Board has suggested to the Executive Committee that firms be required to report MAS fees in two classifications: MAS fees from audit clients and MAS fees from nonaudit clients.

Nevertheless, the perception problem persists. In its March 1979 report on "Scope of Services by CPA Firms," the Board stated its belief that certain MAS services—for example, those relating to the internal accounting control systems of clients—were natural opportunities of service for CPA firms to perform. However, it also urged the profession and individual firms to exercise moderation in the expansion of MAS services. It appears that CPA firms continue to expand their MAS departments and now offer services in areas which may have little or no relationship to the traditional services performed by auditing firms.

The Board has suggested an independent study to ascertain the extent to which the larger

firms have expanded the scope of MAS and how such expansion has affected the public perception of the auditor and the credibility of the auditor's report.

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### **Opinion Shopping**

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In the light of the ever-increasing complexity of business transactions, it is not uncommon for management to seek second opinions on how a certain transaction might be reported in financial statements. Some managements, more concerned with attaining a predetermined financial reporting objective than with reporting economic realities, seek an accounting treatment that permits them to achieve the predetermined objective. If their auditor does not condone such treatment, and if accounting literature does not specifically proscribe such reporting, some managements have been known to "shop" for an auditor who will concur with management's proposed accounting treatment.

The SEC has stated that it believes the number of companies engaging in "opinion shopping" is increasing. In a recently issued accounting and auditing enforcement release, it warned managements of public companies and accounting firms that such practice "erodes the public's belief in the integrity of both the financial markets and the independent audit function."

The Board concurs with this view and Chairman Wood has urged the profession "to snuff out [this] insidious practice." Strict adherence to the AICPA's Rules of Conduct, which require a member to consult with the inquirer's auditor in such situations so as to be made aware of all the facts relevant to the opinion requested, should minimize the number of times that opinion shoppers are accommodated.

The Board understands that the Section, based on the report of its Task Force on Professionalism, is considering adoption of several additional membership requirements. One would require each firm to adopt and publish an individual code of conduct and require and enforce adherence to such code. Another proposed requirement would be the establishment within each firm of a rule requiring a partner to consult with appropriate sources within the firm before expressing an opinion in response to inquiries about accounting matters that would have a significant influence on financial statements—regardless of whether such opinion is requested by a client or nonclient—and that such consultation be adequately documented. Compliance with these membership requirements would be subject to peer review.

The Board encourages adoption of such requirements.

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### **Proxy Statement Disclosure re: Auditing Firm**

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In July 1985, the Securities and Exchange Commission issued a release that proposes proxy statement disclosure of whether the registrant's auditing firm is a member "of a voluntary self-regulatory organization which has a peer review program and an independent oversight function, both of which are subject to review by the Commission." Based on its oversight of the Section's program, the Board believes that the peer review process is constructive and has improved the quality of accounting and auditing practice of member firms. Since the Board believes that all auditing firms, especially those that audit publicly-held companies, should subject their quality control systems to independent review periodically, the Board favors adoption of the SEC's proposed proxy statement disclosure.

## An Introduction to Board Members

The Public Oversight Board was first appointed in 1978. Eight persons have served on the Board since its inception. The following were members of the 1984-85 Board:



**ARTHUR M. WOOD, Chairman**, is a charter member of the POB and served as vice chairman from 1982 until 1984. Mr. Wood served as chairman of the board and chief executive officer of Sears, Roebuck and Co. from February 1, 1973 until his retirement on January 31, 1978. He joined Sears in 1946 to organize the company's law division and served the company in several other capacities, including secretary, vice president and controller, territorial vice-president, and president. He was a director of Sears and several other companies. He has a distinguished record of public service, including two presidential boards and trusteeships at the University of Chicago, the California Institute of Technology, the Art Institute of Chicago, and Rush-Presbyterian-St. Luke's Medical Center in Chicago.

