

Public Oversight Board

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SEC Practice Section

Division for CPA Firms

American Institute of Certified Public Accountants

Annual Report 1985-1986



Public
Oversight
Board

Public Oversight Board

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Foreword

This eighth annual report of the Public Oversight Board contains a review of the Board's oversight of the AICPA SEC Practice Section's activities during the year and the conclusions of the Board concerning the Section's program.

The year under review was marked by several important events. Hearings concerning the accounting profession were conducted by Congressional committees and a bill was introduced in the House of Representatives that could profoundly affect the relationship between independent accountants and their audit clients. Three sets of recommendations calling for substantial reforms were issued by groups in the private sector—one by a special committee of the AICPA, one by a major accounting firm, and one jointly by several other major firms.

In addition, the Section continued to revise and strengthen its peer review and special investigative programs whenever circumstances warranted. It also modified its policy of confidentiality relative to the activities of the Special Investigations Committee by giving the SEC access to certain information regarding cases reported to that committee.

We hope you will review this report carefully. The peer review and special investigative programs provide significant assurance that the accounting firms which audit the overwhelming bulk of publicly-held companies in this country adhere to high quality standards. As a result, the credibility of audited financial statements is greatly enhanced. It is important that all those who use audited financial information be aware of the measures which are being taken to improve the reliability of that information.

For the Public Oversight Board



ARTHUR M. WOOD
Chairman

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Highlights and Insights

■
(Seated, center)
Arthur M. Wood
(Back, left to right)
Melvin R. Laird,
A. A. Sommer, Jr.,
Robert K. Mautz,
Paul W. McCracken.

Highlights and Insights

The Public Oversight Board was established in 1977 by the American Institute of Certified Public Accountants to oversee the activities of the SEC Practice Section of the Division for CPA Firms. The Section was established to assure that firms auditing issuers which made filings with the SEC had satisfactory quality control standards and that they adhered to them. To that end, the SEC Practice Section requires, among other stringent membership requirements, that every three years each member firm undergo a "peer review" by other auditors of its quality control policies and procedures and compliance with them.

Membership

	SEC Practice Section	Division for CPA Firms
At July 1, 1985	395	1,518
At June 30, 1986	391	1,574

While membership in the Section declined slightly during the year, companies which account for over 99% of sales of all companies whose stocks are listed on the major stock exchanges or traded over-the-counter are audited by members of the Section.

In 1985, 80 member firms of the SEC Practice Section underwent peer review. In the course of these peer reviews, five sets of financial statements audited by reviewed firms were found not to have been in compliance with generally accepted accounting principles or not to have been audited in accordance with generally accepted auditing standards. In each case, appropriate action was taken to assure that the public was not misled by these statements.

In 1979, the Section established the Special Investigations Committee to ascertain when a member firm was sued with respect to the financial statements of issuers who filed with the SEC whether the litigation suggested any fault in the design of or compliance with the firm's quality controls, or some deficiency in accounting or auditing standards.

Peer Review Reports Issued on 1985 Reviews

No reportable deficiencies noted	4
Corrective actions recommended	69
Corrective action(s) required in certain key policies and procedures	7
Significant or extensive corrective actions required	0

The Special Investigations Committee opened files with respect to 44 suits alleging audit failure and closed files on the same number. In each case which was closed, the Committee satisfied itself that the firm reporting the litigation currently had adequate quality controls. As a consequence of the special investigative process, six cases were referred to the AICPA Professional Ethics Division for further review as to compliance with the Institute's ethical standards.

Members of the Board and its staff attended all meetings of the committees of the SEC Practice

Section and reviewed all Peer Review and all Special Investigations Committee activity.

Summary of SIC Activity

Case files open at July 1, 1985, including special reviews of two firms	33
Case files opened during year	44
Case files closed during year:	
Allegations had no quality control implications	7
After ascertaining that firm's quality controls were not deficient	28
After obtaining assurance that the firm had made or would make appropriate changes in its quality controls	9

Conclusion

Based upon a comprehensive and thorough oversight program, which is detailed in the following pages, the Public Oversight Board concludes that during 1985-86 the SEC Practice Section of the AICPA Division for CPA Firms conducted its affairs in a manner that was sensitive to and in accord with the public interest.

The Board has identified to the relevant committees of the Section modifications in their peer review and special investigative programs which would be desirable. However, we have not discovered any significant failure on the part of the Section to accomplish its goals. The diligence with which the programs are administered and accepted provides assurance that member firms are committed to have satisfactory quality control policies and procedures and comply with them and with the other membership requirements of the Section.

The officers and committees of the Section, as well as its member firms, are to be commended for the vigor, professional skill, and integrity which they have brought to this process and for their continuing dedication to the improvement of the quality of audits.

Numerous lawsuits against accounting firms have created the impression in many quarters that there is a serious breakdown in the quality standards of the accounting profession. The Board believes, based upon its intensive oversight activity, that this conclusion is unwarranted. The lawsuits at worst are the result of personnel failures rather than pervasive shortcomings in quality control.

However, the profession must guard against becoming complacent. It must continue to deal effectively with real problems as they arise and to continually reassess the effectiveness of the policies and programs in light of changing conditions.

Report of the Board

In response to concerns about the quality of auditing services expressed during the course of Congressional hearings on SEC oversight of the accounting profession in 1977 and 1978, the American Institute of Certified Public Accountants (AICPA) created a new self-regulatory organization, the Division for CPA Firms with two sections, an SEC Practice Section (SECPS) and a Private Companies Practice Section (PCPS).

The two sections have similar membership requirements, including a triennial peer review of each member firm to determine whether it has an effective system of quality control which meets established standards and which provides reasonable assurance of professional quality in the performance of accounting and audit services. The SEC Practice Section has additional requirements that apply to audits of SEC registrants and other specified entities in which there is a public interest. For example, such audits must be subjected to review by a second partner in addition to the review by the partner with primary responsibility for the engagement. Member firms must also rotate partners in charge of such audits at least every seven years.

The Public Oversight Board oversees and reviews the activities of the SEC Practice Section in the public interest. The Board consists of five members not engaged in public accounting who represent a broad spectrum of experience. As indicated herein, Professor Paul W. McCracken joined the Board to fill the vacancy created by the untimely death of John D. Harper.

To fulfill its public responsibility, the Board conducts direct continuous oversight of all of the Section's activities. The Board also has responsibility to make recommendations for improvement in the operation of the Section and to publish such reports as it may deem necessary with respect to its own activities and those of the Section.

The Board does not have, nor does it believe it needs, line authority. The Board is satisfied that its suggestions are given appropriate consideration in the development and refinement of the policies, standards, and operations of the Section and that it has had an influence on the development by other AICPA bodies of professional standards. Some of the Board's contributions are identified in this annual report.

Board Activities

Board Chairman Arthur M. Wood attends meetings of the Executive Committee; Vice Chairman A. A. Sommer, Jr., in his capacity as Board liaison, attends meetings of the Peer Review Committee and its subcommittee; and Board member Robert K. Mautz, as Board liaison, attends meetings of the Special Investigations Committee and its subcommittee and task forces. The Board is assisted by a staff of four experienced 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.

Positions taken by the Board result from the discussion of detailed reports on activities of the Section's committees by the Board members and staff assigned to those activities. In addition, AICPA and Section officials and other leaders of the profession are periodically invited to Board meetings to provide relevant information and to discuss issues under consideration. Also during the year, Vice Chairman Sommer met informally with the chairman and members of the Securities and Exchange Commission, and Board members addressed various meetings and conferences, including several held on college campuses.

