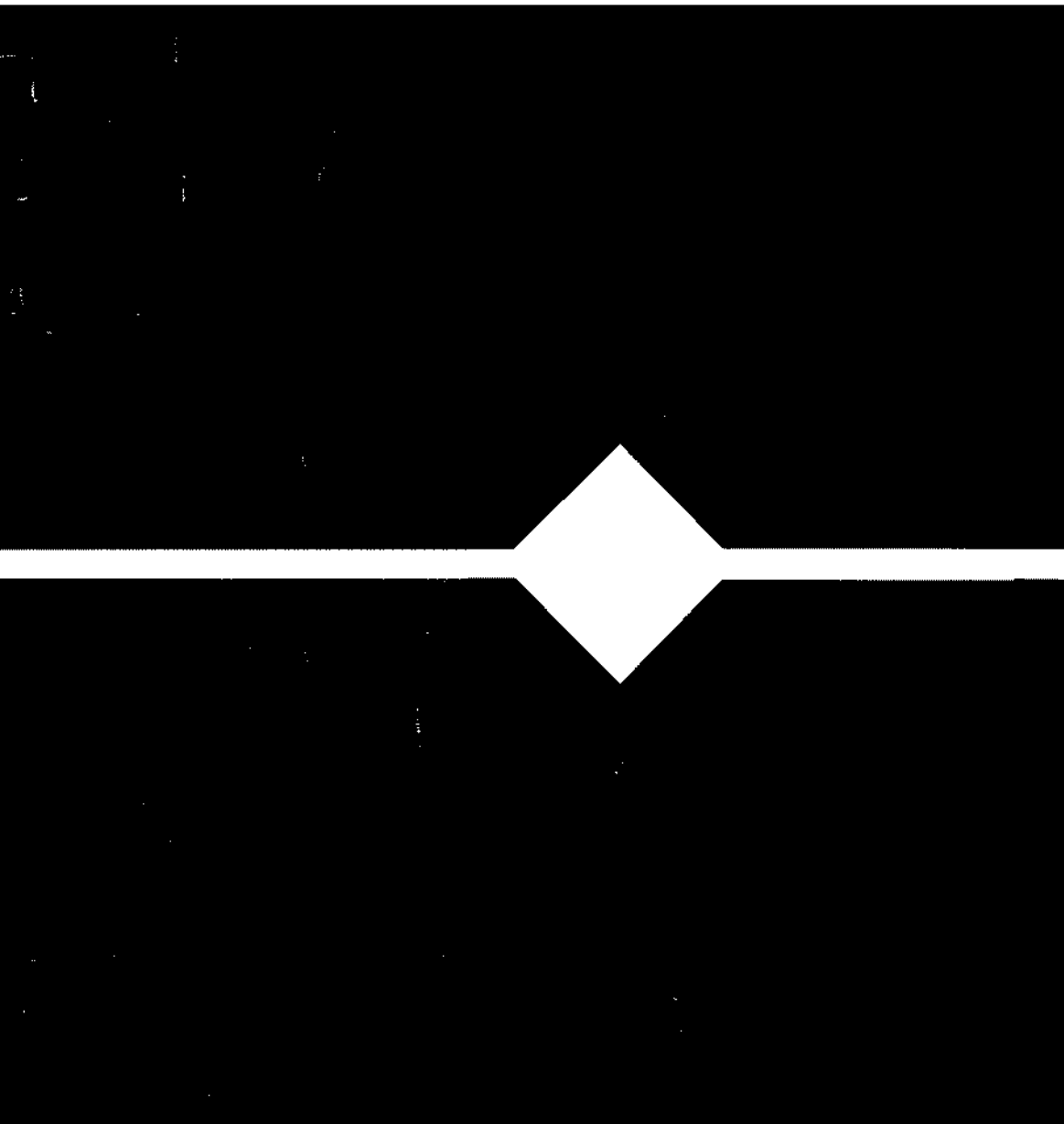


**Public  
Oversight  
Board**



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## **PUBLIC OVERSIGHT BOARD**

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

**ROBERT K. MAUTZ**, *Vice Chairman*

**ROBERT F. FROEHLKE**

**MELVIN R. LAIRD**

**PAUL W. McCracken**

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**RICHARD A. STARK**, *Legal Counsel to the Board*

### *Staff*

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*Executive Director and Secretary*

**CHARLES J. EVERS**  
*Technical Director*

**JOHN E. CULLEN**  
*Assistant Technical Director*

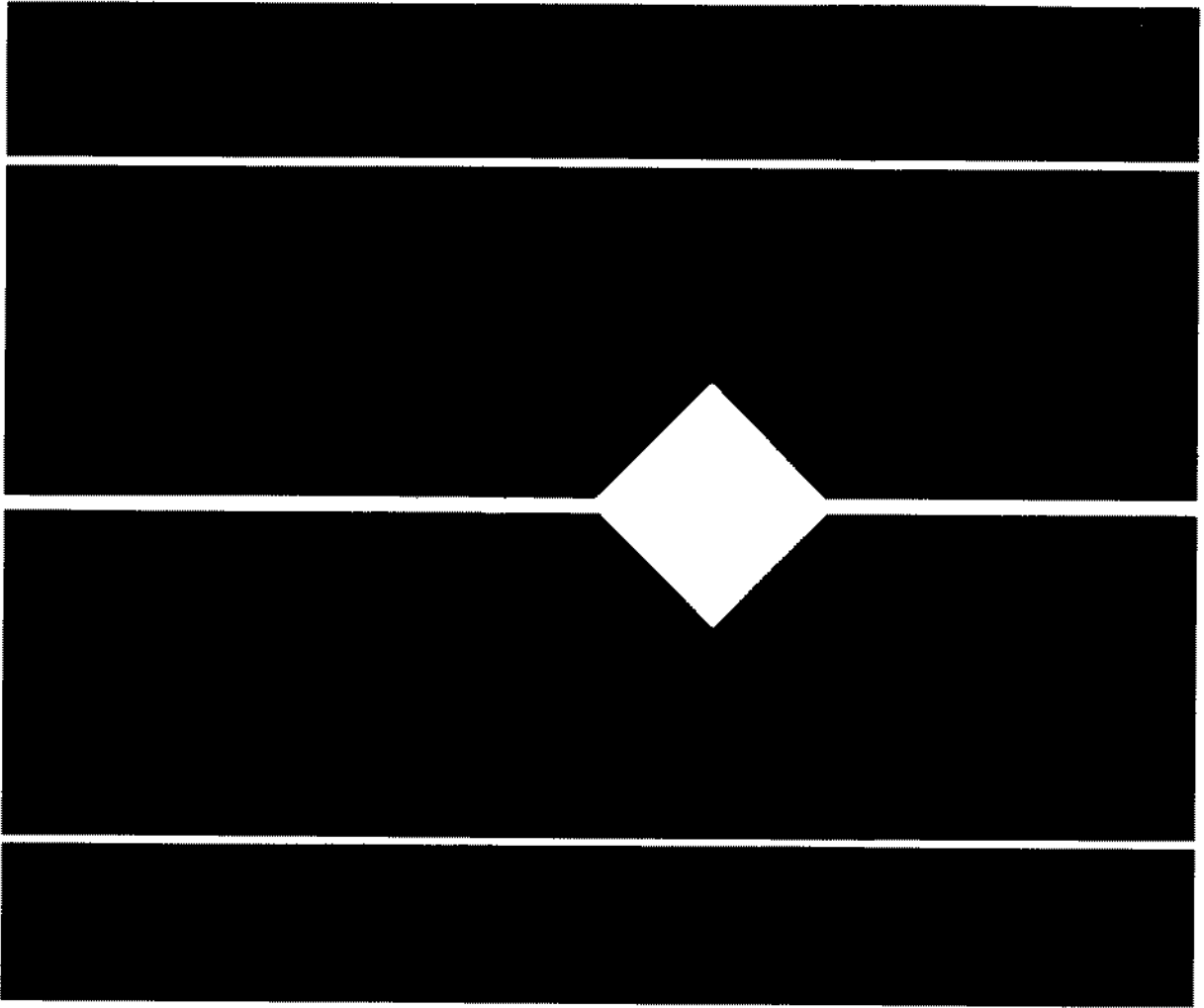
**ALAN H. FELDMAN**  
*Assistant Technical Director*