“ An audit committee of the American corporation should play a major role in assuring the board of directors—and the shareholders—that the audit is complete and unfettered by pressure from management. An audit committee can inform itself of the quality control system of the audit firm by requesting access to the latest peer review records at the AICPA offices in New York. Self-regulation begins at the corporate level. ”



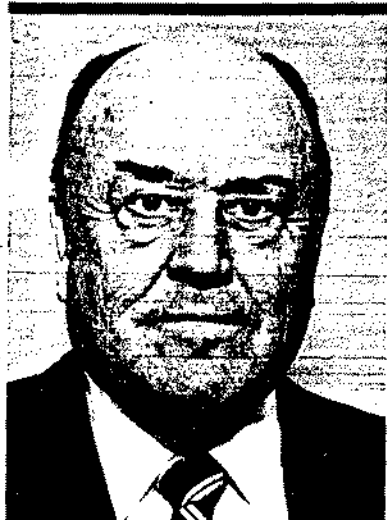
**A. A. SOMMER, JR., Vice Chairman**, joined the Board in 1982 and was elected vice chairman in March 1985. Mr. Sommer served as commissioner of the SEC from 1973 to 1976 and is currently a partner in the Washington, D.C. law firm of Morgan, Lewis & Bockius, specializing in securities law. He is a member of a host of legal and civic organizations and has actively served such organizations in various capacities, such as advisor, trustee, and committee chairman and member. He is a member of several boards of directors and serves on a number of advisory boards. He is a frequent lecturer on corporate, securities, and accounting subjects and has authored more than forty articles which have been published in several prestigious law reviews and business publications.

*“ There is no foolproof system that will guarantee detection of all errors in a set of financial statements. However, the fact that an auditing firm has submitted its quality control system to critical review by peers affords a higher level of public assurance regarding the quality of its accounting and auditing services than any other regulatory device we know. ”*



**JOHN D. HARPER** was a charter member of the Board. Mr. Harper served as chairman of the board of the Aluminum Company of America from 1970 to 1975, was chairman of its executive committee from 1975 until his retirement in 1977, and was a member of its board of directors until his untimely death. He had recently retired as chairman of Communications Satellite Corp., was a member of a presidential commission, several boards of directors, business and university organizations, and civic and social groups.

*“ The profession should concern itself with maintaining the public's perception of the independence of the auditor. Continuing expansion of management advisory services to audit clients can compromise this perception. The profession should consider moderating principles and procedures to keep its primary emphasis on auditing financial statements. Self-discipline and restraint would be the best remedies. ”*



**MELVIN R. LAIRD** became a member of the Board in August 1984. Mr. Laird served as Representative in the U.S. Congress from Wisconsin for nine terms, as Secretary of Defense from 1969 to 1973, and as Counsellor to the President for Domestic Affairs from 1973 through 1974. He is a member of several corporate boards of directors and over sixty boards of directors of civic organizations. He has received many honors, including the U.S. Medal of Freedom, the Order of Merit (Federal Republic of Germany), the Legion of Honor (France), Man of Year Awards by the American Cancer Society and National Association for Mental Health, and the Military Order of the Purple Heart. He currently serves as a senior counsellor for National and International Affairs for the Reader's Digest Association.

“ The profession, and in particular the Section, need to better articulate the difference between business and audit failure, or the public—and some members of Congress as well—will continue to read the newspaper and magazine accounts of business failures and wonder where the auditors were. ”



**ROBERT K. MAUTZ** joined the Board in 1981. Mr. Mautz is professor emeritus of the University of Illinois and the University of Michigan. He is a member of the Accounting Hall of Fame, past president of the American Accounting Association, and a former editor of the *Accounting Review*. He has been awarded the Gold Medal, the AICPA's highest honor, and the American Accounting Association's Outstanding Accounting Educator Award. He is a renowned author of textbooks and technical articles. His list of service contributions includes member of the AICPA Committee on Auditing Procedure, AICPA Council and Board of Directors, Commission to Study the Common Body of Knowledge for CPAs, Cost Accounting Standards Board, Financial Accounting Standards Advisory Council, and chairman of the Governmental Accounting Standards Board Organization Committee.

“ Unlike government regulation, self-regulation, properly performed, assures continually improving service to the public because its emphasis is on remedy and prevention. It is in closer touch with practice, more aware of changing conditions, and more responsive to the needs of those who use the service than any other form of regulation can be. ”

The Board is deeply indebted to  
three distinguished former members:



**JOHN J. McCLOY**, who served as chairman from inception until his resignation in early 1984. Mr. McCloy has had an illustrious career and public service record. He served as Assistant Secretary of War during World War II, High Commissioner of Germany, president of the World Bank and chairman of Chase Manhattan Bank, N.A., and as senior partner in the New York law firm, Milbank, Tweed, Hadley & McCloy. The AICPA has presented its Medal of Honor—the highest award the accounting profession can bestow on non-CPAs—to Mr. McCloy in recognition of his significant contribution to the profession and the public it serves.



