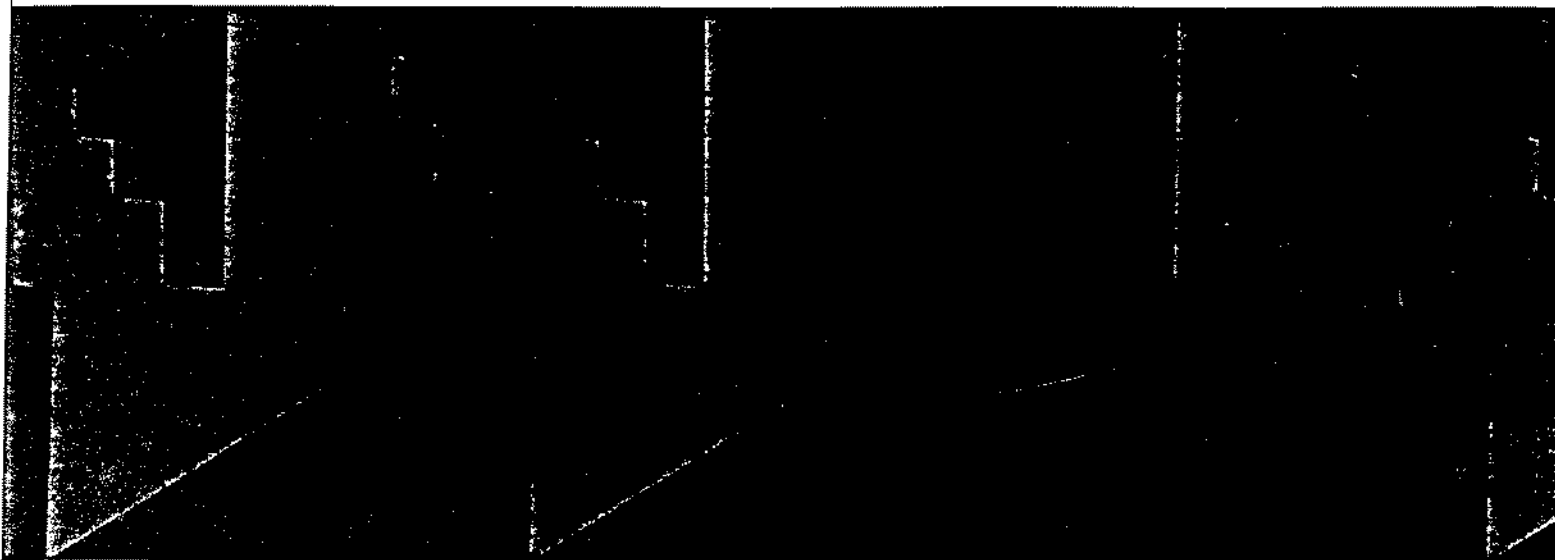


**Annual Report
1988-1989**

Public Oversight Board





***Annual
Report
1988-89***

***Public
Oversight
Board***

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.



Robert K. Mautz, Vice Chairman, 1987 -; joined Board in 1981; Professor Emeritus of the University of Illinois and the University of Michigan; Partner, Ernst & Whinney, 1972-78.



Robert F. Froehke, 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; Counselor 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.



POB Staff: Alan H. Feldman, Charles J. Evers, Louis W. Matusiak, John F. Cullen

Foreword

The Public Oversight Board is pleased to report in this, its eleventh annual report, that the SEC Practice Section's programs are sound, rigorously applied, and continue to enhance the quality of audit practice of member firms. During the year ended June 30, 1989, the Board gathered considerable evidence to support such conclusions: one or more Board members accompanied by staff attended every meeting of the Section's three major committees, and the Board held a joint meeting with the Quality Control Inquiry Committee; on other occasions, it met with representatives of the Peer Review Committee and Executive Committee; its staff carefully reviewed every peer review performed and the work of the Quality Control Inquiry Committee task forces; and the Board considered the reports of its staff concerning these activities.

The attendance of Board members at Section committee meetings produces several benefits. It makes committee members acutely aware of the Board's interest in their activities and allows committee members to hear directly from Board members their views on matters concerning the public interest. Board members observe firsthand the efforts put forth by member firm representatives in developing and operating the Section's programs. This active oversight provides a broad base of information and experience, which the Board uses to offer advice and suggestions, to criticize when necessary, to compliment when appropriate, and to judge whether the program serves the public interest.

Board members also participated in a number of activities relating to the accounting profession at large. POB Chairman Al Sommer met with the AICPA Board of Directors and addressed the Spring Meeting of AICPA Council. The full Board met with the chairman and key staff officers of the Institute and with representatives of various organizations interested in the accounting profession's self-regulatory program.

We conducted four of our nine meetings outside New York City in order to meet with practitioners, regulators, and legislators on matters relating to the self-regulatory program and the profession in general. Our goals in these meetings are to make the SECPS program better known, to explain our role and responsibilities, and, most importantly, to be apprised of the views and concerns of those interested in the program. We were pleased with the responsiveness of those who participated in our first "Outreach Program"—a roundtable discussion with the managing partners of local firms headquartered in Minneapolis and St. Paul and representatives of the Minnesota Society of CPAs and of the Minnesota State Board of Accountancy. We held a similar session in June with the managing partners of seven large local firms headquartered in New York City. We plan to hold two or three such meetings annually in various cities throughout the country.

Managing partners at both meetings expressed satisfaction with the self-regulatory process and view the peer review program as being both essential and valuable to them in monitoring and improving the quality of their firms' accounting and auditing practices.

Some participants at both meetings expressed concerns that "professionalism" among members of the profession is declining and that auditors were being considered less and less as professionals by outsiders. Opinions were expressed that audit services are no longer considered the primary service offered by some CPA firms. Participants indicated that some firms appear to be performing audits for fees that do not cover variable costs. In an editorial* Vice Chairman Bob Mautz has called attention to two contrasting concepts of professionalism, and has raised questions regarding the ultimate effect of forces impinging on public accounting and whether public accounting can survive as a traditional profession. These and other trends impacting auditing have long-term negative implications which the accounting profession must guard against. See page 22 for additional commentary.

During the current year, the Board established The John J. McCloy Award for Outstanding Contributions to Audit Excellence. Details of the first presentations of the award are noted on page 10.

John Abernathy of BDO Seidman and David Pearson of Arthur Young & Company have completed their third and final years as chairmen of the SECPS Executive Committee and Peer Review Committee, respectively. It would be remiss on our part if we did not acknowledge the effective and vigilant manner in which they have discharged their leadership responsibilities in maintaining and enhancing the high standards of their predecessors.

*Mautz, Robert K., "Public Accounting: Which Kind of Professionalism?", *Accounting Horizons*, September 1988.

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**Report of
The Public
Oversight Board**

We are pleased to report that during the year ended June 30, 1989, the Public Oversight Board implemented its mandate, as described 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 responsibilities to represent the public interest in the Section's self-regulatory program, members of the Board and staff attended and participated in all meetings of the Executive, Peer Review, and Quality Control Inquiry Committees of the Section during the year.

We reviewed all revisions to the standards for performing and reporting on peer reviews and the materials developed to train those who conduct such reviews. We also tested compliance with those standards through application of our visitation, workpaper, and report review programs on all peer reviews performed in 1988.