### *Office*

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**540 Madison Avenue**  
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**(212) 486-2448**

Public Oversight Board



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## FOREWORD

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**I**t is a pleasure to present this tenth annual report of the Public Oversight Board. The year just ended has been a good one both for the SEC Practice Section and the Board. The Board last December spent considerable time reviewing the first ten years of the Section's self-regulatory program and the Board's oversight of it. It concluded that the program is functioning quite well and that it has demonstrably raised the quality of auditing practice among its members.

However, the Board concluded that measures should be taken to strengthen the program and the functioning and role of the Board; these measures are detailed later in this report. Briefly, they principally entail greater hands-on oversight by Board members and more exposure of the program through public appearances, both within the profession and outside, articles and other measures to enhance visibility.

The Board has observed with satisfaction the increasing success of the program. This is directly attributable to the dedication of the pioneers who designed the program and those who have contributed generously of their time to implement it by serving on committees in an exemplary fashion.

To honor those who have made singular and outstanding contributions to the success of this program and other efforts that have improved the quality of audit practice, the Board has instituted an award, named after one of those pioneers of this effort, the first chairman of the Public Oversight Board, the distinguished public servant John J. McCloy, to be given annually to one or more of that number. The first such award will be made before year end.

Speaking more generally, the Board commends the profession for the significant strides made during the past year in strengthening the accounting profession and its practices. The membership of the AICPA overwhelmingly approved the recommendations of the Special Committee on Standards of Professional Conduct for Certified Public Accountants (the Anderson Committee). These recommendations, which will bring about a restructuring of the profession's code of ethics, an upgrading of its minimum educational requirements, and a mandatory program to monitor the quality of professional performance for all AICPA members, assure that the profession will be equipped to meet the challenges of the remainder of this century and the beginning of the next.

Similarly, the nine so-called "expectation gap" standards promulgated by the Auditing Standards Board indeed do go far to close the gap between the public understanding of the role of auditors and auditing and the profession's perception of its responsibilities. These will enhance the likelihood that auditors will uncover frauds, strengthen the increasingly important relationship between auditors and the audit committees of their clients, and assure further that client internal controls are adequate.

We congratulate all those who have contributed to these achievements.

There are, however, clouds on the horizon that trouble the Board.

The Board strongly believes that the current structure of the self-regulatory program of the accounting profession has been a singular success. This effort has included the establishment of accounting principles by a privately organized and privately funded body, the Financial Accounting Standards Board. Because of its strong belief in self-regulation of the profession, the POB is concerned about the rising hostility in some quarters toward the FASB because of some controversial statements it has issued.

The FASB was born in an atmosphere described in the Report of the Study on Establishing of Accounting Principles (its recommendations resulted in the organization of the FASB) as one "marked by contention approaching rancor among those outside the government who are involved in the financial reporting process." That atmosphere is again with us.

At the banquet which marked the organization of the FASB, Reginald Jones, then chairman and chief executive officer of General Electric Corp., urged his colleagues in industry to support the Board and its work, and warned that the test of their support would come when the Board moved into controversial areas and highly revered oxen began to be gored. The undersigned in 1974 while a Commissioner of the Securities and Exchange Commission said,

*“...it is imperative that everyone recognize the authority of the Board and accord its determinations preeminent status. In a field that has been characterized by considerable latitude in the treatment of accounting principles it may be difficult for many to accept the primacy of Board pronouncements. To them I would ask whether they wish to contribute to the failure of the Board and all that would follow from that.”*

Establishing accounting standards and principles for financial reporting is inevitably a complex process. Issues will arise about which reasonable people will disagree. Obviously, the process must take into account the views of all interested groups — professional accountants, financial officers in industry, academic scholars, and others.

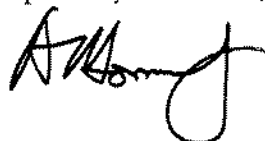
There is, however, no more reason now than there was in 1972 when the Study on Establishment of Accounting Principles considered the alternatives to believe that the quality of standard setting would be better or more efficient if it were done by the SEC or another governmental body, and there is no reason to believe that another privately organized body, if it did its job properly, would be any less subject to controversy than the present body. We urge continued support for the FASB and a renewed effort on the part of all concerned with its work to strengthen this important institution.

Another matter which has engaged the attention of the Board almost since the beginning of its existence has been the relationship between auditing and consulting practices conducted by members within the same firm and sometimes for the same client.

Recent publicity has suggested growing tensions between those engaged in auditing practice and consulting practice of some firms. The Board, of course, is in no position to assess the sources of these tensions or the merits of the assertions by interested persons. However, the Board urges member firms to make clear that, notwithstanding the growth of consulting practices, they are first and foremost auditing firms, committed to the standards of the accounting profession and the auditing process, and that no amount of internal discord will dilute the primacy of the audit portion of their practice. A failure to do so can only result in heightening the perception problem described in the Board sponsored study, the results of which were published in November 1986, *Key Publics' Perceptions of the Management Advisory Services Issues*.

The Board looks forward to its continuing oversight of the SEC Practice Section's worthy and proven worthwhile program and is planning and acting to assure the continued and enhanced effectiveness of it.