Oversight of the Peer Review Process

During fiscal year 1985-86, Board or staff members attended each of the seven meetings of the Peer Review Committee, six of the meetings of its Evaluations and Recommendations Subcommittee, and five of the meetings of its various task forces.

The Board's staff, as in past years, exercised varying degrees of oversight over every peer review performed during the year. This extensive oversight program enables the Board to observe the effectiveness not only of the peer review program but also of private regulation at the firm level. As we have noted in prior reports, continual attention to quality controls by a CPA firm's management is the most direct and effective means available for improving that firm's quality of service. In this regard, we have noted that the internal inspection programs of firms frequently identify the need for additional guidance or training

and the improvement of audit performance. The effectiveness of such internal programs is critically reviewed and candidly reported on by peer reviewers.

Members of our staff have reviewed and were favorably impressed with the training materials developed by some member firms which communicate, and are intended to correct, the deficiencies noted in either the firm's peer review or its internal annual inspection.

As a by-product of its oversight of the self-regulatory process, Board and staff members are made aware of trends in the practice of public accounting. This information is discussed by the Board to ascertain whether those trends may adversely affect the attest function.

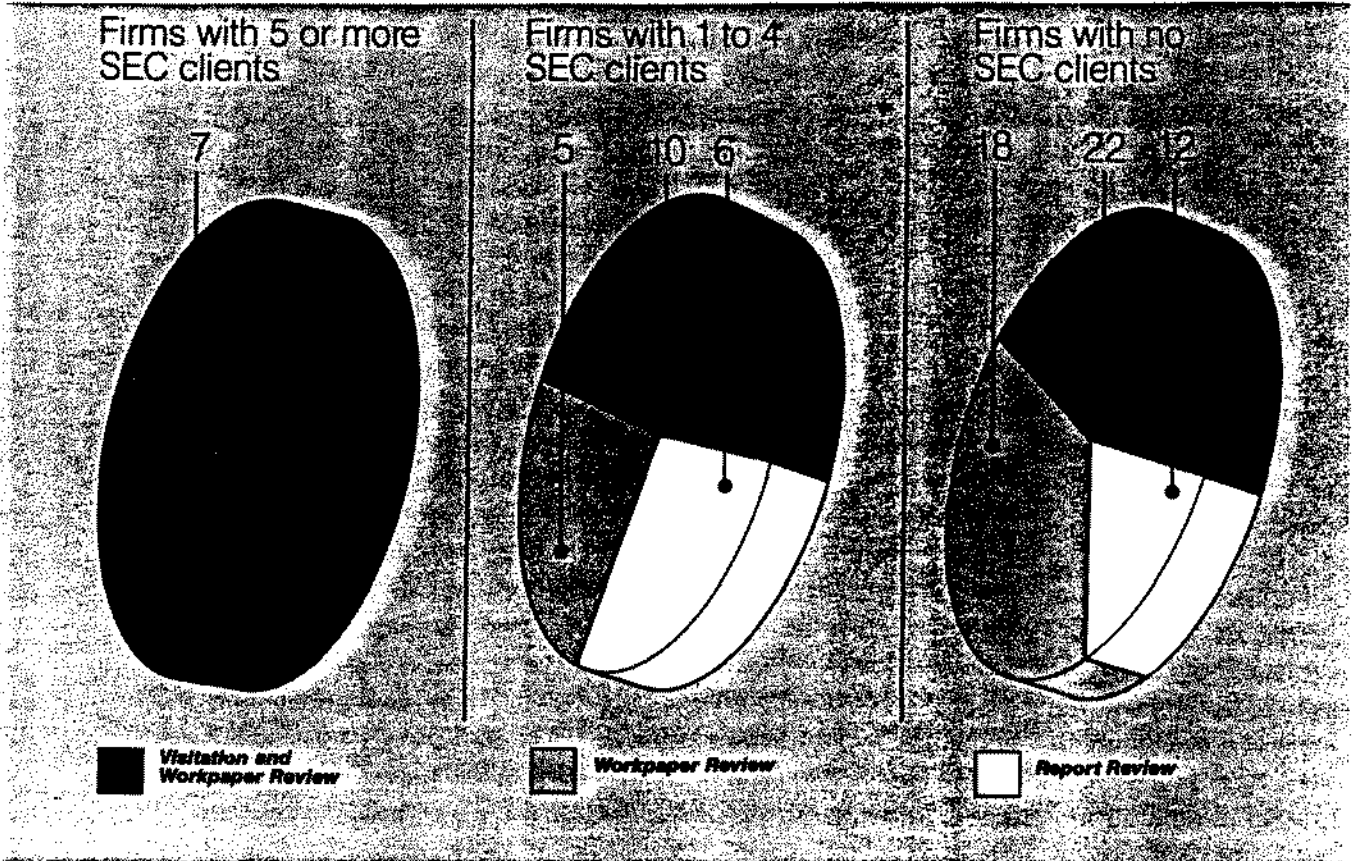
Oversight of Individual Reviews

Each peer review is reviewed by the Board through application of one of its three oversight programs:

■ Vice Chairman Sommer, left, discusses Peer Review Committee matters with PRC Chairman Ed O'Grady and PRC Chairman-Elect Dave Pearson.



CHART A Scope of Board Oversight of 1985 Peer Reviews Classified by Number of SEC Clients of Reviewed Firms



- Visitation and workpaper review—observation of the performance of the field work, attendance at the exit conference, and review of the review team’s workpapers, report, letter of comments, and the reviewed firm’s letter of response,
- Workpaper review—review of all of the review team’s workpapers, the report, and the letters of comments and response, and
- Report review—review of selected portions of the review team’s workpapers, the report, and the letters of comments and response.

For firms reviewed during the past year, the Board applied its most

intensive oversight program to reviews of 100% of the firms with five or more SEC clients, to 48% of the firms with one to four SEC clients, and to 42% of the firms with no SEC clients.

As shown in Chart A, the staff observed 39 peer reviews while they were being conducted and attended the final exit conferences for those reviews. Members of the Board also attended some exit conferences. Any deficiency in the performance of or the reporting on a peer review that the POB staff believed had not been adequately addressed by the Peer Review Committee was brought to the attention of the Board.

As noted, the Board does not have line authority with respect to acceptance of peer review reports; however, the Section is responsive to Board suggestions or criticisms. The Board's staff has, on occasion, questioned the adequacy of a review team's reporting of quality control deficiencies. In each case, the matter was resolved to the Board's satisfaction, resulting in the issuance of a revised report or letter of comments as appropriate.

As indicated elsewhere in this report, the Committee accepted some reports on 1985 reviews on condition that the reviewed firm take specified corrective action and subsequently provide the Committee with evidence that such action had produced the intended improved results. The Board's oversight extends to monitoring the Committee's diligence in assessing the effectiveness of required corrective actions, some of which required firms to secure the services of competent outsiders as consultants and preissuance reviewers of workpapers, audit reports, and financial statements.

Improvements in the Peer Review Process

In last year's report, we expressed concern about some inconsistency among review teams in evaluating and reporting on deficiencies noted during the course of a peer review and suggested that additional guidance materials be published. The Board also suggested that the peer review report include a reference to the letter of comments, if one was written.

A task force evaluated these suggestions and concerns and

developed improved and expanded guidance in the application of peer review standards. The task force's recommendations, which dealt with all of the Board's concerns, have been adopted by the Committee and are in effect for reviews completed after July 31, 1986. See "Modification of Peer Review Standards and Procedures" on page 21.

To assure that team captains understand and implement the new standards, peer review training materials have been revised to incorporate these changes. Further, persons wishing to serve as team captains on reviews expected to be completed after July 31, 1986 are required to attend a training course covering the new materials. Our staff participated in or observed three peer review training courses.