We reviewed the operation of the Quality Control Inquiry Committee to ascertain whether its activities are conducted with the public interest as their primary objective. We monitored the committee's analysis of and inquiries into all cases reported by member firms by, among other means, attending a majority of its task force meetings with firms at which inquiry was made concerning the quality control implications of cases. We also performed on-site oversight on all special reviews conducted during the year.

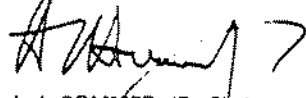
We monitored the follow-up actions taken by the Peer Review and Quality Control Inquiry Committees to assure that member firms take the required corrective actions to eliminate quality control deficiencies noted by peer review and special review teams.

We monitored and evaluated the activities of the Executive Committee and its Planning Subcommittee, the adequacy of membership requirements, and the appointments 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 by its member firms. Nevertheless, as commented on in the discussion section that follows, we 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, 1989

THE PUBLIC OVERSIGHT BOARD


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


MELVIN R. LAIRD


ROBERT K. MAUTZ, *Vice Chairman*


PAUL W. MCCRACKEN


ROBERT F. FROEHLKE

Discussion of Board Activities

July 1, 1988
to June 30, 1989

The Board monitors and evaluates the activities of the SEC Practice Section and makes recommendations for improving the operation and the effectiveness of the Section's programs. The Board is autonomous and consists of five members representing a broad spectrum of business, professional, regulatory and legislative experience. To assure its independence and objectivity, the Board appoints its own members, chairman, and staff, and establishes its own compensation and operating procedures.

The primary responsibility of the Board is to assure that the public interest is carefully considered when the Section sets, revises, and enforces standards, membership requirements, rules, and procedures. The Board, assisted by legal counsel, a staff of four CPAs, and two administrative assistants, discharges its responsibilities through application of appropriate oversight procedures to all phases of the Section's activities.

It should be noted that we believe our charge from the profession includes concern for how the profession is perceived. Accordingly, in this report, we call attention to some actions and trends that cause us concern, in some measures because of the perceptions they create.

Scope of Board Oversight. While the Board has no formal jurisdiction beyond monitoring the activities of the Section, it has interpreted its mission to include speaking out on issues affecting the credibility of the independent auditor's report and the role and responsibility of the auditor. Accordingly, the Board has established strong liaison relationships with all components of the profession and also with the Commissioners, Chief Accountant, and staff of the SEC, and with the Comptroller-General of the U.S. Both the SEC and the

GAO are vitally interested in the CPA profession and the effectiveness of its self-regulatory program. We monitor all comments, reports, and proposals these agencies issue that affect the profession and the role and responsibility of the auditor in the financial reporting process.

During the year, the Board spoke out on several issues which it deemed within its scope of oversight, although the resolution of such issues could come only from outside the Section.

Mandatory Peer Review. The Board strongly believes that every firm should undergo peer review and one that audits public companies should undergo peer review as a member of the SEC Practice Section. Peer review is an effective means of assuring the public that a firm has performed its accounting and auditing engagements at a satisfactory level of professional achievement; membership in the Section identifies a firm dedicated to providing high quality accounting and auditing services.

Under a current SEC proposal, the Commission (a) would set peer review standards, and (b) require a firm that audits SEC registrants to belong to a peer review organization acceptable to the Commission and to undergo either periodic peer reviews as rigorous as those of the SEC Practice Section or peer reviews conducted by the SEC. While we favor mandatory peer review, we believe the public interest is best served when peer review standards are set in and peer reviews are conducted by the private sector. See page 21 for additional commentary.

Independence Rules. At our request, during the year the Section's Peer Review Committee referred three matters to the AICPA's Professional Ethics Executive Committee for its consideration and resolution. These matters involved apparent misinterpretation by three different firms of the ethical rules regarding auditor independence.

*Continuing the practice started last year, the SEC Practice Section is issuing a report on its operations and the results of its peer review, quality control inquiry, and other activities. This eleventh annual report of the Board should be read in conjunction with the Section's 1988-89 annual report.

During the year, we learned that the Chief Accountant of the SEC had been asked to issue a modification of the Commission's independence rule so that an audit firm would not be deemed to have impaired its independence by performing services in a prime-subcontractor relationship with an audit client for a third party, if the fees received for such services were immaterial in amount. Because of the possible impact such relationships could have on auditor independence and public perception of auditor independence, the Board urged the Commission to seek public comment on the request.

Role and Responsibility of the Auditor. During the year, the Board asked the Section to bring to the Auditing Standards Board's attention a matter which surfaced during the course of our oversight of the quality control inquiry process. As a result, the Auditing Standards Board placed on its agenda a project to determine the degree of understanding an auditor, in the absence of an audit base, should have of an entity's control structure in order to issue a review report on the entity's interim financial statements, particularly when the review report is to be included in a prospectus.

The Board has proposed a liaison relationship with the recently restructured Planning Committee of the Auditing Standards Board which includes three members not currently in public practice. This direct communications link will facilitate Board input into the standard-setting process.

Proposed Management Report on Internal Control and Auditor Association with Such Report. The SEC has issued for public comment a proposal that management issue a report on its internal control system, including an assessment of that system's effectiveness. The Board wrote the SEC in support of such proposal, but noted that it should not be adopted until the Auditing Standards Board had decided what an auditor must do in order



AICPA Special Assistant to the Chairman B. Z. Lee and Vice President-Federal Government Relations Joe Moraglio with POB Vice Chairman Bob Mautz and POB staff members Lou Matusiak and Chuck Evers at the POB's January 10, 1989 meeting.

to comment on management's assertions when the auditor had not been engaged to examine and issue a report on internal controls. In addition, the Board agrees with the Committee of Sponsoring Organizations of the Treadway Commission that adoption of the proposal should be delayed until criteria for management's use in evaluating the adequacy of a company's internal controls had been identified and agreed on by all concerned parties. That committee has been the catalyst for a research effort to develop such criteria.

Increased Board Visibility. The Board, ever mindful that the profession's self-regulatory activities are virtually unknown by the financial and business communities and, for that matter, not sufficiently well-known within the accounting profession, has endeavored to inform members of the profession and the business and financial communities about the Section's programs and the Board's role therein. The calendar on pages 24-25 summarizes the Board's extensive involvement in the self-regulatory process.

During the year, the Board conducted two "outreach programs"—one in Minneapolis/St. Paul and the other in New York City—during which the Board had round-table discussions with management repre-

representatives of local firms headquartered in those areas. Representatives of the Minnesota Society of CPAs and the Minnesota State Board of Accountancy also attended the Minneapolis meeting. Reactions to both meetings were very positive. The Board heard the concerns of local practitioners on

a wide range of topics, including their perceptions of professionalism, the difficulty that smaller firms have in complying with certain Section membership requirements, and the lack of recognition within the business and financial communities of the significance of membership in the Section.

Outreach Meeting in New York

The meeting was attended by representatives of seven large local firms headquartered in New York City.



(Left to right) Phil Zimmerman, POB Chairman Al Sommer, PC Technical Director Chuck Ever, POB Vice Chairman Bob Maut, POB Executive Director Lou Matusiak, Gerry Golub, Eli Hoffman of Richard A. Eisen & Co., and Gerald Marsden of Eisner & Lubin.



POB member Bob Froehlike and Norman Lipshie of Weber, Lipshie & Co.



Gerald Golub of Goldstein, Golub, Kessler & Company and Philip Zimmerman of Paneth, Haber & Zimmerman with POB member Paul McCracken.