Respectfully submitted,



A. A. Sommer, Jr.  
Chairman, Public Oversight Board

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## **REPORT OF THE PUBLIC OVERSIGHT BOARD**

We are pleased to report that during the year ended June 30, 1988, the Public Oversight Board implemented its mandate, as enumerated in the Organizational Structure and Functions Document of the SEC Practice Section of the Division for CPA Firms of the American Institute of Certified Public Accountants, by conducting a comprehensive program of oversight of the activities of the Section.

In carrying out our assigned responsibilities to represent the public interest in the SEC Practice Section's self-regulatory program, members of our staff, usually accompanied by one or more Board members, have attended and, as appropriate, participated in all meetings of the Executive, Planning, Peer Review, and Special Investigations Committees of the Section.

We have reviewed the standards for performing and reporting on peer reviews, as revised, and the materials developed to train those who conduct reviews, and have tested compliance with those standards through application of our visitation, workpaper, and report review programs.

We have reviewed the operation of the Special Investigations Committee to ascertain whether its activities are conducted with the public interest as its primary purpose. We followed the Committee's inquiries into all cases reported by member firms, including attendance at a majority of its task force meetings with firms reporting litigation at which inquiry was made concerning the quality control implications of cases.

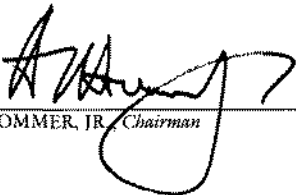
We have monitored the follow-up actions taken by the Peer Review and Special Investigations Committees to assure that member firms take the required corrective actions to eliminate quality control deficiencies.

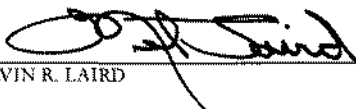
We have monitored and evaluated the activities of the Section's Executive Committee and the Planning Subcommittee thereof, including but not limited to the propriety of policies and procedures for Section activities, the adequacy of membership requirements, and the appointments of persons to the Section's committees and task forces.

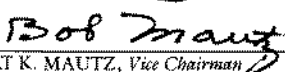
In our opinion, the programs of the SEC Practice Section are suitably comprehensive and operating in a manner that reasonably assures a high quality of accounting and auditing practice of its member firms. Nevertheless, as commented on in the discussion section that follows, we have noted areas in which the Section's programs can be improved or operated more effectively. Consistent with our charge, such matters have been communicated to officials of the Section.

June 30, 1988

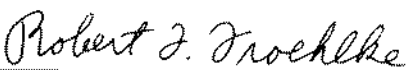
### **THE PUBLIC OVERSIGHT BOARD**

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

  
MELVIN R. LAIRD

  
ROBERT K. MAUTZ, *Vice Chairman*

  
PAUL W. McCRACKEN

  
ROBERT F. FROEHLKE

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## DISCUSSION OF BOARD ACTIVITIES

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*July 1, 1987 to June 30, 1988*

**R**eaders of past reports of the Board will notice a different format this year. In prior reports, the Board reported extensively on the activities of the SEC Practice Section as well as on its oversight activities.

At our suggestion, this year the Section itself is reporting publicly for the first time on its operations and the results of its peer review, special investigative, and other activities. Thus, this tenth annual report of the Board is to be read in conjunction with the Section's first annual report.

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### **Role of the Board**

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The Board monitors and evaluates the activities of the SEC Practice Section and makes recommendations for improving the operation of the Section and the effectiveness of its programs. The Board is independent of the AICPA and the Section and consists of five individuals representing a broad spectrum of business and professional experience. The Board appoints its own members and chairman and establishes its own compensation and operating procedures.

The primary responsibility of the Board is to assure that the public interest is not neglected when the Section sets standards, membership requirements, rules, and procedures. The Board, assisted by its legal counsel, a staff of four CPAs, and two administrative assistants, discharges its responsibilities through application of extensive oversight

procedures to all phases of the Section's activities.

### ■ **Reassessment of the Program.**

In this the tenth year of its existence, the Board took the opportunity to step back and assess, at a two-day "retreat," not only the Board's role and operation, but also the entire process which it oversees.

In preparation for that meeting, the Board solicited comments from both critics and proponents of the program. Commentators were encouraged to interpret the solicitation broadly, to forward suggestions that would benefit the program's peer review and special investigative processes as well as the work of the Board. Comments were received from over 100 persons; copies of the respondents' letters were distributed to Board members, discussed at the "retreat," and considered in deciding future courses of action.

Of the many suggestions offered regarding the operations of the Section, the Board endorsed those it considered to be in the public interest, implemented those that pertained to its own operations, and forwarded several recommendations to the Section for its consideration and possible adoption. These are commented on in appropriate sections of this report.

While some commentators suggested that the Board seek line authority, the vast majority concurred that the granting of line authority to the Board would be counter to the concept of self-regulation. The Board reaffirmed its belief that its



appropriate role is one of oversight and that line authority would diminish rather than enhance its effectiveness.

■ **Scope of Board Oversight.** The Board also considered suggestions that it extend its oversight to other of the accounting profession's self-regulatory programs. The Board concluded that formal oversight responsibility over such other programs was outside its purview but that, in its concern for the public interest, the Board should more intensively monitor those programs that affect the quality of independent auditing.

Accordingly, the Board intends to review and comment on proposed revisions to professional standards when, in its judgment, to do so would be in the public interest. Such activity will not be entirely new to the Board. In the past, the Board has commented on such matters as the exposure draft of the National Commission on Fraudulent Financial Reporting and the SEC's proposal for mandatory peer review.

In addition, the Board will continue to meet periodically with representatives of the profession's standard-setting bodies to discuss matters of mutual concern. It has directed its staff to monitor, analyze, and report to the Board on proposed standards. The Board has also asked its staff to report major developments in the operations of state boards of accountancy, whose positive enforcement programs have objectives similar to those of the Section.

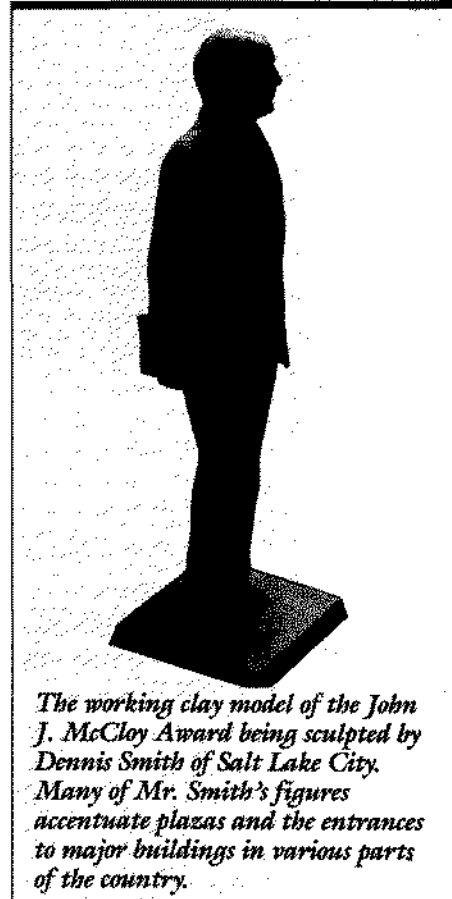
■ **Visibility of the Board.** The Board is sensitive to the repeated criticism that the Board and the Section are virtually unknown to the public and not sufficiently well-known even within the accounting profession. In response, the Board adopted a wide-ranging program to increase its visibility.

