

SEC Practice Section

*American Institute of
Certified Public Accountants*

**Accounting firms face
more than 3,000 suits
seeking up to \$13 billion**

**Liability cover
for accounting
firms growing
hard to find**

**CPA insurance soars
as claims take off**

Peat chief attacks legal crisis

**Legal-liability awards are frightening
smaller CPA firms away from audits**

Litigation—A Crisis and An Opportunity

In the estimation of the leadership of the accounting profession, the present flood of litigation assailing accounting firms and the multi-million dollar judgments and settlements resulting constitute a grave danger to the continued viability of the accounting profession as it presently exists and to its ability to perform its vital function of providing assurances of the integrity of financial information relied upon by investors and creditors.

While the Public Oversight Board's most immediate responsibility is oversight of the programs of the SEC Practice Section of the AICPA's Division for CPA firms, it believes—and has repeatedly said—that it cannot be indifferent to any situation or occurrence that may adversely affect the integrity, the utility and the reliability of the audit function or the ability of members of the accounting profession to perform that function.

In the face of the concerns of the profession, and our own perception of the significance of the litigation against accounting firms, the Board determined it cannot be a mere spectator, but must assess this problem in the light of the public interest. The Board's responsibility is to the public; that responsibility cannot be separated from concern with the fate of the accounting profession and its ability to continue to provide quality audit services.

Thus, the Board has carefully studied the accounting profession's litigation problem to determine whether it may adversely affect the public interest. To complete its study, members of the Board and its full-time staff met for two days in a setting that permitted an uninterrupted examination of the accounting profession's liability concerns in the context of its current and prospective performance of the audit function. Members of our staff, whose professional backgrounds and continuing oversight activities uniquely equip them to do so, spent considerable time in developing an appropriate agenda. To reduce the possibility of overlooking important matters, we invited thoughtful and provocative thinkers who share our concerns about the accounting profession but who approach them from various backgrounds and positions to provide us with suggestions about the matters that should be discussed. We are deeply indebted to them for sharing their insights and their experience with the Board and staff.

The Board concluded that the public interest is adversely affected by the present litigation threat confronting the profession. The reasons for this conclusion will be set forth in detail in a special report which the Board expects to publish early in 1993. In brief, these include the problems which would flow from the failure of a major firm; the impact of litigation on recruitment and retention of trained and competent personnel; the unwillingness of firms to assume responsibility for the audit of smaller firms and firms in their early stages which pose greater risks of failure; the hesitancy of the accounting profession to assume new responsibilities because of litigation fears; and the possibility that firms may eventually be unwilling to give the assurances they have traditionally provided to American industry, its investors and its creditors.

However, the Board concluded that the litigation problem cannot be considered apart from the widespread feeling in many quarters that independent auditors as a group have not met either their audit responsibilities or the expectations of investors and creditors as fully as they should. Concurrently with efforts to secure legislation that will sensibly limit the exposure of the profession to liabilities that exceed the extent of their responsibilities, we believe the profession must also address these beliefs concerning the adequacy of auditor performance.

As we have studied this public concern, it appears it may stem from a number of circumstances. For the moment, it appears to us

the principal ones are these. The first is the alleged failure of generally accepted accounting principles to provide financial statements that understandably and realistically present financial condition, results of operations, and the probability of continuing viability for the reporting company. The failure of accountants to communicate clearly to the general public the nature and extent of assurance an audit can provide to readers of financial statements is the other, and particularly the limited extent of that assurance about some assertions imbedded in financial statements. Independent accountants do sometimes fail to perform their audit function in an exemplary manner. Far more often, however, they are accused and held responsible for events and conditions beyond their ability to foresee or forestall.

We believe the task of restoring public confidence in the profession and its willingness to face its responsibilities requires that the profession find a means of going beyond what the SEC Practice Section's Quality Control Inquiry Committee presently does—inquire whether litigation against a firm indicates a quality control problem. The purpose of such expanded inquiry would be to accumulate knowledge which would permit the refinement of accounting principles and auditing standards in the light of hard experience; and also to provide guidance to all practitioners about risks that they should address in planning and performing audits. This must be done without jeopardizing the litigation posture of firms charged with audit failures. To do so will require imagination and courage. We are confident means can be found to do it.

The accounting profession's present self-regulatory program has already had a profound and exemplary impact on the quality of independent auditing in this country. We are confident that program can be strengthened further. The profession has been remarkably responsive to suggestions for its improvement, and we are confident that it will accept suggestions for further improvement if these are realistic.

In the near future, we expect to propose to the leadership of the profession, regulators, and legislators measures that we think will strengthen both the quality of audit performance and the reality of auditor responsibility. In return we hope and expect that the present unfair and unconscionable burdens of class action litigation against accountants should be mitigated materially.

Our chairman, Mr. A. A. Sommer, Jr., recently offered a suggestion for a possible course of action for the Board and the profession in a speech to the American Accounting Association on "The Challenge of Accountability." A portion of Mr. Sommer's remarks are included in the POB Commentary on the Accounting Profession section of this report.

About the SECPS and the POB

The SEC Practice Section (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 involving a publicly-held entity contained in litigation filed against member firms to determine if the firms' quality control systems require corrective measures.

