



ANNUAL REPORT / 1990-1991

PUBLIC OVERSIGHT BOARD

SEC Practice Section

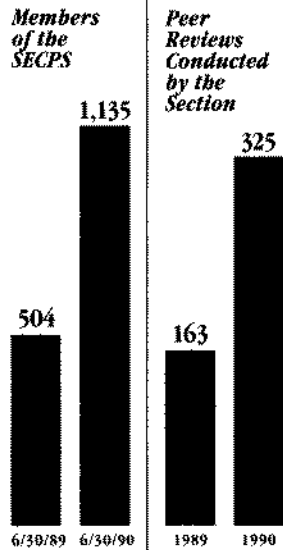
***American Institute of
Certified Public Accountants***

he staff of the Office of the Chief Accountant has noted significant improvements in the quality of the documentation provided to it by the QCIC. This improved documentation, along with discussions with the POB, allows the staff to better understand the QCIC process. The Commission believes that the process provides added assurances, as a supplement to the SECPS peer review program, that major quality control deficiencies, if any, are identified and addressed in a more timely fashion. Therefore, the Commission believes that the QCIC process benefits the public interest.

This is a summary of the Public Oversight Board's thirteenth annual report. The complete 1990-1991 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.

Impact of Mandatory SECPS Membership

The most important factor driving the Public Oversight Board's activities in 1990-1991 has been the increase in SECPS membership and the related expansion of oversight responsibility caused by the January 1990 AICPA bylaw change. That change mandated SEC Practice Section membership for all firms in the AICPA that audit SEC clients and has dramatically affected the Section and its peer review program. As of June 30, 1991, 1,135 firms were members of the SECPS, compared with 504 in June 1989. More significantly, the number of peer reviews conducted by the Section doubled from 163 in 1989 to 325 in 1990. In 1991, 392 firms will undergo reviews; for 306 of these firms, this will be the first independent review of their quality control systems. Because of this substantial rise in Section membership and the coincident increase in peer review oversight, the Public Oversight Board has taken steps to ensure that its responsibilities are fulfilled in a manner that safeguards the public interest.



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 more than 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 ensure 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, which reviews allegations of audit failure contained in certain litigation filed against member firms to determine if the firms' quality control systems require corrective measures.

Currently, the requirements of the SECPS affect more than 113,000 professionals at 1,135 member firms, which audit more than 14,200 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 safeguard the public interest (1) when the SECPS sets, revises and enforces standards,

membership requirements, rules and procedures, and (2) when the Section's committees consider the results of individual peer reviews and the possible implications of litigation alleging audit failure. The Board also evaluates whether SECPS peer reviews are conducted by carefully trained professionals possessing the requisite objectivity and skill. To preserve its independence, the Board appoints its own members, chairman and staff, sets its compensation, and establishes its own operating procedures.

Board Activities

The Board acknowledges its responsibility to consider the integrity of the audit process from the broadest possible perspective. Accordingly, it maintains active relationships with organizations that scrutinize the profession, including the Securities and Exchange Commission, 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. In its deliberations, the Board carefully considers all comments, reports and proposals that these bodies and authorities publish which may affect the profession.

In addition to its six regularly scheduled meetings, this year the Board met with representatives of the largest SECPS member firms, regulators and other constituents. The Board also held an "outreach program" with the Illinois Society of CPAs, at which it met with leaders of large and small SECPS member firms. All these discussions helped shape the Board's views on topics such as the current economic environment and its impact on firms' audit practices, the significance of accounting standards-setting efforts to resolve issues concerning "mark to market" accounting, the need for understandable standards to facilitate consistent evaluations of internal control by public companies and their auditors, and the importance of decisive action by the profession to enhance auditors' independence for financial institution engagements.