The Board finds its access to the peer review activities of the Section entirely satisfactory for the discharge of its responsibilities. Discussion at committee meetings is unrestrained and frank, and the Board has adequate opportunity to make its views known. The Board especially applauds the diligence and perseverance of the task force in developing the new guidance materials.

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



■ Chairman Wood conducting a session at Northwestern University as part of its Annual Meeting of the Kellogg School Accounting Advisory Council, June 4, 1986.

interest, defined generally as an entity that is required to file financial statements with the SEC or certain other federal regulatory agencies.

The Board and its staff actively monitor activities of the SIC and its task forces and have unrestricted access to all committee meetings and files. Members of our 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 the memorandum prepared by the SIC's staff, which summarizes the allegations in the complaint, the accounting, auditing, and quality control issues involved, and applicable professional standards. These memoranda, supplemented by information and comments developed by POB staff in carrying out the Board's oversight function, serve as the basis for discussion by the Board

relative to SIC actions on reported cases.

Board and staff members attended each of the six meetings held by the Committee during the year, most of the 53 task force meetings with firm representatives to discuss allegations in reported cases and six meetings with the firm's peer reviewers to discuss comments and suggestions made during the last peer review that might be relevant to the allegations. In some cases, the SIC requested the firm's peer review team to perform specific procedures during the firm's next peer review and report the results thereof to the Committee.

During the year, the Board conducted a comprehensive review of the special investigative process and developed suggestions for consideration by the Section that could enhance its effectiveness, efficiency, and credibility.

The SIC formed a special task force to consider the Board's suggested changes in procedures which include:

- Establishing specific guidelines for determining when a special review should be performed.
- Further expanding SIC authority to require member firms to report significant litigation that is not now required to be reported under existing membership requirements. Under present practice only the Executive Committee can require a firm to do so.
- Making task force findings with respect to quality control implications of cases involving the firm to be reviewed available to the peer review team.

The prompt and serious consideration given to these most recent suggestions of the Board by the Executive and Special Investigations Committees is further evidence that all involved in implementing the program are diligent in discharging their assigned responsibilities. Overall, the Board believes the SIC is achieving its objectives by effectively complementing the peer review process and improving the quality of professional practice and literature.

As noted elsewhere in this report, the Section reached agreement with the SEC, whereby its Chief Accountant and members of his staff are permitted access on a trial basis, through the offices of the Board, to certain information regarding cases closed by the SIC. The arrangement is being evaluated by both the Commission and the Section. As of June 30, 1986, the Board's staff provided the SEC with materials and responded to questions concerning twenty-eight cases. Twenty-seven of the cases were closed after completion of the standard investigatory procedures and one after a special review had been conducted.

It is expected that SEC access to the SIC process will strengthen public credibility for the entire self-regulatory program.

Oversight of Executive Committee Activities

Board Chairman Wood attended, along with staff members, each of the meetings of the Executive Committee held during the year ended June 30, 1986. The staff also attended all meetings of the Plan-

ning Subcommittee of the Committee. The chairman of the Executive Committee participated in two Board meetings to exchange views on various issues of significance.

As indicated in the following section, the Committee made several significant changes in the membership requirements of the Section, some of which were initiated at the suggestion of the Board. The actions of the Committee provide further evidence of its commitment to operate the self-regulatory program in the public interest.

Scope of Services by CPA Firms

The Board made an analysis of the promotional literature of management advisory services (MAS) published by major CPA firms. The primary purpose was to ascertain how such services were promoted and what perceptions they may create. A secondary purpose was to obtain a better understanding of the scope of consulting services being offered today.

■ POB member Mautz, center, discusses matters with SIC Chairman Bob Mellin, right, and AICPA Group Vice President Tom Kelley.



The survey indicated that CPA firms (a) are offering a much wider range of services than were offered when the Board made its study of scope of services in 1978, (b) identify themselves as auditors and consultants, (c) describe their MAS role as one of partnership with the client, and (d) indicate willingness to assist not only in the identification and definition of the problem but also in formulating and implementing the proposed solution.

Peer review teams review MAS engagements as well as audit engagements for whom the firm has also done MAS work. In the eight year history of peer reviews, no firm has been found to be doing any proscribed MAS services, and there is no evidence that the performance of MAS engagements has impaired auditor independence or objectivity.

However, the Board is of the opinion that the continuous expansion of consulting services may be perceived as impairing auditor independence and thus adversely affect the value of the audit function in the long run. Accordingly, the Board has authorized a professional research organization to conduct a survey to determine if such a perception exists among users of accountants' services.

■ Vice Chairman Sommer at the Thirteenth AICPA Annual Conference on Current SEC Developments, January 7, 1986.



Activities
of the
SEC
Practice
Section

The major programs of the SEC Practice Section are its peer review and special investigative programs. In each case, the program was revised to make it more effective and efficient and to adapt it in the light of changing conditions.

Peer Review Activities

In 1985, 80 member firms were required to submit their quality control systems to peer review. Of these, 69 had previously been peer reviewed. Three were firms that were required to undergo a full-scope review prior to the expiration of the normal three-year cycle because the previous review had disclosed quality control system deficiencies requiring extensive or significant corrective action by the firm. Eleven firms were peer reviewed for the first time in 1985.

Seventy-five reports on 1985 peer reviews had been accepted by the Peer Review Committee as of June 30, 1986. Processing of the reports on the remaining reviews was deferred pending resolution of certain matters, either by the reviewed firm or by the review team, to the satisfaction of the Committee.

Types of Reports Issued

As indicated in Chart B, over 91% of the firms reviewed in 1985 received an unqualified opinion, the vast majority of which were accompanied by a letter of comments. Letters of comments accompany all modified reports and typically accompany unqualified opinions except those issued to very small firms with relatively simple quality control systems. Approximately 9% of the firms reviewed in 1985

received qualified opinions. Details are shown in Chart B.

The peer review process continues to improve the quality of accounting and audit practice by member firms. Such improvement is difficult to measure quantitatively. It has been widely observed, however, that review teams are now more experienced in identifying quality control deficiencies than they were when the peer review program was instituted and are holding firms to higher standards each year. Further, comparison of the letters of comments issued in 1985 with those issued to the same firms on the prior review indicates that most firms, including those that received unqualified reports on both reviews, had improved their quality control systems in the three-year period.

As in past years, the Peer Review Committee and its staff vigorously and equitably enforced the standards for performing and reporting on peer reviews. In doing so, the Committee deferred acceptance of 12 reports after initial consideration. The primary reasons for deferring acceptance were:

- The report and letter of comments issued were not consistent with the deficiencies noted in the course of the review and the review team was asked to change the report and/or letter.
- The accounting and auditing engagements reviewed did not constitute a representative cross-section of the firm's practice.
- Questions as to whether one or more of the audit engagements reviewed had been performed in