(Left to right) Jerry Sullivan (appointed POB Executive Director effective October 1, 1989), POB member Mel Laird, Kenneth Weiser of M. R. Weiser & Co., Al Sommer, Paul McCracken, and Phil Zimmerman. Roger Donohue of Edward Isaacs & Co. also attended the meeting.



Outreach Meeting in Minneapolis-St. Paul

The meeting was attended by the managing partners of six CPA firms headquartered in Minneapolis-St. Paul and representatives of the Minnesota State Board of Accountancy and the Minnesota Society of CPAs.



POB members Bob Froehke and Mel Laird and Minnesota State Board of Accountancy Executive Secretary Pam Smith.

Dave Nelson of McGladrey & Pullen and POB Chairman Al Sommer.



POB Technical Director Chuck Evers and POB Assistant Technical Director John Cullen.



Richard Hansen of Hansen, Jergensen & Co. and Dennis Peterson of Boulay, Heutmaker, Zibell & Co.



Pam Smith and Minnesota State Board of Accountancy Chairman Michael Vekic.

The Board intends to hold at least two such meetings annually in various cities across the country to gain continuing insight into the problems and concerns of practitioners, and to use such input in improving the operations of the Board and the Section.

The John J. McCloy Award. This award, named in honor of the Board's first chairman, who was an outstanding statesman and public servant extraordinaire, honors persons who have served the public and the profession by making outstanding contributions to audit excellence. At the Annual AICPA National Conference on SEC

Developments in January 1989, the Board presented John J. McCloy Awards to two practitioners who gave unstintingly of their time and talents as chairmen of the initial Peer Review Committees of the SEC Practice Section and Private Companies Practice Section: Donald L. Neebes of Ernst & Whinney and James P. Luton, Jr., a sole practitioner in Oklahoma City. The Board's choices of these CPAs as initial recipients for the award were widely applauded. The Board intends to present this award annually to persons selected for their meritorious contributions to audit excellence.



POB Vice Chairman Bob Mautz and POB Chairman Al Sommer with the first recipients of The John J. McCloy Award for Outstanding Contributions to Audit Excellence, James P. Luton, Jr. of Luton & Company in Oklahoma City and Donald L. Neebes of Ernst & Whinney.

Oversight of the Peer Review Process

The Board's most significant charter responsibility is to monitor and evaluate the effectiveness of the Section's peer review process. Peer review is the keystone of the profession's self-regulatory effort. Member firms participate to assure themselves and the public that they are delivering high quality professional auditing and accounting services.

The Peer Review Committee establishes and enforces peer review standards and administers the peer review program. It also obtains sufficient evidence to assure itself that member firms have adequate quality control policies and procedures, are in compliance with them, and are taking corrective actions to remedy any deficiencies noted. The Board uses a wide-ranging "hands-on" oversight program to ensure that the committee discharges these responsibilities in the best interests of the public.

Types of Oversight Programs. The Board's monitoring procedures include staff review of each peer review administered by the Section, using one of three oversight programs. The programs vary in intensity. All test the review team's application of the peer review performance and reporting standards.

The type of oversight program applied to a given review is based upon attributes of the firm to be reviewed and of the review team. The attributes given the most consideration are:

■ **Firm to be reviewed:**

- Number of SEC audit clients*
- Type of report issued on the firm's prior review*
- Number of professional staff*
- Number and types of auditing and accounting engagements*
- Type of POB oversight program used on prior review*

■ **Review Team:**

- Evaluation of performance on prior reviews*
- Experience in relation to the nature, size, and complexity of the practice of the reviewed firm.*

The POB uses three oversight programs with varying degrees of attention to the review team's performance, its evaluation of the firm's quality control system, and its reporting of results obtained therefrom.

■ **Visitation and Workpaper Review.**

This includes "on-site" observation of the review of one or more operating offices, attendance at the final exit conference, and review of all the review team's workpapers, the peer review report, the letter of comments, and the firm's response. During the 1988 review year, the Board's staff, at times accompanied by a Board member, attended 49 operating office and final exit conferences held in conjunction with the reviews of 42 firms. The visitation and workpaper review program was applied, as has been past practice, to all reviews of firms with five or more SEC clients and to reviews of other firms on a stratified random sample basis.

■ **Workpaper Review.** This includes a comprehensive review of all the review team's workpapers, the report, the letter of comments, and the firm's response. During the 1988 review year, the Board's staff applied this program to the reviews of 41 firms, including, as in the past, the reviews of all firms with less than five SEC clients that were not randomly selected for the visitation program, and a stratified random sample of reviews of firms with no SEC clients.

■ **Report Review.** This includes a staff review of selected portions of the review team's workpapers, peer review report, letter of comments, and the firm's response. It is applied to all peer reviews not subjected to the above programs. If such review indicates a possible misapplication of peer review standards, the scope of Board oversight is extended to the review of all the review team's workpapers. The report review program was applied to 29 of the 112 reviews performed in 1988.

**Scope of POB Oversight
of 1988 Peer Reviews
Classified by Number of
SEC Registrants Audited
by Reviewed Firm**



Observe Peer Review
In Progress and
Attend
Exit Conference

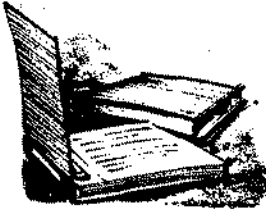
And

42

Review of All
Peer Review Team's
Workpapers

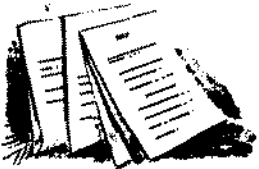
And

Review of
Peer Review Reports



And

41



Review of
Peer Review Reports
and Selected
Workpapers

29 Firms with no
SEC Clients

20 Firms with
1 to 4 SEC Clients

27 Firms with
no SEC Clients

11 Firms with
5 or more SEC Clients

15 Firms with
1 to 4 SEC Clients

15 Firms with
no SEC Clients

Evaluation of Individual Peer Review Reports. The Board closely monitors the adherence to standards by peer review teams and by the Peer Review Committee.

Prior to each Peer Review Committee meeting, the Board's staff meets with the committee's staff and a subcommittee of

three committee members to discuss results of individual reviews and the reports to be considered for acceptance at the following committee meeting. The group identifies issues to be brought to the attention of the committee in the report-acceptance process. Questions asked include: Was the review effective? Are the report

and letter of comments appropriately candid and complete? Has the firm taken or committed to take appropriate corrective actions? Should the firm be required to provide evidence that such action was taken? Many of these questions are addressed prior to the meeting so that the committee's chairman and staff may be early apprised of serious questions and concerns raised by the POB staff during the course of applying the POB oversight programs. In every instance, the committee has satisfactorily responded to staff questions and concerns.

During the year, Board and staff members attended all meetings of the committee and participated in the discussions of the performance of review teams and the evaluations of individual review reports whenever appropriate to do so.

The high level and frequency of communication between the committee's chairman and staff and the Board's staff is in large measure responsible for the satisfactory and timely resolution of any and all questions that have arisen. The Board commends the committee members for their commitment and dedication to the program.

Timely Processing of Reviews.

Policy requires that a review team issue its report to the reviewed firm no later than thirty days after the exit conference. The reviewed firm must respond by letter and identify the actions it plans to take with respect to every deficiency noted in the review team's letter of comments. That letter, the peer review report, and the letter of comments are required to be submitted to the committee no later than thirty days after the receipt of the review team's report and letter of comments. The majority of review teams and reviewed firms complied with these time requirements. By June 30, 1989, all reports on the 112 peer reviews performed in 1988 had been processed by the committee.