This year the Board spoke out on several occasions on matters affecting or potentially affecting the independent audit function. In early January, the Board wrote to the chief executive officers of the 20 firms then represented on the SECPS Executive Committee, urging that great care be exercised in audits of financial institutions and that financial statement disclosures adequately communicate the risks and uncertainties inherent in balance sheet asset valuation. In March, the Board asked the SECPS to proscribe professionals in Section member firms from borrowing from financial institution clients in order to maintain independence in fact, and also, the public's perception of it. Before the Section could implement this recommendation, the AICPA's Ethics Committee took decisive action on this matter and proposed a proscription for the entire profession. Finally, the Board wrote to the Auditing Standards Board with observations on two proposed statements on auditing standards and to the Committee of Sponsoring Organizations of the



Treadway Commission (COSO) on its exposure draft "Internal Control—Integrated Framework." The Board's concerns about the COSO exposure draft are referred to in the commentary section of this report.

To maintain the intensity of its oversight activities in the face of surging membership, this year the Board again expanded its staff, engaging and training three recently retired partners from SECPS member firms to supplement—on a part-time basis—the four permanent and four part-time staff who conduct peer review oversight. The new part-time staff are located in geographic regions with high densities of member firms, which will help minimize the costs associated with the oversight program. These staff additions will enable the Board to continue its tradition of close and rigorous oversight despite the record number of reviews scheduled for 1991.

It is the Board's opinion, based on its intensive oversight, that the SECPS self-regulatory program contributes significantly to the quality of auditing in the U.S., particularly the quality of public company audits. The Board is pleased that the SEC shares this view, and that a growing number of other regulatory agencies have required triennial peer reviews for firms performing audits under their jurisdiction.

The POB is proud to report that this year's recipient of The John J. McCloy Award was Thomas L. Holton. The Award was presented to Mr. Holton in January in recognition of his outstanding contributions to the improvement of audit quality in this country. The first codification of U.S. auditing standards was completed during his tenure as chairman of the AICPA Auditing Standards Executive Committee. Mr. Holton also chaired the AICPA Special Committee to Study Quality Review for Multi-Office Firms, which helped shape the profession's peer review program.

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. Each 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, and are available for inspection.

The Public Oversight Board carefully monitors and evaluates the effectiveness of peer review. Board members and staff attend all Peer Review Committee meetings, and the Board's staff provides comprehensive written reports on the committee's deliberations.

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

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 and past compliance record of the reviewed firms and the review teams.

Peer Reviews Accepted

Unqualified
Qualified
Adverse
Total:

Peer Reviews Accepted

Unqualified
Qualified
Adverse
Total:

Peer Review Oversight Activities

Visitation and Workpaper Review. This is the most intense level of oversight. Of the 325 SECPS peer reviews conducted in 1990, the Board's staff attended 85 operating office and final exit conferences held in connection with 70 reviews.

Workpaper Review. The POB conducted a thorough examination of all workpapers and reports of 137 firms, including virtually all the reviews of firms that audit SEC clients which were not visited.

Report Review. For the remaining 118 firms, the Board reviewed reports and selected peer review workpapers.

Because of the dramatic increase in the volume of peer reviews resulting from mandatory SECPS membership, the number of POB staff visitations to firms undergoing peer reviews has risen from 56 in 1989 to 70 in 1990. Of those 1990 visitations, 44 involved member firms that had never undergone an independent review of their quality control systems.

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 1990 peer reviews is substantially complete, and the Board expects the SEC to again endorse the process in its annual report.

Commentary on Peer Review

The Board has identified two ways to strengthen an already sound peer review process. The first, addressed in last year's report, concerns the length of time taken to process certain reviews. As of June 30, 1991, nine of the 325 reports on 1990 reviews were not yet complete. In each case, the reviewed firms failed to respond on a timely basis to requests for information. The Board has communicated its suggestions for expediting review processing to the Section's Peer Review Committee.