**RAY GARRETT, JR.**, who served as vice chairman from inception until his untimely death in 1980. Mr. Garrett served as chairman of the Securities and Exchange Commission from August 1973 until October 1975. From 1954 to 1958 he served on the staff of the Commission, serving for most of that period as director of the Division of Corporate Regulation. Both prior to and after his tours of duty with the SEC, he was a partner in the Chicago law firm of Gardner, Carton & Douglas. He was an active member of the American Bar Association and served as chairman of several of its committees. In 1976, he was appointed a governor-at-large of the National Association of Security Dealers and was also a director of the American Arbitration Association.



**WILLIAM L. CARY**, who served as a member from inception until his resignation for health reasons in 1982. Mr. Cary was Dwight Professor of Law at Columbia University and served as chairman of the SEC from 1961 to 1964. Previously, he served on the SEC staff and held other government positions both in this country and abroad. He also served as counsel to the New York law firm, Patterson, Belknap, Webb & Tyler, and authored several books on law and government.

been its unique function: assuring the integrity of the financial information on which our capitalistic society depends.

CPAs are members of a profession that has had a long and honorable history in this country. They are critical, indispensable elements of any economy that depends on private capital. Without the work they do, savers would be reluctant to invest in private enterprises, particularly in equity investments or in any but the most established enterprises.

In response to demands made by society on the profession, it has, over the years, expended vast amounts of time and money to articulate sound accounting principles that maximize uniformity in accounting and comparability among enterprises. Considerable effort has been devoted to developing and refining auditing techniques and skills

which the SEC has, notwithstanding the thousands upon thousands of hours that have generously been given to make this system a success, the profession is again under public scrutiny and is subject to criticism based on a number of sensational, far-reaching and very unfortunate cases in which the public accounting profession appears to its critics and others to have failed its public responsibility.

It is not my purpose to dwell on charges currently being made against the profession. Rather, I would like to express the perceptions of my fellow board members and myself about what must be done if the profession is to regain public confidence and, in the course of that, perhaps its own self-confidence.

**Beyond quality control and peer review**  
Let me start with a disquieting ob-

jection which the Division for CPA firms was founded that if the program succeeded it would remove once and for all the prospect of legislative controls and be a giant step in regaining public confidence. Yet now, less than a decade later, the profession is once more under fire—if anything, more intense than it was subjected to eight years ago.

The repair job cannot be accomplished this time with a new structure, a new system, a new device. It can be done only if the profession is willing to undertake a bold rethinking of its role and has the will to make necessary changes to restore public confidence in the auditor's opinion.

This is already beginning to happen. The AICPA now has a major effort under way to examine the long-accepted proposition—long accepted in the profession but not by the public—that audits are not designed or likely to detect fraud.

## Exhibit I

decisions, the self-regulatory program will never gain the credibility it deserves.

The POB believes that the Securities and Exchange Commission should be given access to the SIC process to permit the SEC to form an independent opinion about the process. If this were done, we believe that the SEC would publicly state, as it has with respect to the peer review process, that the special investigative process is effective and is achieving its intended objective. I am pleased that earnest efforts are under way to provide the commission with the opportunity for fuller insight into the work of the SIC; I earnestly hope that they will culminate in a *modus operandi* that will satisfy the legitimate needs of the SEC and avoid unduly alarming members of the section.

Can the SIC perform its functions satisfactorily without some access to cases in litigation? None of us at

the POB advocates establishing the enormous structure that would be necessary to permit the board or the SECPS to determine if an individual or firm had been guilty of misconduct in performing an audit. As members of the board have repeatedly said, without subpoena power any such inquiry would pose the danger of inflicting grave injustice on persons and firms.