The committee's vigorous pursuit of late filings, often through the personal

involvement of the chairman, is the primary reason why all the peer review reports for reviews performed in 1988 were processed by the committee on or before June 30, 1989. The Board commends the committee for expediting the processing of reports, thus decreasing the length of time between the discovery of a deficiency in a firm's quality control system and assurance to the committee that the firm has taken appropriate corrective action.

Monitoring Committee Follow-up

Actions. The committee requires a firm with serious deficiencies in the design of its quality control system, or pervasive non-compliance with important quality control policies and procedures, to demonstrate that it has taken corrective measures. Sometimes the committee even specifies actions that the firm must take.

The Board monitors committee follow-up actions and, by so doing, is made aware of the quality control improvements effected. Follow-up actions are not limited to ensuring that firms implement appropriate corrective actions. The committee is just as rigorous in evaluating the performance of the review team captain and members, and culling out from its "reviewer bank" those whose work is deemed to be substandard.

Peer Review Standards. The standards for conducting peer reviews and reporting their results are continuously reevaluated to assure that peer review is a probing process sufficiently recognizing the dynamic environment in which audits are conducted. Some changes in standards and procedures are made as a result of new circumstances encountered. Other changes in standards were adopted during the 1988-89 year in response to our concerns and those expressed by the Securities and Exchange Commission, the General Accounting Office (GAO), the National Commission on Fraudulent Financial Reporting (Treadway Commission), and the U.S. House of Representatives Committee

on Energy and Commerce (Dingell Committee):

- As the result of a change in SEC regulations, peer review teams are now required to review initial audits performed by the reviewed firms for SEC registrants for which a "reportable event" was reported in a Form 8K by the predecessor auditor.
- As the result of the GAO's adoption of revised government auditing standards which require firms that conduct specified audits to meet minimum requirements, peer review teams are now required to review compliance with these standards.
- As the result of a recommendation of the Treadway Commission, peer review standards now require review teams to select for review those offices of the reviewed firm that had performed the greatest number of initial audits of public companies, and to review at least one such audit performed in each office visited.
- As the result of a concern expressed by the Dingell Committee that the SEC is not being notified quickly enough of potential problems, the Section now requires a member to notify a former client in writing of termination of the auditor-client relationship within five business days of such termination and to send a copy of such letter to the SEC Chief Accountant at the same time. Peer review teams are required to test compliance with this requirement.
- As the result of concerns expressed by

the POB and the SEC, review teams are now required to test not only the completeness but also the timeliness of reporting litigation to the Quality Control Inquiry Committee.

Improvements in Quality of

Practice. The Board concurs with the Section's conclusion that the peer review process has improved the quality of audit practice of member firms. These improvements are discussed at length in the accompanying annual report of the Section.

Peer review is a vibrant and relevant program that benefits both reviewed firms and reviewers. As reported in an April 1988 *Journal of Accountancy* article entitled "Lessons Learned from Peer Review" co-authored by our Technical Director, Charles J. Evers, and PRC Chairman David B. Pearson, all firms, even those that have been peer reviewed several times, derive benefits from each review.

A firm cannot become complacent as a result of having received an unqualified report on its peer review. Compliance with quality control policies and procedures must be emphasized continually and monitored carefully. Two firms apparently did not heed such advice; the firms received modified reports in 1988 after receiving unqualified reports on their 1985 reviews. Managements of member firms must be committed to maintaining quality service, communicating that commitment throughout the firm, and continuously monitoring compliance with quality control policies and procedures.



POB Chairman Al Sommer with PRC members Harry DeVerter and Tom Stemlar at November 1, 1988 meeting.



Oversight
of the
Quality Control
Inquiry Process

The quality control inquiry process supplements the peer review process. It is administered by the Quality Control Inquiry Committee (QCIC), originally named the Special Investigations Committee (SIC), which reviews all litigation and government proceedings that allege a firm did not perform an audit of a publicly-held company in accordance with professional standards. All such litigation is required to be reported to the QCIC by member firms. The QCIC's task is to determine whether the allegations indicate possible deficiencies in the firm's quality controls.

Thus, the objectives of the peer review and QCIC processes coincide. The QCIC process supplements the peer review process by evaluating the allegations in contested audits and their implications. It determines whether to review certain aspects or operations of a firm's quality control system not reviewed by the peer review team, or in light of these allegations to review in greater depth certain aspects or operations that had recently been subjected to peer review.

In addition, the QCIC's job is to analyze such litigation to determine whether professional standards, quality control standards, or the Section's membership requirements need revision or whether additional guidance is needed.

Joint Meeting with the QCIC.

Last September, the Board met with the full Quality Control Inquiry Committee to exchange thoughts on the many thorny issues relevant to the credibility and effectiveness of the QCIC process, focusing on issues requiring decisions in the 1988-89 year. This joint meeting provided both the Board and committee members with a better understanding of the critical issues, and generated ideas on how they might be resolved in the best interests of the public and the member firms. These issues and proposed solutions are the subject matter of the balance of this section.

Change of Committee Name.

During the year, the committee's name was changed from the Special Investigations Committee to the Quality Control Inquiry Committee. The Board and others had urged a name change for several years because the former name was considered misleading. An investigatory committee is generally perceived as intended to pass judgment on events and the responsibility for them. That was never intended to be the primary mission of this committee. Its mission is and always has been to gain assurance in the light of adverse allegations whether a firm's quality control system is adequate and being complied with. Hence, the name, "Quality Control Inquiry Committee," more appropriately describes this mission.

Evaluation of Actions Taken on Individual Cases.

The Board monitors the activities of the QCIC and has unrestricted access to the committee's files as well as to all meetings of the committee and its task forces. The Board's staff reads the complaint, pertinent financial statements, other public documents, and relevant professional literature for each reported case. During the 1988-89 year, all QCIC meetings were attended by one or more Board members and staff. Staff members, at times accompanied by a Board member, also attended a substantial majority of the meetings during which QCIC task forces and firm representatives discussed the quality control implications of the allegations. Additionally, staff members observed the performance of all special reviews ordered by the committee. The staff reviewed all workpapers documenting the performance of the special review teams and attended closing meetings where the findings of the special reviews were reported to management representatives of the firms reviewed. The results of these monitoring procedures are reported at each Board meeting.



QCIC Chairman Bill Hall
and POB Chairman
Al Sommer.

Generally, the Board concurred with decisions on individual cases made by the committee during the year. In one instance where a firm had conducted internal reviews of other engagements performed by the teams which had supervised allegedly faulty audits, the Board concluded that the committee had not obtained sufficient documented evidence that the firm had implemented appropriate corrective action. While the committee had received broad oral assurance that needed actions had been taken, the Board felt the public interest would be better served if the committee obtained greater assurance by reviewing and testing the results obtained from the firm's internal reviews. The committee adopted the Board's recommendation and ascertained the specific actions the firm had taken.

Committee Communication with Standard-Setting Bodies. The QCIC has communicated, as appropriate, with the Auditing Standards Board and the Accounting Standards Executive Committee whenever the committee concluded additional guidance or clarification was needed concerning accounting or auditing issues identified in reported cases. The Board commends the committee for these efforts.