The accompanying chart on page 18 summarizes the personal involvement of Board members in overseeing the activities of the program.

### ■ **The John J. McCloy Award**

**Program.** The Board has initiated a program to honor those who have made significant contributions to strengthening audit quality control and effectiveness in the United States. The Board believes that persons who contribute significantly to that process deserve recognition.

The award is named in honor of John J. McCloy, the first chairman of the POB, who has had a long and distinguished record of public service. The Board intends to make the first award in 1988.



*The working clay model of the John J. McCloy Award being sculpted by Dennis Smith of Salt Lake City. Many of Mr. Smith's figures accentuate plazas and the entrances to major buildings in various parts of the country.*

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### **Oversight of the Peer Review Process**

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Because the Board believes the peer review process is the foundation for the Section's self-regulatory program, it monitors that process closely. The Board and its staff closely monitor not only the performance of the Peer Review Committee in setting standards and processing reports but also the performance of independent peer review teams as they comprehensively review the appropriateness of the quality control systems of member firms and compliance by the

firms' personnel with stated policies and procedures.

■ **Types of Oversight Programs.**

The Board's oversight of the peer review process involves staff review of every peer review performed by the Section, pursuant to one of the POB's three oversight programs. These programs, which are designed to evaluate whether review teams understood and complied with peer review performance and reporting standards in completing their reviews, are as follows:

- Visitation and workpaper review program—This involves observation of the performance of field work, attendance at the exit conference during which the review team reports its findings and recommendations to management of the reviewed firm, and review of the review team's workpapers and reports and the reviewed firm's response.
- Workpaper review program—This consists of the review of the review team's workpapers and reports and the firm's response.
- Report review program—This entails review of selected portions of the review team's workpapers, its reports, and the firm's response.

Since it is unnecessary and not cost beneficial to subject every peer review to intensive oversight, the Board determines which oversight program to apply to each review based upon certain attributes of the firms to be reviewed and the review teams:

- Attributes of the firm to be reviewed:*
  - Number of SEC registrants audited.
  - Size of firm.
  - Type of report issued on the firm's prior review.
  - Number of times peer reviewed.
  - Type of POB oversight program applied to prior review.
- Attributes of the review team:*
  - Performance on prior reviews.

- Experience of review team in relation to the nature, size, and complexity of the practice of the reviewed firm.

Some reviews, such as those of firms that audit five or more SEC registrants, are automatically subjected to visitation and workpaper review oversight. The type of oversight program assigned to other reviews is on a stratified, random basis. Application of this assignment process resulted in the following:

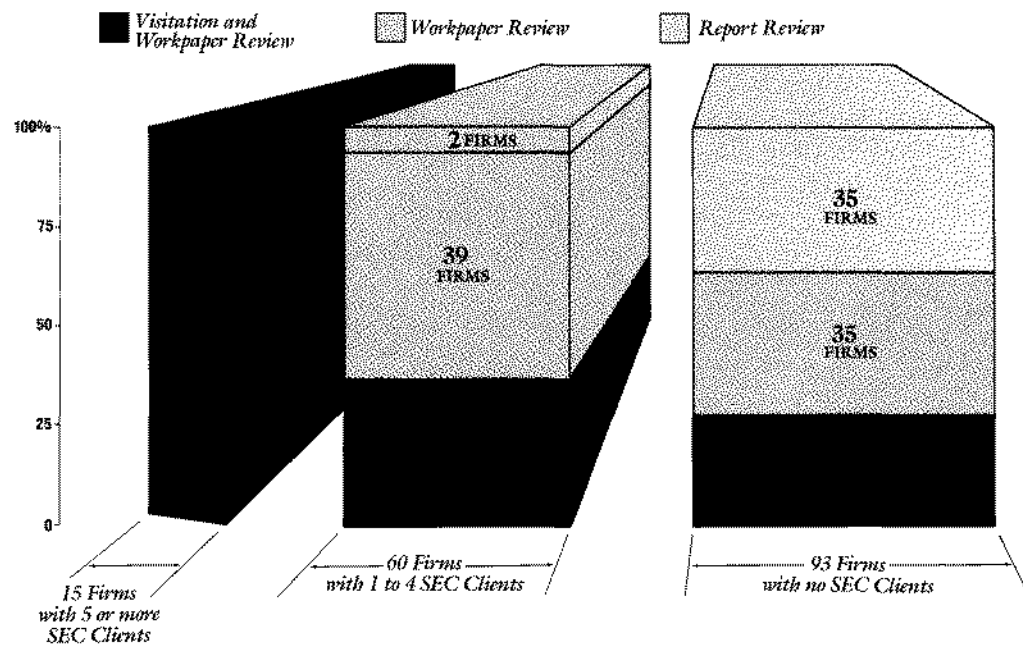
<i>Type of POB Oversight Program</i>	<i>Percent of SECPS Firms Reviewed in 1987</i>
Visitation and Workpaper Review Program . . . . .	34%
Workpaper Review Program . . . . .	44%
Report Review Program . . . . .	22%

Additional details are shown in the chart on page 9.

The review of a multi-office firm, pursuant to the visitation-observation workpaper review program, requires POB staff to observe the performance of the review team at one or more of the reviewed firm's operating offices, to attend exit conferences held in conjunction therewith, and to attend the final conference at which the overall review findings are reported to top management. As a result, during the 1987 review year, POB staff members, at times accompanied by a Board member, attended 75 operating office and final exit conferences held in conjunction with the reviews of 57 firms.

■ **Evaluation of Individual Peer Review Reports.** One or more Board members attended five of the six meetings of the Peer Review Committee; staff members of the Board attended all such meetings. The Peer Review Committee evaluates each report to determine whether the review team appropriately applied peer review standards. Each evaluation is based in part on the review, conducted by the Committee's staff members, of some or all of the review

**Scope of POB Oversight of 1987 Peer Reviews Classified by Number of SEC Registrants Audited by Reviewed Firm**



team's workpapers and reports.