However, that belief does not justify the continuation of many of the limitations that surround the activities of the SIC. Among those limitations is the one that precludes the committee, in seeking to determine whether the litigation that occasions the inquiry indicates quality control deficiencies, from making any investigation of the very audit that is the subject of the litigation. This limitation stems, in my estimation, from fear on the part of firms that such an inquiry might in some fashion prejudice them in litigation, even though its purpose and thrust would not be to pass judgment on the audit.

We have no desire to put the SIC in the position of determining guilt or responsibility in individual cases. We do think it may be necessary to permit it to discover what really occurred with sufficient accuracy and reliability so it can assess the effectiveness of the firm's quality controls in the specific situation that gave rise to the litigation.

#### Second partner review

Second partner review is another matter that warrants immediate attention. At present, the SECPS's membership requirement on second partner review applies only to audits of SEC registrants.

It is somewhat difficult to explain to skeptical congressmen why the audits of financial institutions whose recent failures have had vast repercussions in financial circles are not considered important enough to be subject to this requirement of the section. I would think that the audit of any financial institution or organization of more than modest size should be subject to the requirements of second partner review, in addition to all other membership requirements applicable to SEC registrants.

The scope of such review also should be more precisely defined, including the requirement that "key area" work papers be examined, to give the firm even greater assurance that the engagement was performed in accordance with professional standards.

#### "Opinion shopping" and bent principles

Another by-product of today's intensely competitive economy is the tendency of some corporate managers to jettison an auditor thought to be too conservative or too rigid and to find one more pliable. No respectable professional countenances this; still SEC complaints provide evidence that there are members of the profession who do not blanch at the opportunity to gain a client, even if it means bending a principle.

The ideal solution to this, of course, is a heightened sense of professionalism. Sadly, that has not been sufficient to snuff out the insidious practice of "opinion shopping." Thus, I think it is imperative that the peer review process be amended to require appropriate

documentation that firms, for first-time audits, made appropriate inquiry of the predecessor auditor and examined its work papers, and reviewers should be permitted to make whatever inquiries of the predecessor they believe appropriate.

#### MAS: discipline and restraint

Finally, I call to your attention the concern of the Dingell committee about the effect on auditor independence of the performance of management advisory services for audit clients. The POB's report on *Scope of Services by CPA Firms* issued in March 1979 stated:

"[T]here is enough concern about the scope of services in responsible quarters so that the questions cannot be dismissed as a 'non-problem.' The Board believes that there is potential danger to the public interest and to the profession in the unlimited expansion of MAS to audit clients, and some moderating principles and procedures are needed."

Apparently, our call for moderation has gone unheeded, for we continue to read announcements by CPA firms offering consulting services that extend their MAS activities into such areas as consumer research, site evaluation, media market research, distribution planning and design, store operations, operations improvement programs, manpower planning and control, materials management—the list seems endless.

Again, self-discipline and restraint would be the best remedies; absent those—and they do appear to be absent—I would urge that the POB's work in the late 1970s in reviewing this activity be updated.

While fees for MAS still represent a modest percentage of total fees earned by firms, the trend is clearly in the direction of increasing reliance on this revenue. We hear today the assertion that some CPA firms consider auditing to be a commodity. They are using the audit as a "loss leader" in order to reap the rewards of profitable MAS engagements. The intensive price competition for audit services in which the profession is now engaged is interpreted by many as proof that the assertion must be fact. These perceptions demand serious attention by the profession.

#### A harbinger of regulation

The members of the POB are fully committed to the belief that the accounting profession and the nation are best served by a system of self-regulation and that there is no need for further federal regulation. I would be less than candid, however, if I did not express our concern that a failure to come to grips with the problems discussed above, and others as well, will be the harbinger of a measure of regulation that can only stifle innovation, competition, opportunity and professionalism.

The profession is divided in its counsels. It must forego its differences, recognize the crisis and act in unity to defeat it. We share a conviction that the solution to the faults in financial reporting does not lie in more regulation. The solution lies within the profession. ■



**SEC PRACTICE SECTION****Executive Committee**

<i>Member</i>	<i>Firm Affiliation</i>
John W. Zick, Chairman	*Price Waterhouse
John D. Abernathy, III	*Seidman & Seidman
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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.

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Joseph A. Zulfer	Ernst & Whinney

\*Retired.

\*\*Effective October 1985, these members will have exhausted their six-year eligibility for service on the committee in accordance with the section's existing regulations.