Timeliness of Reporting Cases. In our last year's report, we noted that some firms had not reported relevant litigation or proceedings to the committee, as required within thirty days of filing or initiation. The matter was brought to the attention of the Executive Committee by the QCIC chairman, and procedures were implemented by the Section's staff to improve the timeliness of reporting. However, some instances of late reporting were still observed. As a consequence, tardiness in reporting cases to the QCIC was included in a large firm's peer review letter of comments, and the Peer Review Committee revised review procedures so that the reporting of cases to the QCIC will be tested more extensively by peer review teams. We strongly urge member firms to develop, and enforce compliance with, procedures to assure timely reporting of cases to the QCIC so the committee can address the quality control implications of the allegations in a timely manner.

Improving the Effectiveness of the Process. The Board continues to believe that the quality control inquiry process is effective and operated in the public interest. Improvements have been made in the efficiency and effectiveness of the process primarily through further implementation of the recommendations of the Task Force on SIC Methodology, which issued its report in 1987.

The committee during the year refined its inquiry process. In order to better serve the public interest and increase the willingness of firms to cooperate with its requests, the committee developed procedures that permit discharge of its responsibilities while protecting the rights of a firm not to prejudice its defense in litigation. This requires a delicate balance between aggressiveness and restraint; the Board has suggested that the committee, when faced with a difficult decision, lean in the direction of serving the public interest.

Committee procedures are uniformly applied to cases in a positive, structured manner. If analysis of the allegations of audit failure are not considered frivolous, the QCIC performs additional stipulated procedures until it concludes that the firm's quality controls and compliance therewith are satisfactory. If such satisfaction is not obtained through its inquiry and investigative procedures, a special review is ordered with a scope tailored by the results obtained from its prior procedures.

Approach to Special Reviews.

To further implement its recently adopted structured approach, the QCIC drafted guidelines for performing special reviews and intends to order more special reviews to be performed, particularly those focusing on other audits supervised by the management team on the allegedly faulty audit.

The draft guidelines give the special review team captain the option of using personnel of the firm to be reviewed in a review capacity. The committee believes, and the Board concurs, that such reviews may be more effective because of the intimate knowledge such personnel have of the firm's quality control system, and would have the concomitant benefit of reducing the cost of special reviews.

The Board, however, believes that personnel of the firm to be reviewed may not be perceived as being sufficiently objective to serve as members of special review teams. The Board communicated its views to the QCIC, recommending that, at a minimum, no person be assigned to a special review team that is to review a part of a firm's quality control system that such person had recently opined on.

We commend the QCIC for its willingness to conduct more special reviews in defined circumstances and for its concern that member firms not be unduly burdened by the cost of such reviews. We believe that the above-described policy for appointment of members to special review teams

will result in effective and cost-efficient special reviews, and will enhance the public's perception of the objectivity and credibility of the process.

Possible SEC Endorsement of the QCIC Process. The Chief Accountant of the SEC has indicated that he believes that, whenever the allegations indicate that the firm's quality control policies may not have been complied with, the QCIC should require that a review be conducted of other engagements supervised by the professionals involved in the allegedly failed audit. In addition, he indicated that the format of the closed case summary needed to be expanded to include the bases for the QCIC's various actions.

Members of the Chief Accountant's staff met with our staff on several occasions in the 1988-89 year to review and discuss cases on which the QCIC had concluded its inquiries. The SEC staff was complimentary of QCIC efforts and of the effectiveness of POB oversight, but concluded that the closed case summaries provided did not include sufficient detail about (a) the inquiries made by the QCIC, (b) the results obtained from such inquiries, and (c) the basis for actions taken.

POB-QCIC joint meeting on September 14, 1988.

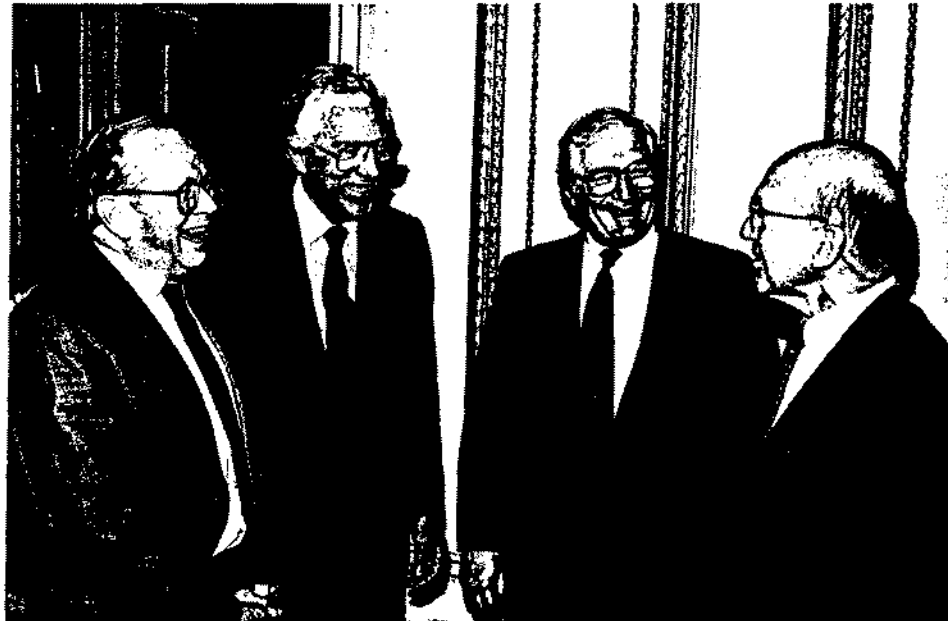


During the year, discussions were held within the Section seeking to find a format for the closed case summary that could serve as a basis for satisfactory SEC monitoring of QCIC activities without unduly prejudicing the outcome of litigation. A task force of Executive and QCIC members and house counsels of member firms was appointed to study this matter.

We believe that appropriate attention is being given to securing full SEC endorsement of the process. Whether the closed case summary can be as comprehensive as the Chief Accountant would like without significantly affecting the litigation risk of firms is a question we cannot answer. Since the Commission is a responsible federal

agency that appreciates the difficulties in resolving the legal issues regarding SEC access, the Board remains confident that an accommodation can be reached whereby the SEC will be able to provide endorsement. We pledge ourselves to work closely with the Section and the SEC to this end.

The Board must emphasize, however, that SEC endorsement of the process will not in itself make the process more effective or more in the public interest. Given the present quality of QCIC performance, SEC endorsement of the process is sought for only one reason—to enhance credibility of the process to the public.



PQB Chairman Al Sommer, AICPA Chairman Bob May and AICPA President Phil Chenok with PQA Vice Chairman Bob Mautz at meeting on December 14, 1988

Membership Requirements

We have monitored the activities of the Section's Executive and Planning Committees and conclude the public interest and the interest of member firms were reasonably balanced in the setting of rules and membership requirements.

Extent of QCIC Jurisdiction. On September 1, 1988, the Board wrote to the Executive Committee expressing its concerns about an interpretation the committee had given to paragraph six of the QCIC's organizational document when it decided not to grant the QCIC's request for jurisdiction in a matter of litigation alleging audit failure on a non-public company audit. Paragraph six reads:

"The [QCIC] committee may identify a significant public interest in an alleged audit failure that is not required to be reported to the committee. The executive committee shall determine what actions, if any, shall be taken by the section with respect to such matters."

In its letter to the Executive Committee, the Board indicated that it was more concerned with the sharply divergent interpretations of the relevant paragraph by the QCIC and the Executive Committee than with the fact that the QCIC was not granted jurisdiction over the case in question. Consequently, the Board urged that the widely differing interpretations of the two committees be resolved and the meaning of this paragraph be clarified.