The Board also believes that peer review letters of comments should communicate review findings clearly, not only to the firm's management and the Peer Review Committee, but also to audit committee members and other public users. However, the brevity of the commentary in some letters might lead to misunderstandings

Oversight of 1990 Peer Reviews Classified by Registrants Audited by Reviewed Firm

'10/ Total 28 Firms	■ Visitation and Workpaper Review / 8	114 / 12 /
	■ Workpaper Review / 70	
48 /	Report Review	Total 174 Firms
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106 /	Total 123 Firms	
Visitation paper Reviews	Total 137 Workpaper Reviews	Total 118 Report Reviews

During Year Ended June 30, 1991

	<i>Initial</i>	<i>Subsequent</i>	<i>Total</i>
.....	88 (88%)	206 (95%)	294 (93%)
.....	10 (10%)	10 (5%)	20 (6%)
.....	2 (2%)	0 —	2 (1%)
.....	100 (100%)	216 (100%)	316 (100%)

Since Inception

	<i>Initial</i>	<i>Subsequent</i>	<i>Total</i>
.....	592 (85%)	995 (93%)	1,577 (90%)
.....	89 (13%)	70 (7%)	159 (9%)
.....	19 (2%)	2 —	21 (1%)
.....	690 (100%)	1,067 (100%)	1,757 (100%)

by those not familiar with the procedures and the terms used in connection with peer reviews. In response to this concern, the Peer Review Committee will reconsider the standards for preparing letters of comments this year.

The QCIC: A Complement to Peer Review

No matter how strongly peer review encourages firms to maintain effective quality controls, business and other failures occur—and lawsuits often follow. When a lawsuit involving, generally, a public company is filed against an SECPS member firm or its personnel, the firm must report it to the Section within 30 days.

The Quality Control Inquiry Committee (the "QCIC"), which receives these reports, complements the peer review process by considering whether allegations of audit failure by member firms indicate either (1) an aberrational error, (2) a shortcoming in the firm's quality controls or its compliance with them, or (3) a need to reconsider professional standards.

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. Rather, the QCIC decides whether deficiencies exist in the defendant firm's quality control system and, if so, recommends corrective actions. If a firm refuses to cooperate with the QCIC, the QCIC can recommend to the SECPS Executive Committee that the firm be sanctioned. To date, no such action has ever been necessary.

The Board exercises close scrutiny of QCIC activities. This year, members of the Board's staff, usually accompanied by a Board member, attended the five QCIC meetings and nearly all QCIC task force meetings with representatives of the firms reporting litigation. The Board also reviews memoranda on each case to determine that the QCIC properly fulfills its responsibilities. Based on these activities, the Board believes that appropriate consideration was given to the 51 cases closed this year, and that the QCIC adequately complements the peer review process.

Commentary on the QCIC

The Board identified several initiatives that can improve the effectiveness of QCIC activities, and communicated these to the QCIC chairman. In particular, the Board recommended that prior to meeting with representatives of a firm reporting litigation, the QCIC staff should obtain more data about the firm's quality controls and the environment in which the allegedly faulty audit was conducted. The Board also urged the QCIC to review its policies for the inspection of documentation, such as firm guidance and policy relating to the allegation. The QCIC considered these suggestions in August 1991 and is acting on them.

The Board commends member firms for having improved their procedures for reporting cases to the QCIC on a more timely basis, an area noted for improvement in last year's report.

This year, the QCIC established a new requirement short of a "special review"—it can now request other engagements conducted by the engagement team to be inspected by the firm under QCIC direction to determine if any corrective action is needed to improve compliance or understanding of quality controls. Moreover, if the committee decides that such inspection is unnecessary in defined circumstances, it must give its reasons in the "closed case summary," to which the SEC has access. This closed case summary and the Board's completed oversight program are made available to SEC staff. This year, the office of the Chief Accountant of the SEC reviewed 29 cases closed in 1990-1991.

