



Public Oversight Board

SEC Practice Section
American Institute of Certified Public Accountants

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REPORT OF THE PUBLIC OVERSIGHT BOARD

We are pleased to report that during the year ended June 30, 1990, 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 responsibility 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 evaluated the Peer Review Committee's consideration of and actions taken on (a) the results of individual firm peer reviews; (b) revisions to the standards for performing and reporting on peer reviews; and (c) revisions to 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 1989.

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

We monitored the follow-up actions taken by the Peer Review and Quality Control Inquiry Committees to ensure that member firms take corrective actions necessary 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 that member firms have appropriate quality control systems and that they comply with them. Nevertheless, as discussed in this report, we noted areas in which the Section's programs can be improved or made more effective. Consistent with our charge, such matters have been communicated to Section officials.

September 7, 1990

A. A. SOMMER, JR., Chairman

ROBERT K. MAUTZ, Vice Chairman

ROBERT F. FROEHLKE

MELVIN R. LAIRD

PAUL W. MCCRACKEN

**Annual Report
1989-1990**

Public Oversight Board

**SEC Practice Section
American Institute of
Certified Public Accountants**

This is a summary of the Public Oversight Board's twelfth annual report. The complete 1989-1990 annual report has been issued in combination with the SEC Practice Section. Copies are available by writing to the offices of the Public Oversight Board.

About the SECPS and the POB

The SEC Practice Section was founded in 1977 as a voluntary organization of CPA firms striving for professional excellence in the auditing services they provide to Securities and Exchange Commission (SEC) registrant companies. It is part of the Division for CPA Firms of the American Institute of CPAs (AICPA) — the national professional association of almost 300,000 CPAs in public practice, industry, government and education — and is overseen by the Public Oversight Board.

The Section (or the "SECPS") imposes membership requirements and administers two fundamental programs to assure that SEC registrants are audited by accounting firms with adequate quality control systems: (1) peer review, through which Section members have their practices reviewed every three years by other accountants, and (2) quality control inquiry, through which allegations of audit failure contained in litigation filed against member firms are reviewed to determine if the firms' quality control systems require corrective measures.

In January 1990, the nature of the Section changed dramatically when AICPA members adopted a bylaw change mandating SECPS membership for all firms auditing SEC clients. Currently, the requirements of SECPS govern more than 127,000 professionals in 1,041 member firms which audit more than 14,000 SEC registrants.

The Public Oversight Board (the "POB" or "Board") is an autonomous body consisting of five members with a broad spectrum of business, professional, regulatory and legislative experience. The Board's primary responsibility is to assure that the public interest is carefully considered when (1) the SECPS sets, revises and enforces standards, membership requirements, rules and procedures, and (2) the Section's committees consider the results of individual peer reviews and the possible implications of litigation alleging audit failure. To preserve its independence and objectivity, the Board appoints its own members, chairman and staff, and establishes its own compensation and operating procedures.

1990 Board Activities

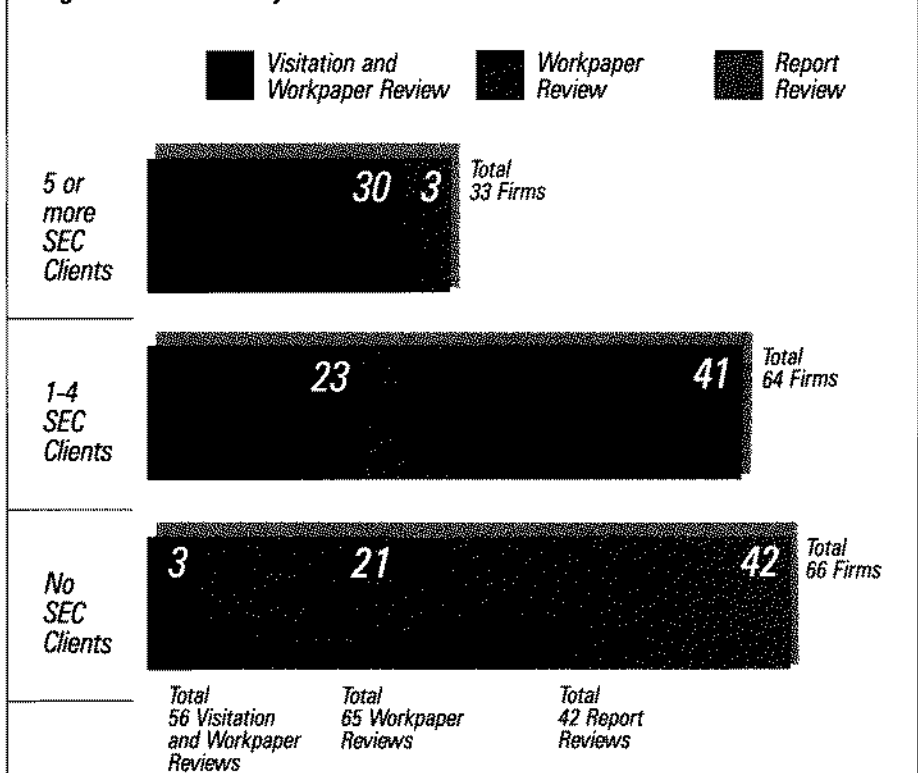
The Board believes it also has a responsibility to consider any criticism which may bear upon the auditor's role. Accordingly, it maintains active relationships with several components and observers of the profession, including the members of the SEC, the Chief Accountant and staff of the SEC, the Comptroller-General of the U.S., the Financial Accounting Standards Board and the Auditing Standards Board. The Board monitors all comments, reports and proposals that these observers issue which affect the profession.