During its deliberations, the Committee is made aware of the findings and conclusions of the POB staff, based on the application of the oversight programs described above. The Board's staff occasionally finds it necessary to question the adequacy of a review team's performance or its application of peer review standards. In virtually all such cases, the Committee arrives at similar conclusions.

Unresolved differences of opinion between the POB staff and a committee of the Section are rare, but when one occurs it receives attention at the next Board meeting. The chairman and other representatives of the relevant committee are invited, at their option, to attend a subsequent meeting of the Board to present the basis for the Committee's judgment.

The infrequency with which such differences in professional judgment occur between Board staff and a committee of the Section suggest that the peer review program is working well. The commitment and dedication of the members

of the Peer Review Committee are in large part responsible for the program's success and the Board's and the SEC's endorsement of the program.

Ultimately, however, the success of the program is dependent on the support of member firms and their commitment to quality service, which in turn depends on the importance that managements of member firms attach to the process. While all firms report results of the peer review to their partners and professional staff, some smaller firms assemble their entire professional and administrative staffs at the exit conference to be informed of the review team's findings and of the firm's plans for corrective action, if applicable. The Board encourages such broad-based reporting.

**■ Monitoring Follow-up Actions of the Peer Review Committee.**

In addition to monitoring the Committee's processing of individual peer review reports, the Board and its staff monitor the Committee's actions in obtaining assurance that a firm implements any corrective measures

deemed necessary, such as revising its quality control system to correct significant design deficiencies or initiating procedures to assure greater compliance by the firm's personnel with the system. In such cases, the Committee, as a condition for accepting the peer review report, will require the firm not only to take specified corrective actions but to provide evidence that the actions have been effectively implemented. In each such case during the year covered by this report, the subject firm agreed to do so.

This type of action is analogous to a "consent agreement" entered into by a firm with the SEC. If a firm does not consent to take the action considered necessary, the Committee would recommend that the Executive Committee initiate formal sanction proceedings against the firm. The Committee is to be commended for its insistence that firms whose systems are found to be in need of significant improvement provide the Committee with evidence that appropriate and effective corrective actions have been implemented.

#### ■ **Timely Processing of Reviews.**

While the majority of peer review reports are processed within reasonable time limits, some reports remain unprocessed for several months after the exit conferences are held. At June 30, 1988, seven reports on 1987 peer reviews were not yet processed; similar conditions existed at June 30 in each of the two preceding years. The majority of these

reports are of reviews of firms whose quality control systems were found to have significant deficiencies. The Board continues to be concerned with such delays because of the considerable length of time that transpires between the time a review team discovers significant deficiencies in the firm's quality control system and the implementation of corrective actions by the firm. The Board again urges the Committee to examine its processing and administrative procedures to effect more expeditious processing of problem reviews.

■ **Peer Review Standards.** The standards for performing and reporting on peer reviews have undergone continuing review and revision during the ten years that the program has been in existence.

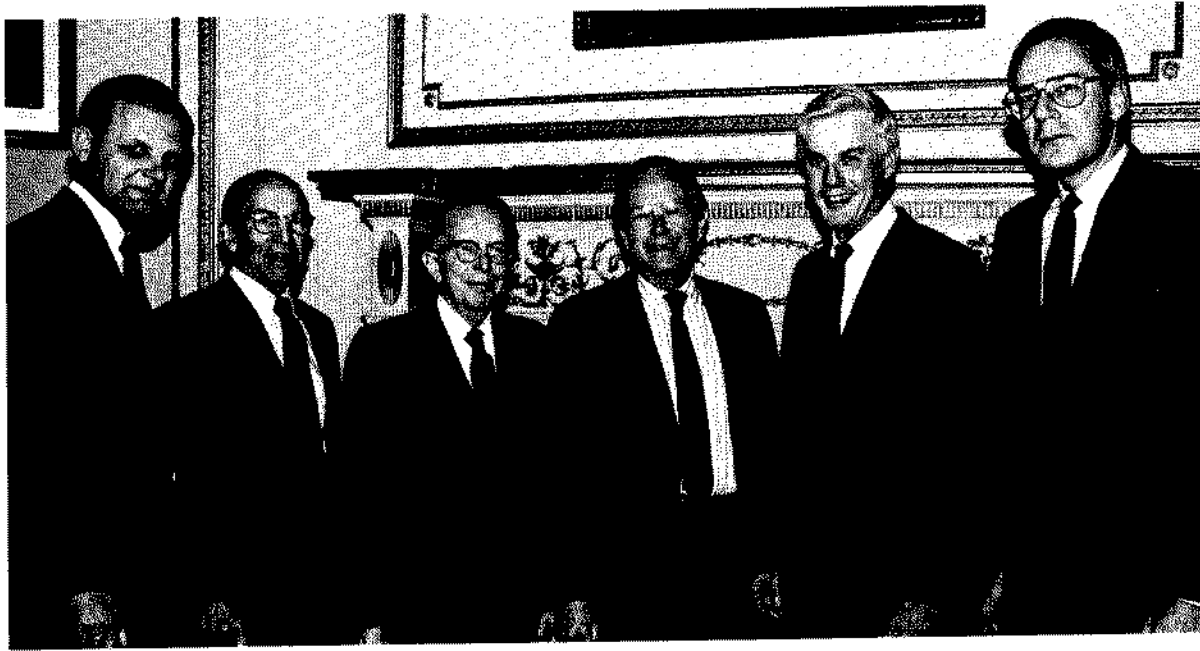
During the course of its "retreat," the Board reviewed the standards and concluded that they were effective and being uniformly and equitably applied by peer review teams and by the Committee. The only recommendation that the Board made during the year with respect to the peer review process was that the Section consider requiring a peer review report or letter of comments to identify an office of a multi-office firm that was found to be in substantial non-compliance with the firm's policies and procedures. The Section has placed the matter on its agenda for consideration.

■ **Improvements in Quality of Practice.** The Board remains convinced of the value of triennial peer review. One hundred and thirty nine of the 168 firms peer reviewed in 1987 had been reviewed at least once before. However, only 128,\* or 92% of such firms, received an unqualified report; 11,\* or 8% of them, did not. Despite the discipline imposed by inspection programs and other quality control monitoring procedures, deterioration in the quality of practice in some firms apparently can go undetected until it is discovered in a peer review. Such may have been the case for nine of eleven firms that received unqualified reports on their immediately preceding reviews but modified reports on

\* These numbers include reports processed by the Committee and the staff's evaluation of the types of reports that are expected to be accepted on the seven reports not processed at June 30, 1988.

POB Chairman Al Sommer makes a point at luncheon break to Ernst & Whimney Chairman Ray Groves, POB Counsel Dick Stark, and POB Member Paul McCracken.