Results of QCIC Activity

	<i>11/1/79 through 6/30/90</i>	<i>7/1/90 through 6/30/91</i>	<i>Totals</i>
Actions Related to Firms:			
Either a special review was made, the firm's regularly scheduled peer review was expanded or other relevant work was inspected.	38	7	45
A firm took appropriate corrective measures that were responsive to the implications of the specific case.	53	8	61
Actions Related to Standards:			
Appropriate AICPA technical bodies were asked to consider the need for changes in, or guidance on, professional standards.	36	3	39
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.	15	1	16
Total:	142	19	161

(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

<i>Action</i>	<i>Number of Times</i>	
	<i>During 1990</i>	<i>Since Inception</i>
Accelerated peer review	1	45
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.	4	33
Revisits by the peer reviewers or visits by a committee member to ascertain progress made by the firm in implementing corrective actions. . .	4	124
Review of the planning for and results of the firm's internal inspection program	36	125
Review of changes made to the firm's quality control document or other manuals and checklists.	4	38

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POB Commentary on the Accounting Profession

While the POB's formal charter is to oversee the activities of the SECPS, the Board also recognizes its responsibility to monitor and, when appropriate, to comment on matters that may affect the integrity of the audit process and the credibility of financial statements. The Board believes it would ill serve the public interest if the quality control process were a model of efficiency and integrity while other forces and circumstances destroyed the profession's or the public's confidence in it. Hence, we feel constrained to include in this report the following comments.

Auditor Independence. Auditor independence presumes integrity, objectivity and the ability to make unbiased judgments about the proper application of GAAP to client financial statements. Historically, these judgments are the sternest tests of independence, as they are often made in the face of strong, often adversarial, management opinion. Not surprisingly, these judgments are at the heart of auditor independence—and are the focus of most allegations of audit failure.

In the aftermath of the economic boom of the 1980s and the ensuing recession, and especially because of the "S&L crisis," allegations of audit failure naturally followed. Today, standards for the performance and independence of auditors are constantly challenged and cries for change are heard in the Congress and echoed in the media.

The Board has observed through its oversight of QCIC proceedings that relatively few allegations of audit failure involve matters about which the auditor was unaware. In nearly all QCIC cases the audit procedures applied detected the nature of the transactions that are being contested in lawsuits. Rather than the auditors "missing" problems, most allegations involve matters that the auditor has considered and reached a judgment about. When entities subsequently encounter economic difficulties, these judgments can be, and often are, challenged by shareholders, creditors or other third parties suffering economic loss.

The Board is not surprised that in these challenges, hindsight frequently prevails. Experts analyzing past auditor decisions often disagree with judgments made on the firing line. In financial institutions, for example, auditor judgments reached early in the decade about asset value, particularly involving real estate, and recoverability are now considered fair game for criticism. Yet the fact that today's values have dropped precipitously since the time the auditor reached an opinion does not alone support an allegation of audit failure.

While the Board recognizes that some aberrant decisions have led to widespread criticism of the auditing function, we believe that these scattered incidents do not reflect a fundamental flaw in the profession or its practices and, therefore, fail to justify taking drastic and ill-conceived steps to improve auditor independence.

Nevertheless, all of this suggests that when applying professional judgment the importance of every professional maintaining a healthy degree of skepticism and being unrelenting in approaching difficult and complex financial statement issues—despite client tensions and outright disagreements—must be continually stressed and focused upon. Auditors must insist on the most appropriate application of GAAP and not accept a presentation designed without regard to the intent of the rules. They must require unbiased estimates that reflect the most probable outcomes. And they must demand disclosures that fully describe the risks and uncertainties about asset recoverability. To do otherwise, even when "permitted" by accounting standards, is to risk damage to the profession and to the firm itself.

When auditors insist upon the most appropriate financial presentation there are occasional tensions with clients. We recognize that these client encounters are difficult. More important, they are often the sternest test of auditor professionalism, in the final analysis what independence is all about.