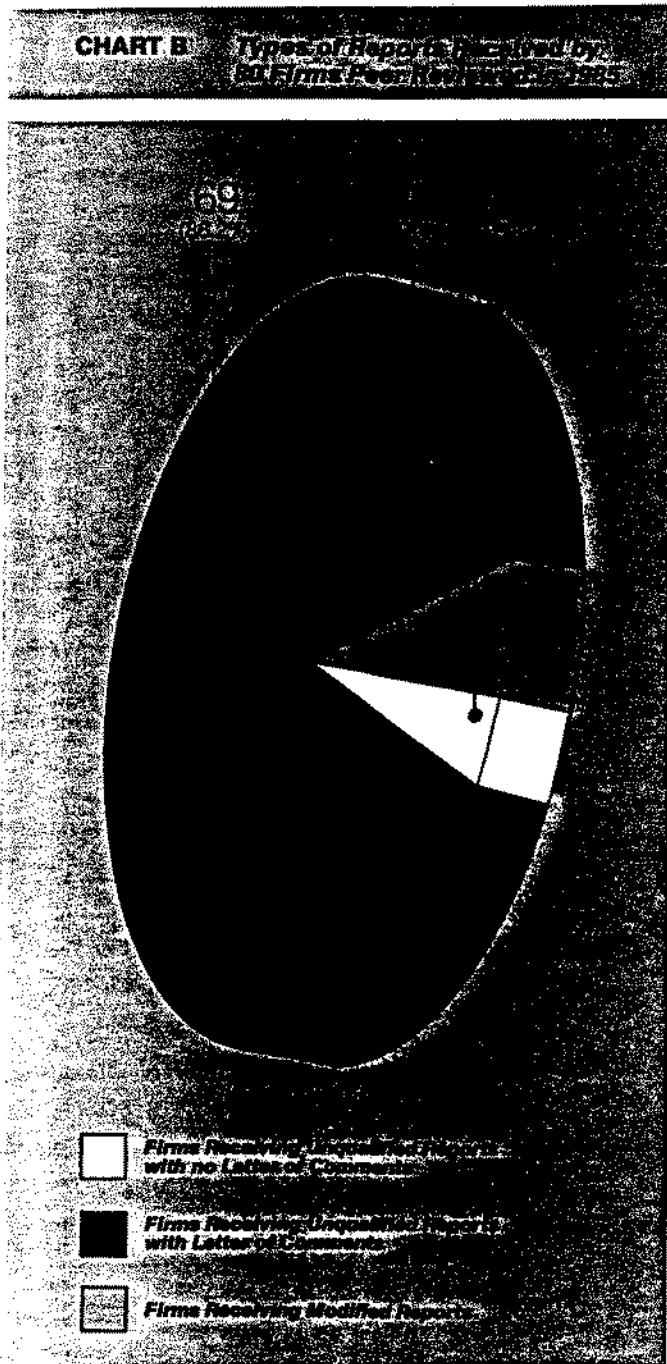
compliance with professional standards were unresolved.

Substandard Performance on Individual Engagements

Each instance of substandard auditing and accounting performance on individual engagements discovered during the peer review process is required to be reported promptly to the Committee.

During 1985, review teams reviewed the financial statements, reports, and workpapers for 657 audit engagements, including audits of 150 SEC registrants. Five engagements—or 0.8% of the number reviewed—were deemed to be substandard in the application of generally accepted accounting principles (GAAP) or generally accepted auditing standards (GAAS). Only one was an audit of the financial statements of an SEC registrant.

In each instance where substandard work was detected, the peer review team had (1) 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), (2) to consider whether the substandard work resulted from noncompliance with existing policies and procedures (a "people problem"), (3) to recommend appropriate remedial measures, and (4) to conclude whether the matter should be reported in a letter of comments or would require modification of the peer review report. Member firms are required by professional standards to take corrective action to bring their performance on such engagements into accordance with profes-



sional standards.

The five non-GAAP/non-GAAS engagements discovered during 1985 in the peer review process were performed by four different firms. One of these firms received a modified report because of the grav-

ity of deficiencies in its quality control system. The three other firms received unqualified reports and letters of comments, because the reviewers concluded that the substandard work did not result from a system deficiency but rather from isolated noncompliance by firm personnel with the firm's policies and procedures. Actions taken by the reviewed firms regarding these engagements varied as follows:

- The financial statements of the SEC registrant and the financial statements of one nonpublic company were deemed not to have been prepared in accordance with GAAP. Each of the firms immediately recalled its report and the financial statements were revised and reissued.
- The peer review team concluded that three audits, two of which were performed by the same firm, had not been performed in accordance with GAAS. In each case, the firms immediately performed the additional auditing procedures that were considered necessary. Performance of the additional procedures did not indicate a need for a change in the financial statements or the audit report, and no further action was considered necessary.

**Additional Requirements
Imposed by the Peer
Review Committee on
Firms Reviewed in 1985**

During the year, the Committee took other actions to obtain assurance that firms were effectively implementing corrective action plans in situations where serious quality control deficiencies had been noted during the peer review. The actions required and monitored

by the Committee consisted of:

- Requiring two firms to have accelerated peer reviews.
- Requiring one firm to hire an outside consultant (a) to perform a preissuance review on all audits of financial statements and audit reports and workpapers, (b) to assist in the revision of the quality control document, and (c) to conduct the annual inspection.
- Revisits to three firms by the review teams to assess the effectiveness of the firms' corrective actions.
- Obtaining copies from ten firms of the report issued in connection with the following year's internal inspection program to ascertain whether the firm's corrective actions had produced the desired effect.
- Obtaining copies of six firms' revised quality control documents to assess whether the revised policies and procedures, if complied with, would eliminate deficiencies found in the peer review.

**Additional Requirements
Imposed by the Committee on
Firms Reviewed in 1984**

At June 30, 1985, the reports on 14 peer reviews performed in 1984 had not been acted on by the Committee, pending satisfactory resolution of certain matters by the reviewed firms. Since then, the Committee accepted reports on 13 of these reviews. After holding an appropriate hearing on the matter, the Committee recommended that the Executive Committee sanction the remaining firm for not taking the corrective actions recommended by the Committee. (See page 27)

In connection with the 13 reports accepted subsequent to June 30, 1985, the Committee took strong measures to obtain assurance that firms would effectively implement corrective action plans in those situations where serious quality control deficiencies were deemed to exist. Such actions consisted of:

- Requiring two firms to undergo accelerated peer reviews.
- Requiring one firm to hire an outside consultant (a) to perform a preissuance review of the financial statements, audit reports, and supporting workpapers on all audit engagements, and (b) to develop and install an appropriate quality control system and audit approach.
- Requiring one firm to permit a revisit by the peer review team captain (or another person approved by the Committee) to assess whether corrective actions recommended by the review team were effectively implemented.
- Requiring one firm to designate a specific partner to perform a preissuance review of financial statements, audit reports, and audit workpapers.
- Obtaining from six firms copies of the following year's internal inspection report; it was further recommended that one firm have its annual inspection program performed by qualified persons from outside the firm.
- Obtaining from three firms copies of, and evaluating the appropriateness of, their revised quality control policies and procedures and audit program modules.

- Obtaining evidence from one firm that it had developed and implemented an appropriate continuing education program for its professional staff.

Modification of Peer Review Standards and Procedures

In 1985, the Joint Task Force on Uniformity of Reporting, consisting of members of the Peer Review Committees of both the SEC and Private Companies Practice Sections, proposed revisions to and clarifications of existing standards and guidelines. Each of the task force's recommendations was adopted by both peer review committees, as discussed below:

- Standards were revised so that:
 - The peer review report is to make reference to the letter of comments, if one is issued.
 - Inspection findings are to be reconciled to the findings of the peer review team and considered in developing the peer review report and the letter of comments.
 - If the firm performs one or more engagements subject to the Single Audit Act of 1984, the sample of engagements selected for review must include at least one such engagement.*
- Sharply defined guidance was issued regarding:
 - Deficiencies that require the issuance of a modified report. This includes circumstances

**During the year, a report issued by the U.S. General Accounting Office was critical of the quality of audits of state and local government units receiving federal grants. This change in the peer review requirements was a direct response to the GAO's findings.*

when one or more offices of a multi-office firm are found not to be in compliance with the firm's quality control policies and procedures, even though the degree of compliance by all other offices reviewed was acceptable.