*The "expectation gap" auditing standards were the primary topic of a meeting of the POB with representatives of the Auditing Standards Board. (Left to right) POB Technical Director Chuck Evers, POB Vice Chairman Bob Mautz, POB Member Paul McCracken, POB Chairman Al Sommer, ASB Chairman Jerry Sullivan, and AICPA Vice President Dan Guy.*

their reviews performed in 1987.

Our staff analyzed the deficiencies reported in the letters of comments accompanying peer review reports issued in 1987 and compared them to those reported in earlier years. The results were generally positive. A number of findings were similar to those noted in the analysis of letters of comments issued on peer reviews performed in 1986. A few new findings warrant attention.

The average number of deficiencies identified per firm was lower in 1987 than the average number identified in this group's prior letters of comments (most of which were issued in 1984). Marked improvements were noted in documentation of consultation and of performance of audit procedures relating to key audit areas. As also noted in the reviews performed in 1986, many of the letters of comments cited deficiencies in applying or documenting application of Statement on Auditing Standards No. 47, "Audit Risk and Materiality in Conducting an Audit."

The fact that peer review teams emphasize compliance with recently promulgated professional standards is salutary, since it directs the attention of member firms to the need for timely implementation of new pronouncements of standard-setting bodies. Such emphasis

is particularly critical at this time because of the significance of the nine standards recently issued by the Auditing Standards Board to help close the so-called expectation gap between what the public expects of auditors and what independent auditors can provide.

Our analysis of letters of comments suggests that two other aspects of quality control warrant attention. Over twenty-five percent of the firms received letters of comments which cited deficiencies in their internal inspections, evidencing that such firms are not obtaining the full benefit to be derived from an effectively implemented inspection program.

In addition, the frequency with which quality control issues relating to independence appeared in 1987 letters is disturbing. Sixteen percent of the firms reviewed in 1987 had such deficiencies, some of which were quite significant. The reports of two firms, for example, were qualified because of independence deficiencies, and there was divided opinion within the Committee as to whether the report of a third firm should have been modified. All three firms had failed to detect client situations that impaired their independence under the profession's rules. In all three cases, knowledgeable professionals concluded that the firms were in technical violation

of the profession's rules but noted that the rules are ambiguous. In all three cases, the audits were considered to have otherwise been performed in accordance with generally accepted auditing standards. Since independence is the cornerstone of the attest function, the Board urges the Section and the profession to take action to educate members so that compliance with independence policies and procedures will be enhanced and ambiguities in the rules eliminated.

■ **Mandatory Peer Review.** The Board has continually urged firms that audit public clients to join the SEC Practice Section. Two recent actions—one an initiative of the profession and the other a proposed rule of the Securities and Exchange Commission—should increase the number of firms that will join an organization that has a mandatory triennial peer review requirement.

In January 1988, the members of the AICPA adopted by ballot vote a recommendation of the Special Committee on Standards of Professional Conduct for Certified Public Accountants, which requires a firm to subject itself to a quality review program in order for the partners of the firm to be eligible for AICPA membership. Thus, if partners in a CPA firm want to be members of the Institute, their firm will be required to subject their quality control policies and procedures to independent review, and take any corrective action that such independent review indicates is necessary. Since adoption of the requirement—by a 76% affirmative vote—many firms have opted to join the Division for CPA Firms.

The SEC has under study a proposal that would require auditors who audit the financial statements of an SEC registrant to belong to a peer review organization acceptable to the Commission. The Board has urged the adoption of such a requirement and hope that by the time this report is published the proposed rule will have been adopted.

## *Members of the Public Oversight Board*



*A. A. SOMMER, JR.,  
Chairman, 1986-; joined Board  
in 1983; SEC Commissioner,  
1973-76; Partner in  
Washington, DC law firm of  
Morgan, Lewis & Bockius  
specializing in securities law.*

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

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The Special Investigations Committee administers the other major program of the Section, a supplement to the peer review program. A member firm is obligated to report promptly to the SIC any litigation or proceeding directed against it that alleges failure in the conduct of an audit of the financial statements of a publicly-held client.

The SIC is not concerned with the validity of such allegations nor does it form conclusions about the firm's compliance with professional standards in the performance of the audit involved in the litigation or proceeding. Those determinations are properly the responsibility of the regulatory authorities and the judicial system. However, such allegations may raise questions about a firm's quality controls. To assure that the public interest is protected, the SIC's responsibility is to determine whether the firm's quality control system is adequately designed and to determine whether firm



**ROBERT K. MAUTZ**, *Vice Chairman, 1987-; joined Board in 1981; Professor Emeritus of the University of Illinois and the University of Michigan.*



**ROBERT F. FROEHLKE**, *joined Board in 1987; Secretary of the Army, 1971-73; Chairman of the Board of Equitable Life Assurance Society, 1982-87; President and CEO of IDS Mutual Fund Group.*



**MELVIN R. LAIRD**, *joined Board in 1984; nine-term U.S. Congressman, 1953-69; Secretary of Defense, 1969-73; Counsellor to the President, 1973-74; Senior Counsellor for National and International Affairs, The Reader's Digest Association, Inc.*



**PAUL W. McCracken**, *joined Board in 1985; Chairman of the President's Council of Economic Advisers, 1969-71; Edmund Ezra Day Distinguished University Professor Emeritus of Business Administration, Economics, and Public Policy at University of Michigan.*

personnel are complying with the system.

The Board and its staff monitor the activities of the SIC and have unrestricted access to all meetings and files. The Board's staff reads the complaint, pertinent financial statements, other public documents, and relevant professional literature for each reported case. During the 1987-88 year, all SIC meetings were attended by one or more Board members and staff. Staff members, at times accompanied by a Board member, also attended (1) a substantial majority of the meetings during which SIC task forces and representatives of firms involved in litigation reviewed relevant documents and discussed the quality control implications of the allegations, and (2) all meetings during which task forces discussed the results of the firm's most recent peer review with the firm's peer review team captain. The results of these monitoring procedures are reported at each Board meeting so as to enable the Board to conclude whether the SIC is properly fulfilling its responsibilities.

■ **Enhancing Credibility in the Process.** The Board believes that

the special investigative process is effective and being operated in the public interest. Significant improvements were made in the efficiency and effectiveness of the process during the year, due primarily to the adoption of the recommendations made by the Task Force on SIC Methodology described in the Section's report. The Board believes the newly-adopted structured approach for analysis of reported cases will make the Committee's actions on individual cases more uniform and will enhance the effective discharge of the Committee's responsibilities. The approach, which was originally recommended by the Board, formalizes the procedures to be followed in the various stages of the Committee's review of a case. It also spells out with reasonable precision those factors that the Committee is to consider in deciding whether to proceed to the next stage of review or to close the file on a case.