A task force of Executive and QCIC members was formed for this purpose. Soon after its formation, the task force was asked to recommend how paragraph six should be applied to the host of non-public savings and loan institutions that had recently become insolvent. As discussed below, the major question was whether the QCIC should be given jurisdiction over lawsuits against accountants initiated by federal agencies, such as the FDIC and FSLIC, which litigation would not be reportable to the QCIC because the financial institutions are not public entities as defined in

the membership requirements.

Concern for the Public Interest in S&L Cases. The task force recommended and the Executive Committee adopted an interpretation of paragraph six which concluded that (a) there is a significant public interest in S&Ls and in financial institutions in general, and (b) the QCIC should conduct inquiries into all litigation initiated by federal agencies such as the FDIC and FSLIC which alleges failure in connection with the audits of financial institutions. The interpretation does not impose a reporting obligation on member firms. Instead, the QCIC, when it becomes aware of the initiation of litigation by a federal agency, will request the firm to provide a copy of the complaint, which the QCIC would screen to ascertain if it raises quality control questions. If the complaint raises such questions, the QCIC will seek the firm's agreement for the QCIC to add the case to its agenda and subject it to standard inquiry procedures. If the firm either refuses to provide the complaint or objects to it being added to the QCIC's agenda, the Executive Committee is to decide the action to be taken.

The Board agrees that there is significant public interest in cases involving financial institutions and that such cases merit, at a minimum, the above-described QCIC special procedures.

We expressed reservations about the procedures in one respect. The QCIC has no authority to become involved with allegations of audit failure unless litigation has been initiated. It will not, for example, deal with matters such as the six alleged audit failures on bankrupt S&Ls reported by the GAO unless they become the subject of litigation. These six "cases" were officially reported to the AICPA before litigation had been initiated for some of them. The AICPA referred them to its Professional Ethics Division. This division traditionally deals only with complaints against individuals and only when litigation or threat of litigation does not exist. We believe the quality control implications of allegations of audit

failure against firms should be dealt with by the Section regardless of whether litigation is initiated.

We have asked the Executive Committee to reconsider whether the quality control implications of alleged audit failures by member firms charged by a governmental regulatory agency should be considered by the QCIC.

In this regard, however, we commend the profession for its performance as the savings and loan crisis was unfolding. The AICPA repeatedly refused to countenance "make believe" accounting practices urged by the regulatory authorities. Its sensitivity and conduct were well stated in AICPA President Philip B. Chenok's testimony before the House Committee on Banking, Finance and Urban Affairs in February 1989.

Lawsuits Involving Other Non-Public Entities. With respect to the aforementioned task force's initial charge to provide guidance on how "significant public interest" in paragraph six of the QCIC's organizational document should be interpreted, the task force concluded there was no need to issue additional guidance on the meaning of the phrase. The Executive Committee concurred, stating subsequent discussions between representatives of the two committees indicated that existing materials were adequate and that the determination of "significant public interest" could be made effectively on a case-by-case basis. The Board directed its staff to monitor the Section's actions in dealing with alleged audit failures by governmental agencies of non-public companies that are brought to the attention of the QCIC.

Concurring Partner Review Requirement. The Board regards a preissuance review of audits of public companies as a key quality control procedure and accordingly strongly endorses the Section's concurring partner review requirement.

The Board recognizes that smaller firms have difficulty in complying with this

strengthened requirement because they may not have a qualified concurring reviewer. Thus, they must look outside the firm for help. In the current litigious environment, outside reviewers are not easy to find. Consequently, the Board urged the Section to study ways in which the Section could assist smaller firms in complying with the requirement. This is especially important if the AICPA's proposal is adopted that would require that CPAs in firms with SEC clients be allowed to retain individual membership in the AICPA only if their firms are members of the Section. In this regard, we have been informed that the liability insurance policy issued under the Institute's plan provides coverage for an outside second reviewer if such review is performed under a contractual relationship, but only on a claims-made basis, which can expose the reviewer to a significant liability risk. Therefore, we urge the Section to explore all possible ways to enable member firms to make themselves available to other member firms for such reviews without unreasonable risk, and, when that is done, to compile and make public a list of such available reviewers.

Direct Communication with the SEC on Termination of Audit-Client Relationship. We commend the Section for the practical resolution of a difficult problem, namely, keeping the SEC informed when an audit firm becomes aware that its audit relationship with an SEC registrant has ended. The Section adopted a new membership requirement effective May 1, 1989, requiring member firms to send the former client a letter within five business days of becoming aware of the termination of the audit client relationship. The auditor is also required to send a copy of such letter to the SEC Chief Accountant to serve as notification that a Form 8K should have been filed by the registrant reporting the fact and circumstances of a change in auditors.

Mandatory Quality Review. The AICPA continues its efforts to expand the scope of its self-regulatory program for accounting firms. The coming year will mark the commencement of a new quality review program, adopted in 1988 by an overwhelming vote of the AICPA's individual members. As a result, to qualify for individual membership in the AICPA, a CPA in public practice must be a member of a firm whose quality control system is subjected periodically to either a peer review or a quality review. As of June 30, 1989, 39,300 firms had enrolled in the new quality review program; an additional 4,700 firms are members of either the SEC Practice Section or the Private Companies Practice Section, both of which have mandatory peer review requirements. All members of the accounting profession can take pride in the scope and rigor of the profession's self-regulatory program, and the commitment of so many of its members to the program.

The major differences between a review under the new quality review (QR) program and an SECPS peer review are: SECPS peer review results are placed in a public file while QR results are non-public; SECPS peer reviews are subject to POB oversight and peer reviews of firms that audit SEC registrants may be selected for review by the SEC; SECPS imposes rigorous additional requirements upon its members, such as mandatory rotation of the partner-in-charge of audits of SEC registrants, mandatory preissuance review by another partner of audits of SEC registrants, proscription of specified consulting services, and mandatory reporting of information about consulting services performed for SEC registrants to audit committees of such registrants.

In a March 6, 1989 report addressed to Congressman Dingell's Subcommittee on Oversight and Investigations, the GAO criticized the SEC for failure to adopt a rule requiring auditors of SEC registrants to undergo periodic peer reviews. The POB

has stated repeatedly that a firm auditing one or more public companies should be required to have its quality control system periodically reviewed by a competent and independent peer. Consequently, the Board hopes that AICPA members will approve a current proposal to strengthen the profession's self-regulatory program. At its 1989 Spring Meeting, the AICPA Council approved reballoting on the Anderson Committee's recommendation that a CPA with a firm auditing an SEC registrant be denied individual AICPA membership if such firm is not a member of the SEC Practice Section. The Board urges all AICPA members to cast an affirmative ballot when the matter is voted on in the fall of 1989. While the Board clearly prefers that matters such as these be dealt with through self-regulatory processes, if the current effort to secure AICPA membership approval of mandatory membership in the SEC Practice Section for firms auditing SEC registrants fails, the Board will strongly urge the SEC to adopt its proposal for mandatory peer review as published in April 1987, hopefully modified as the Board suggested in its comments on the proposal.

POB member Paul McCracken, FDIC Chairman William Seidman, and POB members Mel Laird and Bob Froehke at POB meeting on May 1, 1989.



Conclusions and Commentary

The POB has never been in the direct "chain of command" in the Section's self-regulatory program, and it has never indicated that this would be desirable. Our task is to represent the public's interest in the quality of independent auditing, and to accomplish this oversight by overseeing the activities of the accounting professionals conducting the programs.