□ Deficiencies that are to be reported in a letter of comments.

■ New review team materials were issued:

□ A checklist for review of audits of governmental entities.

□ A revised and expanded program for review of the functional areas of a quality control system.

The changes, which are effective for peer review reports issued on or after August 1, 1986, are expected to further enhance the quality of peer review performance and reporting.

The Committee decided, in light of the extensive revisions and clarifications to the peer review standards and guidance documents, that all team captains, prior to performing reviews under the revised standards, must have attended a training program which incorporates these changes in its curriculum.

The Committee has in process several other projects which are expected to make the process more effective and the conduct of a review more efficient, such as:

■ Specialized checklists for review of engagements in specific industries, such as banking, contracting, savings and loan, and nonprofit organizations.

■ A guide for preparing letters of comments.

Monitoring of MAS Engagements

Member firms are required to report certain information regarding fees received for management advisory services engagements, including MAS fees received from SEC registrants for whom the firm also 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 96% of the SEC registrants audited by member firms, the firm either did not perform an MAS engagement in 1985 or, if it did so, the MAS fee was less than 26% of the audit fee. Details are shown in Table 1.

The Section has been sensitive to criticism that performance of MAS engagements may impair the appearance of auditor independence. Peer review standards require review teams to identify clients for which the firm has received MAS fees in excess of audit fees and include at least one such client in the engagements selected for review. In addition, review teams typically review audits of SEC registrants for whom the firm has also performed MAS engagements, regardless of the amount of MAS fees, to determine through appropriate tests whether the firm has:

■ Made objective accounting, auditing, and reporting decisions in performing the audit of an SEC registrant for which the firm also performed one or more MAS engagements.

■ Complied with independence rules embodied in the AICPA Code of Professional Ethics and its State-

TABLE 1 Analysis of Ratio of MAS Fees to Audit Fees Received in 1985 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 (12) with 100 or more SEC audit clients	11,691	213	131	147	12,182
Firms (10) with 20 to 99 SEC audit clients	435	12	4	2	453
Firms (158) with fewer than 20 SEC audit clients	475	11	2	3	491
Totals	<u>12,601</u>	<u>236</u>	<u>137</u>	<u>152</u>	<u>13,126</u>
Percents	<u>96.0%</u>	<u>1.8%</u>	<u>1.0%</u>	<u>1.2%</u>	<u>100%</u>

*Future annual reports filed by member firms will include 0% as a discrete category which will make future analyses of these data more useful and less subject to misinterpretation.

ments on Standards for Management Advisory Services when performing MAS engagements.

- Complied with the proscriptions relating to 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 application of such procedures to selected engagements performed by the firm for SEC registrants throughout the eight-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 attest function or (b) that proscribed services have been performed.

SEC Oversight of the Process

The SEC independently evaluates the Section's peer review process. The SEC staff has begun its inspection and evaluation of the 1985 reviews but has not yet con-

cluded that process because some of the reports on reviews selected in its sample have not yet been processed by the Committee. We believe that the SEC staff is satisfied with the reviews it has inspected to date.

Special Investigative Activities

The SEC Practice Section established the Special Investigations Committee in 1979. Member firms are required to report litigation and proceedings or public investigations by regulatory agencies, involving the firm or its personnel, that allege deficiencies in the conduct of an audit of the financial statements of an SEC registrant or other entity that files financial statements with certain other regulatory agencies. The objectives of this process are to permit the SIC to ascertain whether such allegations indicate a need either for corrective measures in the design of or compliance with the quality control system of the member firm involved or

for reconsideration of relevant professional standards by the standard-setting bodies.

In June 1986, the second public report of the SIC was issued and provided information on the scope and results of its activities during its first six years of operation with the expectation that it would enable both the public and the members of the accounting profession to form a judgment about the Committee's seriousness of purpose and the success of its efforts.

Cases Reported

Member firms reported 44 new cases during the year ended June 30, 1986, compared to an average of 30 cases per year in the prior five-year period. The increase in the number of cases reported reflects both the increasingly litigious environment in which CPA firms practice and the April 1985 amendment to the membership requirements which requires member firms to report litigation involving selected non-SEC entities.

For each reported case, a task force is assigned to evaluate the allegations in the light of the relevant financial statements, other public documents, and the requirements of professional standards. In addition to reading all pertinent documents, task forces apply other procedures developed by the Committee. During fiscal 1986, those procedures included 53 discussions with representatives of the firms reporting cases and 6 meetings with captains of peer review teams of the firms in question to review peer review working papers and/or to discuss peer review findings as they

related to issues in the case in litigation.

Generally the above-described initial investigatory procedures are completed within a 120-day period. If the Committee decides that relevant additional information may be forthcoming, the case is placed in a monitoring status.

Cases Closed

A file is closed with respect to the reporting firm 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.

The Committee closed its files on 44 cases during the year ended June 30, 1986. In seven cases, the file was closed because the allegations misstated the requirements of professional standards. In 28 instances, the task force's investigation led to the conclusion that the firm's quality control policies and procedures were appropriate and recommended that the SIC close its file on the case. The remaining nine cases were closed after the SIC had ascertained that (a) the firm's quality control policies and procedures were appropriate or (b) the firm took or was committed to take appropriate corrective action to strengthen its quality control policies in areas relevant to the issues in the complaint. The corrective actions in

some cases resulted from findings of the firm's internal investigation and in other cases resulted from special reviews performed at the request of the SIC.

Corrective Actions by Firms

As noted in our last report, special reviews of two firms were in process at June 30, 1985. During the current year, the Committee evaluated the results of those reviews, satisfied itself that the corrective action taken or planned by each firm was appropriate in view of the deficiencies noted in the course of the special review, and closed the files on these two cases. In one case, the Committee has completed monitoring the firm's implementation of its action plan. In the other case, the Committee will monitor the implementation of the firm's action plan by, among other things, reviewing the results of the firm's 1986 peer review.

Corrective actions taken by member firms during 1985-86, either on their individual initiative or at the suggestion of an SIC task force, included:

- Reassignment of certain firm personnel and responsibilities.
- Development and presentation of, or participation in, specified continuing professional education programs.
- Closer supervision of work performed by specified individuals.
- Development of internal guidance materials for audits of clients in specialized industries.

In addition, the SIC referred six cases to the AICPA Professional Ethics Division with a recommenda-

TABLE 2 Special Investigations Committee Activity During the Year Ended June 30, 1986.

	Number of Cases		
	In Initial Investigative Procedures	In Monitoring	In Special Review
Status of cases at July 1, 1985	21	10	2
Activity during year:			
New cases added	44		
Cases transferred to monitoring	(3)	3	
Cases closed	(33)	(9)	(2)
Status of cases at June 30, 1986	<u>29</u>	<u>4</u>	<u>0</u>

tion for investigation into the specific cases.*

A summary of the Committee's activities during the year is shown in Table 2.

Reconsideration of Professional Standards

In addition to assessing the allegations in each case in terms of possible deficiencies in the reporting firm's quality control system or compliance therewith, the Committee considers whether cases, either individually or in the aggregate, indicate a deficiency in professional standards or a need for issuance of additional guidance.

Several cases during the past year 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

*The Ethics Division does not investigate a case until after litigation has been concluded.

auditor intends to issue an unqualified opinion on financial statements that contain material revisions to those opined on by the predecessor auditor.

- The Committee requested the Accounting Standards Executive Committee to review professional literature concerning accounting treatment of related party transactions and reinsurance transactions.