This year, the Board took several initiatives to further strengthen its commitment to represent the public interest. In addition to its regularly scheduled meetings, it met with representatives of SECPS member firms, regulators and others. These discussions helped shape the Board's views on topics such as (1) problems small firms face in identifying independent, partner-level reviewers to conduct mandatory second reviews of SEC engagements, and (2) the private sector project to develop criteria for evaluating internal controls.

In response to the increased volume of peer reviews resulting from mandatory Section membership, which has necessitated a corresponding expansion of the Board's oversight activities, the Board expanded its staff, engaging four former partners from major CPA firms on a part-time basis. This move will enable the Board to continue the extensive scope and high quality of oversight it has conducted over the years.

The POB is proud to announce that this year's recipient of The John J. McCloy Award is LeRoy Layton. The Award was presented to Mr. Layton in recognition of his outstanding contributions to the improvement of audit quality in the U.S. Mr. Layton served as chairman of the Accounting Principles Board, President of the AICPA and a member of The Commission on Auditors' Responsibilities (Cohen Commission). Mr. Layton also distinguished himself as one of the initial members of the Quality Control Inquiry Committee of the SECPS and for his special role as a leader in establishing the QCIC's high standards of performance.

Scope of POB Oversight of 1989 Peer Reviews Classified by Number of SEC Registrants Audited by Reviewed Firm



Oversight of the Peer Review Process

Peer review is the cornerstone of the SECPS's efforts to improve the quality of its members' practices. It involves an independent, rigorous examination of a firm's quality control system for its accounting and auditing practice, as well as its compliance with that system. Every member firm's most recent peer review results — in the form of a report, a letter of comments, which may recommend corrective actions, and the firm's response — are kept in a public file at the AICPA.

The Public Oversight Board devotes substantial resources to monitoring and evaluating the effectiveness of peer review. A Board member attended all but one Peer Review Committee meeting this year, and the Board's staff attended every meeting and provided comprehensive written reports on the Committee's deliberations.

The Board's staff directly oversees each peer review by using one of three types of oversight programs, which vary in intensity according to characteristics of the reviewed firms and the review teams, including their past compliance with quality control and peer review standards, respectively.

In addition, the Board actively monitors the Peer Review Committee's follow-up of corrective actions.

1990 Peer Review Oversight Activities

Visitation and Workpaper Review. Of the 163 SECPS peer reviews conducted in 1989, the Board's staff attended 78 operating office and final exit conferences held in connection with 56 reviews. This program was applied to all but two firms with five or more SEC clients and to a sample of firms with fewer than five SEC clients and some with no SEC clients.

Workpaper Review. This program was applied to 65 reviews, including those of all firms with SEC clients that were not subject to Visitation and Workpaper Review.

Report Review. This program was applied to reviews of 42 firms, none of which served SEC registrant clients.

The SEC, through the office of its Chief Accountant, oversees the peer review process and POB oversight of the process. The SEC's inspection of the 1989 peer reviews is substantially completed, and the Board expects the SEC to again endorse the process.

Commentary on Peer Review

"The Board congratulates the Institute's members for passing the bylaw change mandating SECPS membership for all firms that audit SEC registrant companies. We applaud this display of commitment to the principles underlying the Section's activities."

BOARD CHAIRMAN A. A. SOMMER, JR.