The activities of the Section are important components of the accounting profession's self-regulatory program. Successful operation of the program gives reasonable assurance that its member firms meet professional standards for accounting and auditing services, but it cannot guarantee continuation of quality service.

Therefore, top managements of CPA firms must continually emphasize that the provision of high quality auditing services is their primary objective. In this regard, we believe the leaders of the profession face a difficult and challenging task. The following commentary identifies the bases for that belief.

Professionalism. Public accounting firms are undergoing organizational metamorphoses and becoming involved in an ever-expanding scope of services for present and prospective clients. These services provide obvious profit opportunities for individual firms. While profits ensure the ability of a firm to provide quality audit services and enhance its ability to attract top quality people to the firm, the profit motive cannot be permitted to endanger the "professionalism" of firms.

The maintenance of the traditional concepts of professionalism, which embody integrity, objectivity, and competence, is essential. The profession at large and individual firms must be constantly mindful of the social importance of auditing and not judge professional success solely in economic terms. Educators, providers of continuing professional education programs, and managements of CPA firms must continually reaffirm the need to maintain the credibility of the audit process.

Price Competition. The Board is concerned that an excessive emphasis on growth and profitability by public accounting firms could result in a deemphasis of the social responsibility of the independent auditor. Moreover, intense price competition for audit clients does damage to both the public image and the self-image of the auditor as an objective professional. Pricing services at or below cost may be perceived as "good business" for the purpose of obtaining clients in industries in which a firm has hitherto not been active. But if this leads to cutting the price of audit services as a regular practice to obtain new clients, the possibility of deterioration in the quality of the audit services then provided cannot be overlooked. Low realization on new clients can put a tremendous strain on the engagement team servicing them. In time, the initial rationale by firm management to charge lower-than-normal fees may become obscured, resulting in pressures being brought on the audit teams to increase the "profitability" of services to the client. In the worst case, this could result in inappropriate shortcuts in performing required audit procedures and a subsequent lowering of audit quality.

Profits in Perspective. Public accounting firms are changing. We see continuing increases in the proportion of total firm revenues provided by management advisory services (MAS) and a decline in the proportion provided by auditing. There is nothing wrong with that, per se, but it does raise a difficult question. Is there a point at which total fees or total net income derived from nonaudit services will lead to decreased attention by top management to the importance of audit professionalism?

Member firms are changing their characters in other ways. As their marketing strategies are expanded with the acquisition of other service organizations, public accounting firms are accelerating their entry into a variety of markets unrelated to accounting and auditing. It is not unusual to see an increasing array of services that are

not derived from the firm's traditional expertise in accounting, auditing, and tax matters associated with the attest function. It is not difficult to visualize the day when independent auditing will be offered as but one of the many services provided by firms in a great variety of product and service markets throughout the world, and it is not difficult to argue that the importance of auditing to firms and to the profession may be diminished under such conditions with a commensurate hazard to the quality of auditing.

Our chairman, in his address to AICPA Council last spring, commented on these changes:

"There is an old golden rule, not the one that we are familiar with, but the one that says 'He who has the gold rules.' As consulting services become a larger part of practices and contribute more to profitability, I think there will be challenges in firms to the leadership of those who have the professional dedication that all of you have to quality auditing services.

That is a long-term problem. I think it is one that the accounting profession must be sensitive to and it must work constantly to assure that there is no diminution for any reason in the quality of audit services that are rendered to the American public and abroad, too, for that matter.

I think it is a matter of psychological versus financial primacy. As more and more firms expand much more quickly their consulting practices than they do their auditing practices, the financial contributions that are made by the non-auditing services will grow proportionately."

Profits and growth are appropriate business objectives and both are necessary to the long-term viability of firms. Therefore, a greater sharing of management decision-making powers with MAS and other non-audit personnel is likely inevitable. However, when pursuing "other" business

objectives, and to serve the public interest well, public accounting firms must take special care to remember that the audit of a public company carries responsibilities beyond those of any other service of the firm. To serve the public well and to meet these professional responsibilities, firms auditing public companies must continually emphasize the significance of their role as independent auditors, and must continue to take whatever steps are necessary to assure that the quality of audit services will not be diminished in any way.

Should the sensitivity of firms to the unique responsibility and privilege placed upon them as independent auditors be diluted, the profession and the business and financial community, as well as society in general, will have lost. As our vice chairman observed in his editorial referred to previously:

"If CPAs ever forget or neglect their responsibilities to society in audit practice, or are perceived to have neglected or forgotten that responsibility, that practice may become restricted, regulated, or withdrawn from their exclusive privilege by the society that granted it and now feels itself ill-served."

Auditor Independence. A segment of the public accounting profession is advocating the acceptability of a limited commercial community of interest with audit clients, such as permitting an auditor to enter into a contractor or subcontractor relationship with an audit client to provide services to a third party, when the fees involved are deemed to be immaterial to both parties. While there appears little danger in the specific proposal at issue, it does chip away ever so slightly at audit independence and one chip tends to beget another. And if the concept of audit independence erodes, it may be difficult to restore. Any change in independence rules requires the most careful consideration, because independence is the hallmark of the auditing profession.

This matter is under consideration by the Securities and Exchange Commission. We have urged the Commission to request public comment to assist it in determining whether the proposal at issue should be favorably acted upon.

Litigation Alleging Audit Failure.

The accounting profession continues to be the target of lawsuits claiming enormous damages for allegedly faulty audits. The Board's oversight activity with respect to the Quality Control Inquiry Committee entails a review of all the complaints that are filed against member firms alleging faulty audits of publicly-held companies. This review indicates that in many cases auditing firms are charged with derelictions when they clearly should not be. Further, while many cases charge some involvement of the auditor in faulty financial reporting, it is clear the main responsibility is not the auditor's.

Regardless of the merits of the charges, any suit results in considerable cost and inconvenience. The AICPA appointed a task force to develop means by which the burden of litigation might be reduced. We encourage that effort, and we urge that the courts move more aggressively to dispose quickly of suits against accountants that are clearly ill-founded. However, it must be recognized that some suits are meritorious, that accounting firms do not and should not escape their responsibility to investors and creditors for the quality of their work, and that inevitably they will be held accountable for faulty work. The possibility of civil litigation may be an inducement for some firms to maintain and strengthen the quality of their audit activity. However, it is clear that the courts have not yet developed sufficient procedures to separate out those suits without reasonable foundation from those having such a basis.

Summary of Board Member Activities -- July 1, 1988 to June 30, 1989

1988

JULY	<ul style="list-style-type: none"> ■ AICPA Governance and Structure Committee Task Force on Self-Regulation and Licensure ■ QCIC Chairman and Staff ■ SEC Chief Accountant and QCIC Representatives ■ AICPA Educational Curriculum Task Force 19 ■ POB Meeting ■ QCIC Meeting 	RETURNED
AUGUST	<ul style="list-style-type: none"> ■ PRC Meeting ■ Peer Review Exit Conference 	NOVEMBER
SEPTEMBER	<ul style="list-style-type: none"> ■ QCIC Task Force Meeting ■ PRC Meeting ■ Planning Committee Meeting 14 ■ POB Meeting 14 ■ QCIC Representatives 14 ■ QCIC Meeting ■ Executive Committee Meeting ■ Peer Review Exit Conference 	DECEMBER
		<ul style="list-style-type: none"> 1 ■ POB Meeting 1 ■ PRC Representatives ■ QCIC Meeting ■ Planning Committee Meeting
		<ul style="list-style-type: none"> ■ Address by POB Vice Chairman to Utah Association of CPAs ■ Executive Committee Meeting ■ PRC Meeting 14 ■ POB Meeting 14 ■ AICPA Officers

Every major financial settlement and every decision against a public accounting firm for investor compensation, justified or not, makes the profession less attractive to students as well as to practitioners. Fortunately for them, those now active in the profession and those preparing for it are also well qualified for alternative careers. Unfortunately for the public, their shifting to other careers will lessen rather than maintain the present quality of auditing services.

