- Three reported cases, concerning the accounting treatment of acquisition, development, and construction arrangements by savings and loan associations, were discussed with the AICPA Savings and Loan Association Committee. That committee issued a Notice to Practitioners in the February 10, 1986 issue of *The CPA Letter* that provided guidance on how selected aspects of such transactions should be evaluated in deciding on the proper accounting treatment.

Executive Committee Activities

In 1985-86, the Executive Committee took several actions that were responsive to recent changes in the environment in which public accounting firms practice and to concerns expressed by persons both within and outside the profession.

The Committee strengthened the membership requirement regarding preissuance review by a second partner—in addition to review by the engagement partner—of audits of companies subject to the jurisdiction of the SEC or other specified regulatory agencies. The requirement was revised to mandate that the preissuance review partner

review selected workpapers as well as the audit report and financial statements on such audits.

In its 1984-85 report, the Board noted an increase in the tendency of managements of some business enterprises, more concerned with attaining a predetermined financial reporting objective than fairness of presentation, to "shop for an auditor" who would not object to an accounting treatment that would achieve management's desired financial reporting result. The Board asked the profession to "snuff out this insidious practice." Accordingly and in response to concerns expressed by some leaders of the profession about the appropriate balance between commercialism and professionalism, the Executive Committee amended the membership requirements to require each firm to:

- Establish policies and procedures concerning the expression of an opinion to nonaudit clients on the application of generally accepted accounting principles, including procedures that must be followed in internal consultation and in communicating with a predecessor or continuing auditor. Such procedures are subjected to peer review.

- Communicate through a written statement to all its professional personnel the broad principles that influence the firm's quality control and operating policies. Such "statement of philosophy" must address, at a minimum, matters related to the recommendation and approval of accounting principles, client relationships, and the types of services provided.

In another action, taken in concert with the Private Companies Practice Section, the Committee, recognizing the problems experienced by member firms in obtaining liability insurance coverage, suspended the then-existing insurance requirement, but strongly encouraged member firms to maintain adequate insurance coverage, if available.

The Committee adopted the Board's suggestion to revise a segment of the report that member firms are required to file annually. The number of SEC audit clients for whom no management advisory services engagements were performed during the preceding twelve months is to be reported separately. This change will make future analyses of MAS data (see Table 1) more useful and less subject to misinterpretation.

The corrective actions deemed necessary, by either the Peer Review Committee or the Special Investigations Committee, to improve a firm's quality of practice have been undertaken voluntarily by member firms, with but one exception. In 1985-86, one firm refused to take prescribed corrective actions, and the Peer Review Committee, after an appropriate hearing, recommended that the Executive Committee sanction the firm. The Committee expelled the member firm for not cooperating with the Peer Review Committee and not making changes in its quality control system deemed essential by the Peer Review Committee. However, since the firm did not audit any SEC registrants at the time, the Executive Committee decided not to publish the name of

the firm. The Board took exception to this latter decision and communicated its view in writing to the Committee. The Executive Committee of the Private Companies Practice Section, after conducting its own hearings, also expelled the firm and publicized the fact. The actions of both committees are reported in the public files. The Board has observed that the relevant state board of accountancy took note of this matter.

Membership Statistics

One thousand five hundred seventy-four firms are members of the Division for CPA firms: 383 belong to both the SEC Practice Section and the Private Companies Practice Section, 8 belong only to the SEC Practice Section, and 1,183 belong only to the Private Companies Practice Section.

Membership in the Division began increasing shortly after it initiated a public relations program that is described below. After adjustment for mergers between member firms, the number of firms with membership in the SEC Practice Section decreased by four, and the number of firms with membership in only the Private Companies Practice Section increased by 60 during the twelve months ended June 30, 1986. It should be noted, however, that membership in the Division of firms with one or more SEC clients increased from 288 to 300 during the year. Details are shown in Tables 3 and 4.

The fact that 178 firms withdrew—or had their membership terminated for noncompliance with membership requirements—continues to be a matter of concern.

TABLE 3 Analysis of Membership in the Division for CPA Firms by Number of SEC Clients and by Section—July 1, 1985 to June 30, 1986

Number of Firms	July 1, 1985	Mergers* July 1, 1985 to June 30, 1986	July 1, 1985 Restated	New Members	Net Intra-Division Changes	Resignations, Terminations and Suspended Memberships	Classification Changes	June 30
Firms with one or more SEC clients								
SECPS-only	5	—	5	1	(1)	(1)	—	4
Both sections	175	5	170	9	3	(7)	(1)	174
PCPS-only	118	5	113	8	(2)	(9)	12	122
Totals	298	10	288	18	—	(17)	11	300
Firms with no SEC clients								
SECPS-only	5	—	5	1	—	(2)	—	4
Both sections	218	3	215	6	2	(15)	1	209
PCPS-only	1,028	18	1,010	209	(2)	(144)	(12)	1,061
Totals	1,251	21	1,230	216	—	(161)	(11)	1,274
All firms								
SECPS-only	10	—	10	2	(1)	(3)	—	8
Both sections	393	8	385	15	5	(22)	—	383
PCPS-only	1,146	23	1,123	217	(4)	(153)	—	1,183
Totals	1,549	31	1,518	234	—	(178)	—	1,574

*All eight firms that were members of both sections merged with other firms that are members of both sections. Of the 23 PCPS-only firms that merged, 16 merged with firms that are members of both sections and 7 merged with other PCPS-only members.

Analysis of records maintained by the Institute reveals that 104 firms that withdrew during the year had undergone one or more peer reviews during their terms of membership. Ninety of these firms (87%) had received an unqualified report on their most recent peer review.

Auditors of Publicly-traded Companies

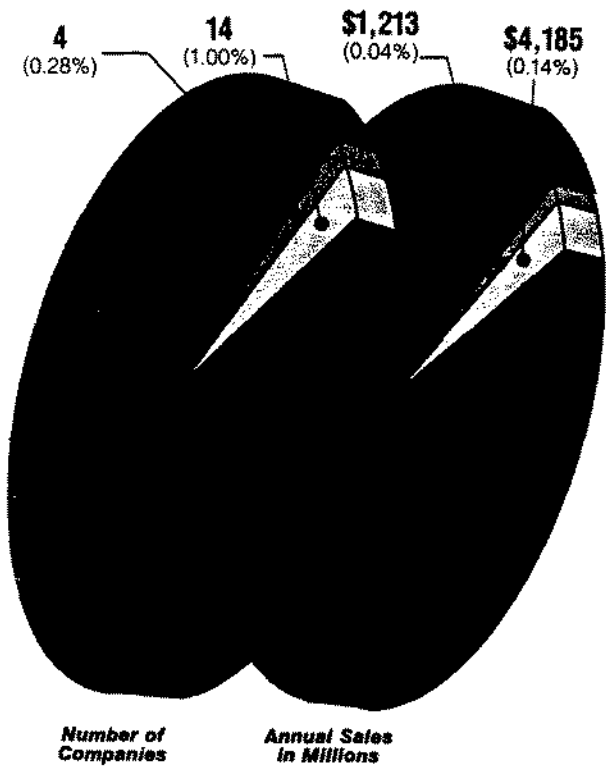
Firms that are members of the Division serve as auditors for the vast majority of companies whose stocks are publicly traded. Member firms audit over 85% of all public companies listed in the fifteenth edition of *Who Audits America*, and

TABLE 4 Analysis of Membership in the Division for CPA Firms—July 1, 1985 to June 30, 1986