The Board is concerned about the difficulty some firms face in meeting the mandatory concurring review membership requirement. Consequently, it requested that the Peer Review Committee develop a system to help these firms. A bank of approximately 60 firms willing to perform second reviews for other firms' SEC clients is now available and is maintained by the Quality Review Division of the AICPA. While the Board endorses the Section's timely action, it remains concerned about the adequacy of the bank's size.

As of June 30, 1990, four of the 163 reports on peer reviews conducted during calendar 1989 remained unprocessed pending resolution of questions. All such questions have been satisfactorily resolved since then. While the majority of peer reviews are processed expeditiously, the Board urges the Committee to examine its operating procedures to assure prompt consideration of problem reviews and implementation of corrective actions.

Peer Reviews Accepted During Year Ended June 30, 1990

	Initial	Subsequent	Total
Unqualified	28 (78%)	119 (97%)	147 (92%)
Qualified	7 (19%)	4 (3%)	11 (7%)
Adverse	1 (3%)	0 —	1 (1%)
Total:	36 (100%)	123 (100%)	159 (100%)

Peer Reviews Accepted Since Inception

	Initial	Subsequent	Total
Unqualified	485 (84%)	787 (93%)	1,272 (89%)
Qualified	78 (13%)	60 (7%)	138 (10%)
Adverse	16 (3%)	2 —	18 (1%)
Total:	579 (100%)	849 (100%)	1,428 (100%)

The QCIC: A Complement to Peer Review

The Quality Control Inquiry Committee (the "QCIC") complements the peer review process by determining whether allegations of audit failure by member firms indicate either (1) the need for corrective measures for the firm's quality control system or (2) a reconsideration of professional standards.

Under the program administered by the QCIC, SECPS member firms must report certain litigation or proceedings against the firm or its personnel to the QCIC. Originally, the reporting requirement applied only to SEC audit clients, but this was amended to include publicly-held banks and other financial institutions that file with regulatory agencies in lieu of the SEC. In June 1989, the QCIC's jurisdiction was expanded further to allow it to address allegations by regulators of deficiencies in member firm audits of all regulated financial institutions.

The QCIC does not duplicate the work of the courts, the SEC or other regulatory agencies. Those bodies determine whether the auditing firm or individual auditors were at fault and impose punishment. If a firm refuses to cooperate with the QCIC or is unwilling to take actions the QCIC deems necessary, the QCIC can recommend to the SECPS Executive Committee that the firm be sanctioned. To date, every firm has coop-

erated with the Committee and has voluntarily taken the corrective actions recommended by the QCIC.

The Board exercises close scrutiny of QCIC activities. This year, members of the Board's staff, accompanied by a Board member, attended the six QCIC meetings and the staff attended all QCIC task force meetings with representatives of the firms in litigation. The Board also reviews memoranda on each case to determine whether the QCIC is properly fulfilling its responsibilities. Based on these activities, the Board believes that appropriate consideration was given to the 60 cases closed this year. However, the Board urges all firms to develop and comply with procedures that ensure timely reporting of litigation.

Commentary on 1990 QCIC Milestones

"We are pleased that the Chief Accountant's office has now indicated that it believes the QCIC process provides added assurance, as a supplement to the SECPS peer review program, that major quality control deficiencies are identified and addressed in a more timely fashion, and thus the QCIC process benefits the public interest."

BOARD CHAIRMAN A. A. SOMMER, JR.

To respond to the SEC's recommendations, the SECPS this year expanded its

closed case summary, prepared when the QCIC completes an inquiry. The expanded format more clearly delineates the steps taken by the QCIC to determine whether the litigation reviewed suggests any quality control deficiencies and, if so, whether the firm has taken steps to correct them. This year, the SEC's staff visited the POB office on several occasions to review 75 closed case summaries, discuss those cases with Board staff and review Board staff documentation.

Furthermore, the Section is developing a procedure calling for firms in certain circumstances and at the QCIC's discretion to review other engagements of auditors involved in litigated audits to determine if there is a pattern of inadequate performance.

The Board commends the Section and member firms for developing procedures to both give the Commission greater insight into quality control inquiry procedures and make the process even more effective.