Regulatory Measures Affecting Professionalism. A settlement agreement between the Federal Trade Commission and the AICPA is pending, under which the Institute will remove from its rules the ban on members engaging in certain activities on a contingent fee or commission basis for non-attest clients. The Board does not at this time wish to comment on the wisdom or desirability of

this settlement. However, it is concerned with suggestions made by FTC staff that, in the interests of expanding competition, there should be no barriers against ownership of accounting firms by outside investors.

Similar suggestions have been made in the United Kingdom and in the European Economic Community. The Board believes these proposals are an invitation to disaster. Outside investors in accounting firms would have only one objective, the maximization of profit, and they would not be likely to have as healthy a concern for professionalism and adherence to professional standards in the conduct of audits.

We would hope that governmental authorities and agencies in this country and elsewhere will realize that the public is ill-served by such changes, ostensibly to stimulate competition, that could erode professional commitments and standards. We are

1989

JANUARY	<ul style="list-style-type: none">  POB Meeting  AICPA Officers  Address by POB Chairman to AICPA National Conference on Recent SEC Developments  QCIC Meeting 	APRIL	
FEBRUARY	<ul style="list-style-type: none">  AICPA Board of Directors  PRC Meeting  Planning Committee Meeting 	MAY	<ul style="list-style-type: none">  POB Meeting  FDIC Chairman  Task Force re: QCIC Organizational Document  PRC Meeting  QCIC Meeting  Address by POB Chairman to AICPA Council  POB Meeting  Executive Committee Representatives
MARCH	<ul style="list-style-type: none">  Executive Committee Meeting  QCIC Meeting  POB Meeting  Outreach Meeting in Minneapolis 	JUNE	<ul style="list-style-type: none">  Planning Committee Meeting  POB Meeting  Outreach Meeting in New York City  Executive Committee Meeting  PRC Meeting

 Meeting attended by entire POB.

 Meeting or event attended by at least one POB member.

pleased that there have been some indications by members of the Federal Trade Commission of sensitivity to these concerns.

Mergers of Larger CPA Firms. In recent months, six of the so-called "Big Eight" accounting firms have either merged or announced that they are considering merger. The implications of these events, both in this country and throughout the world, are not yet clear. The impact these mergers may have upon the activities of the SEC Practice Section is now being studied. Since the beginning of the program, these large firms have typically engaged a similar firm to conduct their peer reviews. Some of these firms, for various reasons, have not conducted peer reviews. Hence, attention must be given to the continuing availability of large firms capable of reviewing, and being willing to review, other large firms.

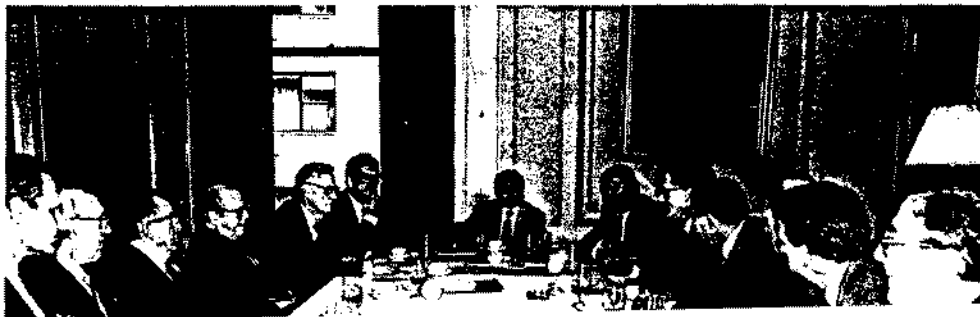
These mergers should not per se result in a diminution of quality auditing by the resulting firms. However, some of the tendencies and trends discussed above may be accentuated by them. We intend to monitor closely the consequences of these mergers and make recommendations, as

applicable, directed at maintaining the quality of the self-regulatory programs of the profession. In discharging our oversight responsibility, we must assure the public that the quality of auditing performed by these firms is not adversely affected.

The Role of Auditing. Our complex economy demands reliable financial data as a basis for the allocation of credit, capital, and resources in general. An indispensable requirement for the effective functioning of our liberal, market-organized, capitalistic economy is accurate, dependable audited financial information about the results of a company's operations. Thus, the independent auditor plays an absolutely necessary role for the successful operation of our capitalistic economy. The public interest and the interest of client managements will not be well served if the quality of auditing services declines.

Society has granted certified public accountants an exclusive franchise to audit financial statements and has allowed the profession, in large measure, to set and enforce its standards. The profession's standard-setting and self-regulatory activities are working and obviate the need for

POB meeting with PRC representatives on November 1, 1988.



public sector legislation and regulatory initiatives. In a real sense, self-regulation benefits society by providing a relatively cost-free control system over activities that could not be controlled as effectively in any other way.

Therefore, loss of auditor independence, or even a perception of a lessening of auditor independence, are problems to which the profession must be sensitive.

We find no evidence that there has been any deterioration in the quality of independent audit services in this country. At the same time, we cannot deny or ignore the potential for deterioration in the trends discussed.

For that reason, those involved in the self-regulatory components of the accounting profession's program must not become complacent about the program's success. A soundly conceived, thoroughly supported, and ever vigilant self-regulatory system is essential to provide the investing public with the quality of service it needs, expects, and demands.

We urge the present leaders of the profession to continue the fine tradition set by their predecessors in utilizing the self-regulatory program to improve the quality of auditing practice in the United States and thus to contribute to the public good.

Finally, a personal note. Because of his retirement, this is the last report of the Public Oversight Board with which Louis W. Matusiak will be associated. Lou capped his long and varied career in accounting with eleven years of service as the first Executive Director of the Public Oversight Board. He is the one who, writing on a clean slate and with no precedents to follow, devised, developed, and directed our oversight programs, and helped develop the role of the Board and the manner in which it interacts with the SEC Practice Section and the relevant divisions of the

AICPA. He has indeed been a pioneer and a seminal thinker, and it is no exaggeration to say that without him the peer review and QCIC programs would not have been the successes they have been.

We salute Lou; we will miss him; we will benefit in the years to come from the tradition of excellence and dedication which he established; and we hope we may continue to call upon him for guidance and wisdom in the acquittance of our duties.

One of the legacies Lou is leaving us is a remarkably dedicated and competent staff. He has brought aboard only the best: our Technical Director Chuck Evers, our two Assistant Technical Directors Alan Feldman and John Cullen—all professionals in the truest sense. We express our admiration of them, we salute them, and in doing so we express our gratitude to Lou for them.

Looking to the future, we are enormously pleased that Jerry D. Sullivan, recently chairman of the Auditing Standards Board as it developed the most important "expectation gap standards" and a partner of Coopers & Lybrand, has agreed to become the executive director of the Board. Jerry is an outstanding professional who will, we are sure, continue the standards of competence and professionalism established by Lou Matusiak.

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OFFICE

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