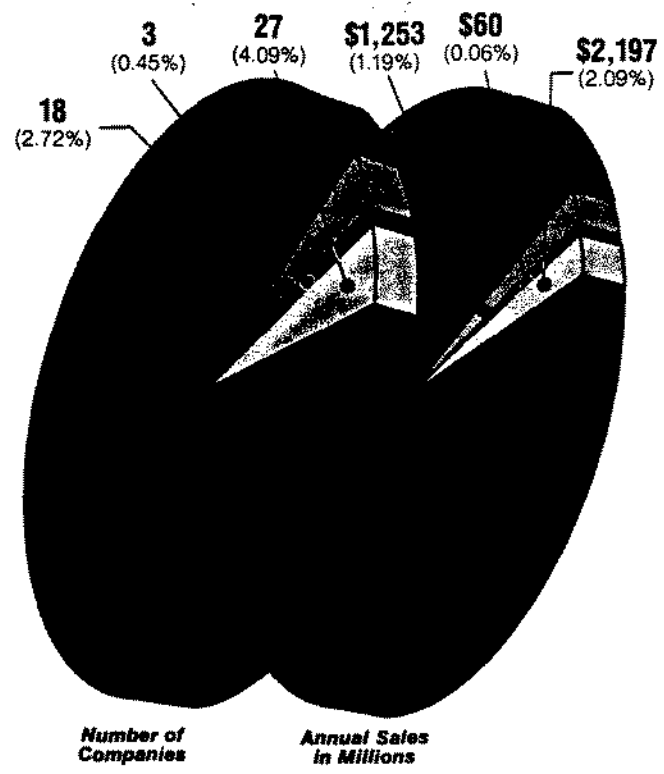
	Division for CPA Firms			SEC Practice Section		
	July 1, 1985	June 30, 1986	Increase (Decrease)	July 1, 1985	June 30, 1986	Increase (Decrease)
No. of firms	1,518*	1,574	56	395*	391	(4)
No. of SEC audit clients	13,070	13,326	256	12,862	13,118	256
No. of practice units	3,639	3,731	92	1,996	2,019	23
No. of professionals	105,154	113,551	8,397	90,044	97,180	7,136

* Restated for mergers between member firms July 1, 1985 to June 30, 1986.

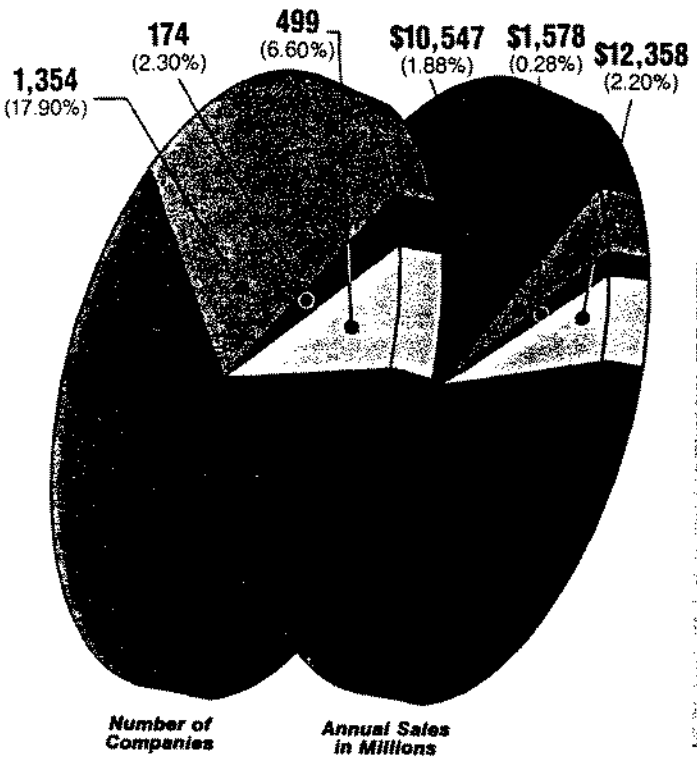
Companies whose stocks are listed on the New York Stock Exchange



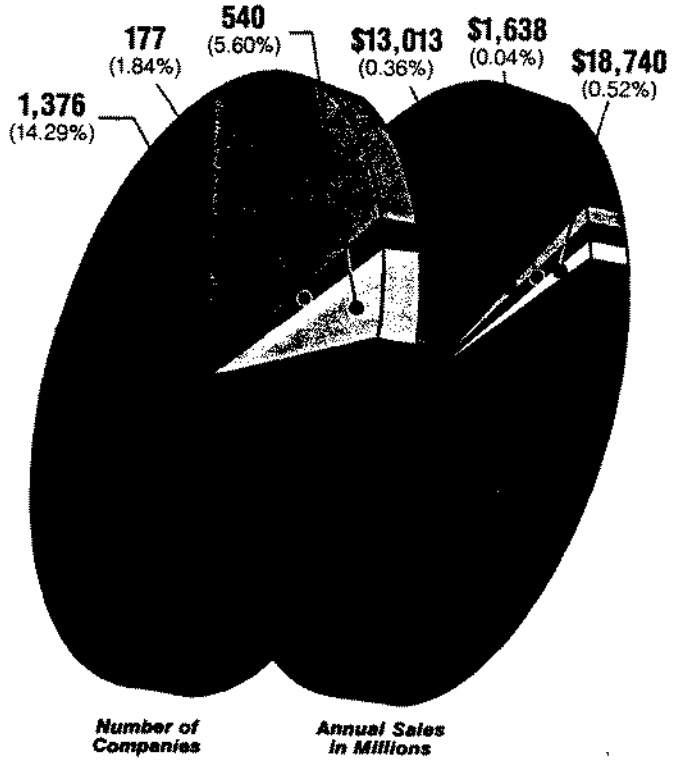
Companies whose stocks are listed on the American Stock Exchange



Companies whose stocks are traded Over-the-Counter



Totals



Companies audited by firms with permanent seats on the SECPS Executive Committee

Companies audited by other SECPS member firms

Companies audited by PCPE-only member firms

Companies audited by U.S. firms that are not members of the Division or whose auditors are not identified

these companies account for over 99% of the aggregate sales volume of all publicly-traded companies. The majority of these companies—78%—are audited by firms that are entitled to a permanent seat on the Executive Committee of the SEC Practice Section.

Members of the Division audit all but four of the companies whose stocks are listed on the New York Stock Exchange, all but 18 of the companies whose stocks are listed on the American Stock Exchange, and over 82% of the companies whose stocks are traded "over the counter." Details are shown in Chart C.

The Division's Public Information Program

Beginning in the early fall of 1985, the Division supplemented its ongoing public information activities with a coordinated advertising program. The Division's advertising was directed at target audiences: attorneys, bank lending officers, and business executives. A total of 33 advertisements appeared from mid-October 1985 through April 1986 in various publications including *American Banker, Inc.*, *Financial Executive*, and the *American Bar Association Journal*. The Division's advertising, which was paid for entirely by its member firms' dues revenue, was designed to alert the financial community to the salutary effects of the peer review process and the beneficial, objective information on Division member firms available to the public.

The results of the Division's public information and advertising programs have been encouraging. From the inception of the advertising

program in October 1985 through June 1986, the Division received 1,845 requests for information about its program or individual member firms. That represented an increase of 875% in the number of such requests received during the comparable period a year earlier. Division membership also appears to have been positively affected by the advertising program. During the year ended June 30, 1986, the Division accepted 234 new member firms, an 81% increase over the previous year. Similarly, withdrawals and terminations decreased 18%, to 178 from 217 in the prior year.

The Division is planning to continue its public information and advertising programs in 1986-87.