QCIC Lessons. This year, the Board published "Evolution of the Quality Control Inquiry Committee" by Robert K. Mautz and Charles J. Evers to memorialize this important component of the profession's self-regulatory program. The booklet also describes how the profession reconciled two conflicting forces: the protection of the public interest on the one hand and, on the other, the right of a firm to mount a vigorous defense against audit failure litigation. The Board is confident that the current QCIC process balances the interests of all parties, but believes that the committee will continue to evolve as it has over the past 12 years.

To that end, the Board believes now is a good time to "step back" and assess whether the QCIC cases collectively suggest matters that Section member firms should consider. Below are the results of this preliminary analysis of QCIC cases closed over the last three years:

- Approximately 55% of the cases allege inadequate response by the auditor to client internal control deficiencies.
- Approximately 33% of the cases allege failure by the auditor to detect the consequences of management fraud.
- The probability of a public company auditor being named in a complaint increases by 600% after the auditor/client relationship has been terminated.
- The probability of a successor auditor being named in a complaint is 300% higher than the probability of an action being brought against continuing auditors of public companies.
- In about 33% of the cases, the engagement team consulted at the regional or national office level with other knowledgeable experts about matters alleged in complaints.

The results of this summary suggest that a comprehensive database about QCIC cases may help the profession to better understand the implications of litigation and perhaps assist in identifying possible actions to reduce the likelihood of litigation. The Board is presently designing its specifications for such a database.

Auditor Litigation. The Board believes that the litigation besetting the profession is perhaps its most far-reaching and pervasive problem. It has been suggested that the financial risk stemming from court judgments may be deterring the most talented students from pursuing accounting careers. The recent bankruptcy of a large firm and the ensuing claims against its partners surely give substance to these concerns.

While the Board believes on the basis of its oversight activities that auditor liability does not stem from deficiencies in firms' control systems, there is evidence that individuals do occasionally

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depart from compliance with these systems or make serious mistakes of judgment that subject them and their firms to liability. No quality control system can prevent these aberrations.

There is also evidence that often auditors are charged in cases where they have limited responsibility for losses suffered by investors, and yet, if other defendants are insolvent, the entire burden of damages falls upon the auditors.

During this coming year, the Board, in addition to developing the database discussed above, intends to study the effects of suits against auditors upon the profession and its implications for future audit quality. The public interest demands a strong accounting profession willing to express meaningful opinions upon which the public may rely in making credit and investment decisions, a profession made up of talented and dedicated men and women unafraid that the aberrational conduct of a partner thousands of miles away may inflict financial ruin upon him or her. We believe our proposed inquiry is demanded by the public interest.

Reports on Internal Control. In its 1989-1990 annual report, the Board observed that existing management reports on internal control effectiveness vary in style and content. Consequently, the

Board urged the Committee of Sponsoring Organizations of the Treadway Commission (COSO) to develop management reporting standards when it developed guidance on internal controls in the private sector. The Board is pleased that COSO included such reporting guidance in its March 12, 1991 exposure draft.

However, the Board also believes that the COSO exposure draft has serious potential for misunderstanding that can lead to false expectations about the effectiveness of the internal controls if and when they are reported on. Most notably, the Board believes the draft does not provide sufficient explanation of the nature and limitations of internal controls. In addition, it includes internal control "components" that are not susceptible to objective evaluation, and proposes a measurement and reporting criteria method that may imply an unrealistic level of reliability in the internal control systems of many reporting entities.

The Board has provided COSO with a comment letter expressing its concerns about the exposure draft standards and containing suggestions that recognize the nature, differences and limitations of internal control systems. We urge COSO to give careful consideration to our comments.

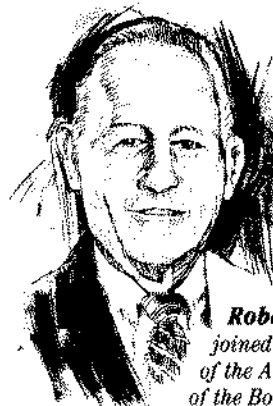
Members of the Public Oversight Board



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. Froebke,
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.

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