Results of QCIC Activity

	11/1/79 through 6/30/89	7/1/89 through 6/30/90	Totals
Actions Related to Firms:			
A special review was made or the firm's regularly scheduled peer review was expanded	35	3	38
A firm took appropriate corrective measures that were responsive to the implications of the specific case	43	10	53
Actions Related to Standards:			
Appropriate AICPA technical bodies were asked to consider the need for changes in, or guidance on, professional standards	36	—	36
Actions Related to Individuals:			
The case was referred to the AICPA Professional Ethics Division with a recommendation for investigation into the work of specific individuals	14	1	15
Total:	128	14	142

(Note: Frequently, more than one action is taken by the QCIC or by the firm.)

Major Corrective Measures Imposed Since Inception to Ensure that Quality Control Deficiencies are Corrected

Action	Number of Times	
	During 1989	Since Inception
Accelerated peer review	1	44
Employment of an outside consultant acceptable to the Peer Review Committee to perform preissuance reviews of all or selected financial statements or other specified procedures	2	19
Revisits by the peer reviewers or visits by a committee member to ascertain progress made by the firm in implementing corrective actions	3	104
Review of the planning for and results of the firm's internal inspection program	24	108
Review of changes made to the firm's quality control document or other manuals and checklists	4	30

POB Commentary on the Accounting Profession

"While our formal charter is to oversee the activities of the SECPS, we strongly believe that we cannot be indifferent to any matters that affect the integrity of the audit process and the public's confidence in it. It little serves the public interest if the peer review and quality control inquiry programs are executed with unsurpassed skill while other practices are eroding confidence in the profession's independence, competence and commitment."

BOARD CHAIRMAN A. A. SOMMER, JR.

Following are excerpts from the Public Oversight Board's commentary, the complete text of which is available in the combined 1989-1990 SECPS/POB report.

Self-regulation, Sanctions and Credibility. The accounting profession has three levels of regulation: government regulation, peer regulation — by such organizations as the AICPA — and private regulation by firms. At the peer and private regulation levels, numerous actions tantamount to sanctions are taken by or imposed on member firms, but none ever receive public recognition. In the Board's opinion, it is time to give the public and other interested parties more information about the extent of sanctions applied at these levels, thereby strengthening the credibility of the entire self-regulatory system.

Mergers of Large CPA Firms. We are pleased that the managements of the newly-merged national firms have taken steps to protect the quality of their audit services by voluntarily accelerating their peer reviews. They are also submitting periodic progress reports to the Peer Review Committee about the implementation of their quality control systems.

Responsibility to Detect Noncompliance with Laws and Regulations. As these comments are written, the AICPA, representatives of the profession and key committees of Congress are close to agreement on legislation relating to auditors' responsibilities in a number of important areas. Among other things, the legislation would require auditors to identify illegalities that have a direct and material effect on the financial statements and to report certain illegalities to regulators.

We are pleased that this accommodation may be reached, and believe that the legislative package in its entirety will likely further protect those who rely on audited financial statements.

In light of this legislative effort, it is particularly important that the public and

Congress recognize the significant limitations on the ability of auditors to identify illegalities. An audit will not inevitably ferret out most illegality. Most laws and regulations do not have a direct and material effect on the financial statements. Unless the auditor's responsibilities are both realistically defined and understood the expectation gap that presently haunts the profession, and brings in its wake public disappointment and professional frustration, will only widen.

Reports on Internal Controls. The aforementioned legislation would also require management and auditors to report on internal control effectiveness. The Board has observed that existing management reports on internal control effectiveness vary significantly in style and content. Absent reporting standards, managements of reporting entities will be on their own in determining what information to include and how to communicate it, leading to inconsistent and potentially confusing discussions. In recognition of this problem, the Board has urged the Sponsoring Organizations of the Treadway Commission to develop management reporting standards as part of their project to develop guidance on internal controls for use by the private sector.

FASB and International Accounting Standards. Concern has recently been expressed that the complexity and costs of implementing U.S. generally accepted accounting principles may have an increasingly important and undesirable impact on the competitiveness of U.S. businesses in international markets. This concern has placed some pressure on the Financial Accounting Standards Board to tailor present or proposed standards to international norms. The Board believes such pressure, from whatever source, could have unfortunate results. While the harmonization of international standards is a laudable goal, it should not be achieved by relaxing U.S. accounting standards to stimulate foreign access to our markets or to

achieve other special interest objectives.

FASB Agenda. Notwithstanding the fortitude the FASB has displayed in dealing with controversial and conceptually difficult accounting and reporting issues, we believe there is an important matter that to date has not received sufficient attention. The 1987 report of the AICPA's Task Force on Risks and Uncertainties underscored the inadequacies of risk disclosures in financial statements and urged the FASB to consider practical ways of requiring disclosures to provide more discussion of the issues involved. The FASB recently issued guidance on disclosing information about financial instruments with off-balance-sheet risk and those with concentrations of credit risk. That guidance does not address the numerous accounting issues relating to the initial and subsequent measurement of financial instruments. There is a dire need to address these issues.