Another significant development which is expected to enhance the SIC's effectiveness in arriving at conclusions earlier regarding the quality control implications of the allegations is the access

of the SIC to selected documentation of, and personnel involved in the audit in question. While a member firm has a right to deny access to its workpapers and personnel, firms are expected to cooperate and are cooperating when such requests are made. The SIC reviewed audit documentation in seven cases, giving it "first-hand" impressions of each firm's compliance with its quality control procedures. This approach permits the SIC to conclude more quickly whether other work of personnel responsible for the allegedly faulty audit needs to be reviewed.

Overall, member firms have cooperated fully, providing the SIC with the information it considered necessary to form conclusions on the quality control implications of reported cases.

The Board has noted that some firms are not complying with the requirement that relevant litigation or proceedings be reported to the Committee within thirty days of filing or initiation. The effective discharge of the Committee's responsibilities requires that the quality control implications of such litigation or proceedings be addressed in a timely fashion. Action should be taken to assure that member firms report cases within thirty days of initiation as required.

#### ■ **SEC Endorsement of the SIC**

**Process.** While the SEC has for many years publicly stated its confidence in the integrity of the peer review process, it has not yet endorsed the special investigative process, primarily because the SEC staff believes it has not had sufficient access to the process to be able to form an independent opinion as to its effectiveness. The Board believes that SEC endorsement of the SIC process would give the process significant credibility. To that end, the Board has worked strenuously to provide the SEC with sufficient information about the process without materially increasing the litigation risk of the firms involved.

The SEC staff was provided summaries of cases for which the SIC had recently concluded its inquiries. While information regarding the SIC's depth of inquiry and

bases for its judgments on the submitted closed case summaries were not considered sufficient by the SEC staff to permit the SEC to evaluate conclusively the effectiveness of the process, the SEC staff considered their submission as a positive development. The Board believes that the Section and the SEC will in time develop a mutually workable arrangement for SEC access that will permit the SEC to be able to publicly express the same degree of confidence in the SIC process that it has expressed with respect to the peer review process.

We believe it is important that every effort be made to assure that closed case summaries contain sufficient detail to afford the Commission staff to gain sufficient knowledge about the activities of the SIC and its task forces. Brevity in the closed case summaries is desirable to reduce litigation risk of member firms but may have led the Commission staff to underestimate the extent of the SIC's involvement.

Conversations with the Chief Accountant of the SEC have convinced the Board that to gain the approval of the Commission it is essential that the SIC more frequently perform procedures known as "special reviews." These are examinations of other audits (1) done by the professionals involved in the allegedly failed audit, (2) performed by the office involved, and (3) involving entities in the same industry. Our review of this matter does not suggest that the cost of such extended activity would be burdensome.

The Board endorses the plan of the Committee to have its representatives meet periodically with the SEC staff to discuss matters of mutual interest, including changes that the Commission believes would make the process more effective.

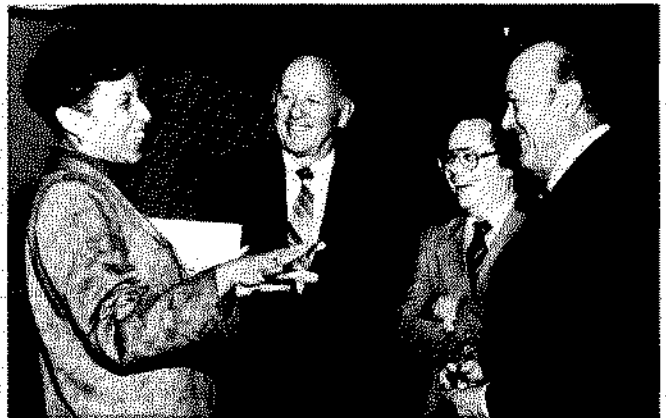
■ **Name of Committee.** In order to have an effective and encompassing self-regulatory program and if the public is to be protected, the Section needs a process to deal with allegations of audit failure, especially when such allegations relate to audits of publicly-held companies. Accordingly, the Special



*On May 25, 1988, the POB met with the SEC in open meeting.*

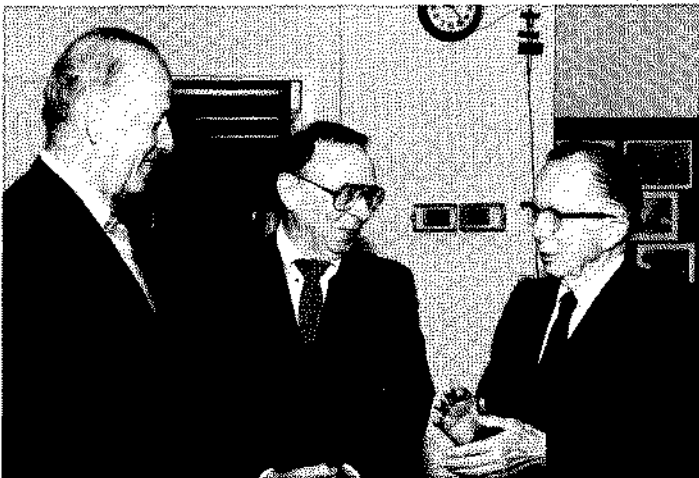


▲ POB Chairman reports on recent activities. (Left to right) SEC Chief Accountant Ed Coulson, SEC Chairman Dave Ruder, POB Chairman Al Sommer, and SEC Commissioner Aulana Peters.



▲ Commissioner Aulana Peters with POB Member Bob Froehlke, AICPA Vice President Ted Barreaux, and POB Member Mel Laird.

▼ AICPA Vice President B. Z. Lee (center) with POB Members Bob Froehlke and Paul McCracken.



▼ SEC Chairman Dave Ruder with fellow Wisconsinites Bob Froehlke and Mel Laird.

Investigations Committee was formed.

Unfortunately, however, the name chosen for the Committee does not describe its function as it has evolved. The Special Investigations Committee is not an executory body intended to inquire into a challenged audit to identify possible deficient professional performance.

Since its establishment, the special investigative process has served as a complement and supplement to the peer review process. Allegations of audit failure are reviewed by the SIC to determine whether (1) professionwide auditing or quality control standards should be revised or additional guidance should be issued to achieve greater compliance with such standards; and (2) some part of the quality control system of the firm reporting the case needs to be strengthened. The SEC's Chief Accountant acknowledged publicly at the open meeting the Commission and the Board held during the year that these are appropriate objectives.

To more properly describe the activity and objective of the Committee, we suggest that the Section consider renaming the Committee to more clearly indicate its function and responsibility.

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## Membership and Membership Requirements

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The Board commends the Section—and the Division for CPA Firms as a whole—for the significant increase achieved in membership during the year. Since the Board believes that firms that audit SEC registrants should become members of the SEC Practice Section, it has recommended that the Section initiate a membership promotion program to attract firms with SEC clients to join the SEC Practice Section. The Section decided to defer action on the recommendation until after the SEC has acted on its staff's proposal for mandatory peer review.