In Closing



ARTHUR M. WOOD, Chairman
Charter member of the Board; Chairman of the Board and Chief Executive Officer of Sears, Roebuck and Co., 1973-78

Largely as a consequence of several publicized business failures during the last few years (particularly in the financial services industry) and the number of lawsuits directed at accounting firms, the accounting profession is undergoing perhaps its greatest challenge. However, even without the business failures and alleged audit failures, the profession would face huge challenges. Competitive pressures have caused increased price competition among firms for audit work, a circumstance that causes some to express concern about the quality of audit services. A number of circumstances have caused firms to expand the scope of their nonattest work, giving rise to expressions of concern about the effect on independence. The explosion in the variety of financial instruments, the increasing complexity of business transactions, and the relentless advance of computer and telecommunications technology have placed enormous burdens on traditional audit methods, training techniques, auditing standards, and accounting principles.

As a predictable consequence of all this, the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce under the spirited chairmanship of Representative John D. Dingell has during the last year and a half held extensive hearings concerning the accounting profession. These hearings have been illuminating and should assist the accounting profession in charting a course of action to deal with present challenges.

One tangible consequence of those hearings has been H.R. 5439 introduced in August 1986 by Representative Ron Wyden and co-sponsored by 18 other members of the House, including John D. Dingell, Chairman of the House Committee on Energy and Commerce. This bill substantially revises, in response to the many concerns expressed by the profession and the SEC, a legislative initiative proposed by Representative Wyden in May 1986.

The revised bill would require auditors of the financial statements of SEC filing clients to develop and implement procedures that would "reasonably ensure" the detection of material illegal or irregular activity by officers, directors, employees, agents of and others associated with the audited entity and to report such findings to an appropriate level within the organization. The auditor would then, if the audited entity fails to report such matter to the appropriate enforcement and regulatory authorities, be required to so report. In addition, auditors would have to evaluate the entity's internal administrative and accounting controls and the entity's own evaluation and reporting on such controls, including its findings and its implementation of corrective actions, and report on these matters to the public.

While this bill is a significant improvement over the earlier one, the Board continues to believe further legislative action should await the outcome of initiatives undertaken by the profession which should in significant measure achieve the objectives of Representative Wyden's proposal. A brief review of

those initiatives makes this clear.

The National Commission on Fraudulent Financial Reporting, organized in 1985 by the AICPA and several other organizations, is conducting an extensive study of the pathology of fraudulent financial reporting and the means which might be utilized to reduce its incidence. Members of the Board have met twice with this Commission and we have been deeply impressed by the competence of its members and staff, the methods they are employing in investigating the nature and causes of fraudulent financial reporting, the earnestness with which they are pursuing this endeavor, and the indications which have been given both privately and publicly concerning the directions in which their thinking is proceeding. Clearly the work of this Commission is directed toward solving some of the problems which are addressed in H.R. 5439.

The AICPA has recently published *Restructuring Professional Standards to Achieve Professional Excellence in a Changing Environment*, the report of its Special Committee on Standards of Professional Conduct for Certified Public Accountants. There is much in this report which is designed to encourage the highest professionalism among certified public accountants. The Board is particularly pleased that the Special Committee has recommended that persons in public practice who wish to be members of the AICPA must be with a firm that subjects its quality control system for accounting and auditing engagements to periodic independent review and, further, if the firm audits

one or more SEC filing clients, the firm must become a member of the SEC Practice Section.

The Auditing Standards Board of the AICPA is currently reconsidering existing standards in a number of areas, including the scope of the auditor's review of internal controls and the reporting thereof to the audit committee. We are hopeful that as a consequence greater emphasis will be placed on internal controls.

Recently, seven of the largest accounting firms in the country published a paper containing recommendations to the AICPA Board of Directors entitled *The Future Relevance, Reliability, and Credibility of Financial Information*. These firms recommended that financial statements of public companies be required to contain audited disclosures of risks and uncertainties as well as an audited and enhanced



A. A. SOMMER, JR., Vice Chairman

Joined Board in 1982; SEC Commissioner, 1973-76; Partner in Washington, DC law firm of Morgan, Lewis & Bockius specializing in securities law

management discussion and analysis. Further, they recommend that such disclosure requirements be extended to a broader entity base. These matters are under active consideration by a special AICPA task force on risks and uncertainties. The firms also suggest that the SEC mandate that firms which audit SEC registrants be members of "a professional organization that has a peer review program and an independent oversight function."

Another large accounting firm has published a study, *Challenge and Opportunity for the Accounting Profession: Strengthening the Public's Confidence*, in which it recommends that:

"The accounting profession should affirmatively acknowledge that the auditor has the responsibility to search for management fraud that is material to the financial statements through the application of professional audit-

ing standards designed to reduce the risk that such fraud will go undetected."

We believe this is a sound suggestion, one that the accounting profession should seriously consider. We urge the Auditing Standards Board, which is presently reconsidering existing professional standards concerning errors and irregularities and illegal acts by clients, to expand its agenda to the extent necessary to examine the proposal made by this firm.

Another proposal of the firm, one that we do not support, is that the present peer review program be replaced by a statutorily established one. This proposal is strange, since the firm acknowledges that "... the AICPA program [of peer review and self-regulation] is far too valuable an investment of the profession's resources to be abandoned" and suggests that the proposed statutorily established system "should combine much of the profession's current system of quality control standards and compliance review with a formal structure—as opposed to the present informal arrangement—for government oversight." In short, the principal change would appear to be the formalization of the present relationship between the SEC and the peer review program. That relationship is already sturdy enough to have permitted the Commission to say in its most recent Annual Report to Congress that:

"The Commission oversees the activities of the SECPS through frequent contact with the Public Oversight Board (POB) and members of the executive and peer

MELVIN R. LAIRD

Joined Board in 1984; Representative in U.S. Congress from Wisconsin, 1953-68; Secretary of Defense, 1969-73; Senior Counselor for National and International Affairs for Reader's Digest Association



review committees of the SECPS. In addition, the staff reviews POB files and selected working papers of the peer reviewers. The Commission believes the peer review process contributes significantly to improving quality controls of members and thus should enhance the consistency and quality of practice before the Commission." (Emphasis added)

We believe that there is ample evidence that the present system is working well. The goal of having all firms that practice before the SEC subjected to peer review is one with which we agree; however, changes presently under consideration, such as mandating membership through either AICPA or SEC action for firms with SEC filing clients, are preferable means of achieving that goal. There is no reason to expect that a statutorily based self-regulatory organization would enhance the effectiveness or the credibility of the system; as a matter of fact, the proposed inclusion of practicing members of the profession on the governing board—in contrast to the POB, none of whose members is engaged in the practice of accounting—might well forfeit the confidence which a board completely independent of the profession enjoys.

The foregoing activity shows that responsible members of the profession are seeking means of accomplishing major objectives that are important to the public—more effective audits, procedures better capable of detecting fraud, and strengthened internal controls. Thus, we strongly urge that, *one*, the pro-



ROBERT K. MAUTZ
Joined Board in 1981; Professor Emeritus of the University of Illinois and the University of Michigan

fession hasten to implement the worthy recommendations of its various committees and firms and that the bodies of the AICPA take action as quickly as possible to deal with the legitimate concerns that individuals both in and outside of Congress have with regard to the credibility of financial reporting by American business, and that, *two*, Congress refrain from adopting any legislation further regulating the profession until it evaluates the nature and effectiveness of the profession's responses to the challenges it now confronts.

Much has been accomplished since the last time Congress put the spotlight on the accounting profession in 1977. Those accomplishments give assurance that the profession can and does deal effectively with problems as they emerge without the need for further legislatively mandated duties and governance. A brief summary of some of the major changes in the self-regulatory program provides convincing evidence that the profession and the Board have indeed taken effective action to cope with each new problem that arose:

Public Oversight Board

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