The S&L Crisis. No doubt regulatory and judicial proceedings will eventually provide a clearer picture of the actions necessary to avoid similar debacles elsewhere. While it may be premature to suggest a full list of reforms, the Board believes that there are two matters associated with the S&L failures that demand attention.

First, many S&Ls did not have independent audit committees to bridge the governance gap between managements and regulators. Would audit committees for S&Ls have made a difference? Yes. Would they have prevented the crisis? Hardly. Yet we are confident that alert and independent audit committees could have reduced the magnitude of the losses. Effective audit committees, at least in some cases, would have applied a brake on the risky investments and abuses by management.

Second, the Board believes that the auditing profession should assume increased responsibility for evaluating and reporting management abuses of corporate assets by officers, such as investments in and "personal" use of collectible automobiles, art objects and resort condominiums. We believe that this is a logical and sensible extension of an audit of financial statements because it involves the ethical values and integrity of management which should be evaluated by the auditor during the audit process.

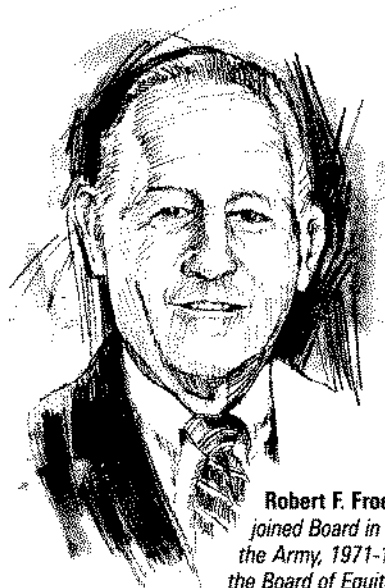
Members of the Public Oversight Board



A. A. Sommer, Jr., Chairman, 1986-present; joined Board in 1983; SEC Commissioner, 1973-1976; Partner in Washington, DC law firm of Morgan, Lewis & Bockius specializing in securities law.



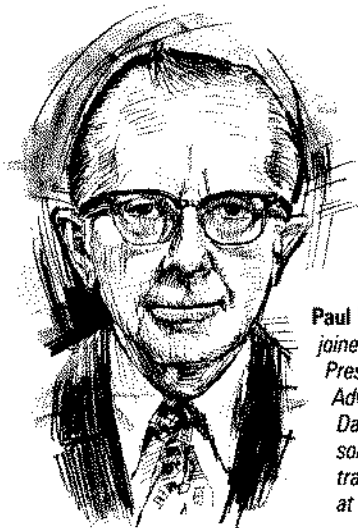
Robert K. Mautz, Vice Chairman, 1987-present; joined Board in 1981; Partner, Ernst & Whinney, 1972-1978; Professor Emeritus of the University of Illinois and the University of Michigan.



Robert F. Froehlike, joined Board in 1987; Secretary of the Army, 1971-1973; Chairman of the Board of Equitable Life Assurance Society, 1982-1987; President and CEO of IDS Mutual Fund Group.



Melvin R. Laird, joined Board in 1984; nine-term U.S. Congressman, 1953-1969; Secretary of Defense, 1969-1973; Counsellor to the President, 1973-1974; Senior Counsellor for National and International Affairs, The Reader's Digest Association, Inc.

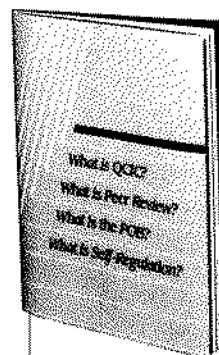


Paul W. McCracken, joined Board in 1985; Chairman of the President's Council of Economic Advisers, 1969-1971; Edmund Ezra Day Distinguished University Professor Emeritus of Business Administration, Economics and Public Policy at the University of Michigan.

Staff

JERRY D. SULLIVAN, Executive Director
 CHARLES J. EVERS, Technical Director
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"What is QCIC? What is Peer Review? What is the POB? What is Self-Regulation?" has recently been published and is targeted to SECPS

member firms, legislators, regulators and academics. It explains the self-regulatory process and the environment in which it operates. Copies can be obtained by writing to the POB offices.