■ **Concurring Partner Review Requirement.** Since its inception, the Section has required a second partner review of audits of public entities. The Board believes that a preissuance review of an audit engagement by a second partner who is knowledgeable in regulatory and relevant industry matters can provide the firm and the public with significant

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*EASB and POB members discuss recent developments. (Left to right) EASB Members Ray Lauver and Jim Leisenring, POB Member Bob Froehlke, EASB Chairman Dennis Bereford, and POB Chairman Al Sommer.*



additional assurance that the engagement was performed in compliance with professional standards in all material respects.

The Board is pleased to note that, based on a recommendation of the National Commission on Fraudulent Financial Reporting and on suggestions incorporated in a recently published article authored by the Board's vice chairman and executive director,\* the Section has amended its membership requirement to define more clearly the responsibility of the concurring review partner and to make application of the second partner review more uniform.

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## The Question of Sanctions

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A few respondents to the Board's request for commentary opined that the self-regulatory program would not be considered successful and credible until it sanctioned individuals whose performance on audit engagements was deemed to be substandard. The suggestion has been made frequently.

The Board carefully reconsidered this matter and concluded that a self-regulatory program for firms does not and should not need a mechanism for sanctioning individuals. Such a mechanism is unnecessary since it would duplicate sanctioning mechanisms now in existence—those imposed by firms, those imposed by the SEC and by licensing authorities, those imposed by judges and juries in civil and criminal suits, and those imposed by the Professional Ethics Division of the AICPA and by state CPA societies. Even more importantly, a mechanism for sanctioning individuals would establish an adversarial relationship between peer review teams and reviewed firms, thus substantially diminishing the effectiveness of the process.

■ **Actions Required of Member Firms.** The organizational document of the Section empowers only

the Executive Committee to impose sanctions. Sanctions enumerated in the document include (1) requiring firms to take corrective actions with respect to either their quality control systems or to their partners and staff members, (2) imposing additional requirements for continuing professional education, and (3) requiring firms to undergo an accelerated peer review or a special review.

In practice, these measures are rarely being imposed by the Executive Committee, but quite routinely dictated by the Peer Review Committee and the Special Investigations Committee when they become aware of deficiencies in a member firm's quality controls or compliance therewith. If a firm does not consent to implement the actions required by either of these committees, the Section's procedures call for initiation of formal sanctioning procedures.

The Board has suggested that greater publicity be given to the number of times that such informal sanctions have been agreed to by firms. The Board recognizes that the word "sanction" has a negative connotation, and suggests that identification of the required actions agreed to as consent agreements or some other more descriptive term would further increase the credibility of the self-regulatory program.

■ **Sanctions Imposed by Firms.**

As the Board has suggested in previous reports, the first, and most effective and immediate, imposition of a sanction on a professional found to have acted unprofessionally is initiated by his or her fellow partners or employers. These actions are rarely made known outside the firm. The Board believes the Section should gather data regarding disciplinary actions imposed internally by firms and publish a summary thereof without identifying either firms or individuals. Such a report coupled with public reporting of the number of "consent agreements" entered into by firms with the Peer Review Committee and the Special Investigations Committee would effectively refute the allegation that the self-regulatory program does not impose sanctions.

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\* Mautz, Robert K. and Matusiak, Louis W., "Concurring Partner Review Revisited," *Journal of Accountancy*, March 1988.

## Summary of Board Member Activities— July 1, 1987 to June 30, 1988

<i>Meetings of the Board and Meetings with Representatives of Other Organizations</i>		<i>Direct Monitoring of SECPS Activities by one or more Board Members</i>																																																																	
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## Conclusions

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During the year, the Section made changes in membership requirements, peer review standards, and SIC operating procedures to increase the effectiveness and efficiency of the self-regulatory effort. Some of the changes were responsive to recommendations of the SEC, our Board, and those of the National Commission on Fraudulent Financial Reporting.

Both the Peer Review and Special Investigations Committees conducted their operations with deliberation and professionalism and received the total cooperation of member firms. Particularly impressive is the willingness of firms to cooperate with the Special Investigations Committee in giving the Committee access to selected documentation of the audit in question.

The Executive Committee found no need to impose a sanction during the year, because all corrective actions required of firms under review by either the Peer Review Committee or the Special Investigations Committee were undertaken promptly. These actions would have been designated as sanctions had they been required by the Executive Committee rather than the Peer Review or Special Investigations Committee.

During the year, the private sector has taken several initiatives that demonstrate that the accounting profession has an effective and encompassing self-regulatory program. The list of major initiatives is impressive:

- October 1987 - The National Commission on Fraudulent Financial Reporting, which was sponsored by five private sector organizations, recommended significant changes, many of which have already been implemented.
- January 1988 - AICPA members adopted, each by a substantial majority, six of the recommendations of the Special Committee on Standards of Professional Conduct, the most important of which is the requirement

that each AICPA member in active practice be affiliated with a firm that regularly undergoes a quality assurance review.

- April 1988 - The Auditing Standards Board issued nine standards dealing with the "expectation gap."

These significant, professionwide, private sector initiatives to improve audit quality deservedly earned the favorable comments of Chairman John Dingell and other representatives of the Oversight and Investigations Subcommittee of the House Committee on Energy and Commerce. The Board joins Congressman Dingell and his colleagues in complimenting the profession on the substantial progress made during the year to improve the quality of auditing in the United States.

We commend the Auditing Standards Board for adopting standards intended to close the "expectation gap." The standards now better define the profession's role in assuring the credibility of financial reporting and, in that sense, represent a meaningful response to the concerns expressed by the Treadway Commission. Based on our ten years of oversight of the profession's efforts, we are confident that satisfactory results will be achieved.

All of these developments convince us that there is no need for additional government regulation of the profession and we are encouraged by the growing recognition in Washington that the profession responds constructively to proposals to improve its own performance.

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A final note. The success of the Section's program in elevating the quality of professional performance of member firms should not be allowed to breed complacency. As firms embark upon their third and fourth peer reviews, there is a danger that reviews and responses to them may become routine and mechanical. This would quickly translate into shortcomings being overlooked, standards being

slighted, and departures from them remaining undiscovered. Very quickly an outstanding professional program could deteriorate and become progressively less relevant, performance would slip, and public criticism mount, resulting in public demands for government intervention.

All this can be avoided if those involved in the program—member firms, professionals who contribute generously of their time to serve on committees, AICPA staff, and the Board and its staff—maintain their vigilance, enthusiasm, and commitment to the quality of the program.

**Public  
Oversight  
Board**

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