The Public Oversight Board (POB) is an autonomous body consisting of five members with a broad spectrum of business, professional, regulatory and legislative experience that oversees the SECPS activities. 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

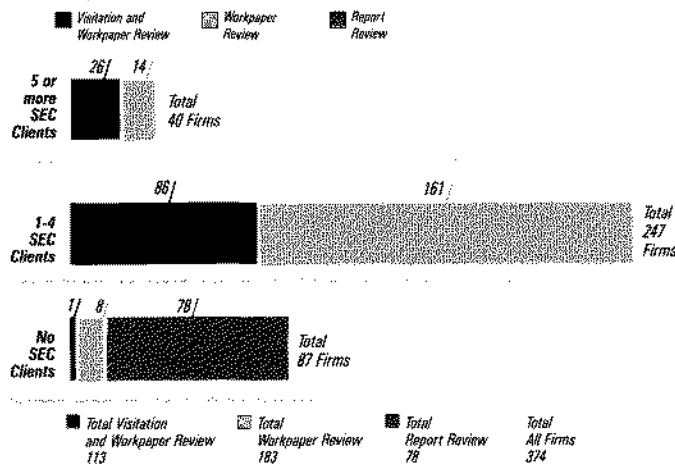
peer reviews and the possible implications of litigation alleging audit failure. As mentioned earlier, the Board believes its responsibilities also include the monitoring of all matters and developments which may affect the integrity of the audit process and, where appropriate, remarking upon them. To preserve its independence, the Board appoints its own members, chairman and staff, sets its own compensation, and establishes its own operating procedures.

Board Activities

The Board maintains active relationships with organizations that scrutinize the profession, including the Securities and Exchange Commission, the General Accounting Office, the Auditing Standards Board, and the Financial Accounting 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.

Altogether, the Board met seven times this year. In connection with these meetings, the Board met with the Comptroller-General of the U.S., the Chief Accountant of the SEC, the President of the Financial Accounting Foundation, the general counsels of two of the largest SECPS member firms, the Planning Committee of the SECPS, and the Chairman, President and other officials of the AICPA. The Board also held three "outreach programs" at which it met with leaders of large and small SECPS member firms who are members of the Wisconsin, California, and Pennsylvania societies of CPAs. All these discussions helped shape the Board's views on a number of topics relating to the SECPS self-regulatory programs as well as other matters relating to audit quality.

Scope of POB Oversight of 1991 Peer Reviews by Number of SEC Registrations Audited by Reviewed Firm



Last year the Board provided extensive suggestions to the Committee on Sponsoring Organizations of the Treadway Commission (COSO) on its initial exposure draft "Internal Control-Integrated Framework." In April 1992, representatives of the Board met with representatives of COSO to express two continuing concerns the Board has with the February 1992 revised draft report exposed for public comment. First, the February draft seems to exempt small public companies from the need to have audit committees as a part of their corporate governance structure. Our research of Quality Control Inquiry Committee cases suggests that there is a higher incidence of fraudulent financial reporting among smaller public companies which suggests that these entities would benefit from improved corporate governance provided by independent directors overseeing the financial reporting process. The final report of COSO issued in September 1992 has been revised to point out the critical importance of independent directors in overseeing the financial reporting process of smaller and mid-size public entities.

Our second concern is that COSO's guidance in both its February draft and its final report on reporting to external parties about the quality of an entity's internal controls will likely result in "boilerplate" assurances being provided as only the existence of material weaknesses need be reported. The occurrence of material weaknesses are relatively infrequent and the material weakness concept does not apply to some of the components of internal control identified in the COSO report. The Board believes that when significant weaknesses exist, as they often do, below the material weakness threshold in any component of internal control their existence should be acknowledged in a report to external parties.

To maintain the comprehensiveness of its oversight activities in the face of a record number of SECPS peer reviews, the majority of which were initial reviews of firms which joined pursuant to the 1990 AICPA bylaw change mandating membership in the SECPS for all firms in the AICPA that audit SEC clients, the Board trained and supervised seven retired partners from SECPS member firms, who assisted the four permanent staff members in the oversight of the 1991 peer review program. The part-time staff reside in geographic regions with high densities of member firms, which helped to minimize the costs associated with oversight of the program. The Board continues to use part-time staff in 1992.

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.

The POB is proud to report that this year's recipient of the John J. McCloy Award for Outstanding Contributions to Audit Excellence was Ms. Barbara Franklin, who is currently the U.S. Secretary of Commerce. The presentation was made in January before she assumed her present office in recognition of her outstanding contributions to the improvement of audit quality in this country. She has served as a director of several major U.S. corporations, regularly serving on their audit committees and frequently as chairperson of the committee. In addition, Ms. Franklin contributed to the enhancement of audit quality through her service as a member of the AICPA's Auditing Standards Board Planning Committee, as a public member of the AICPA's Board of Directors, and as chairperson of its audit committee.

Oversight of the Peer Review Process

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

One or more Board members and staff members of the Board attended the meetings of the Peer Review Committee. The Peer Review Committee evaluates each report to determine whether the review team appropriately applied peer review standards. Each evaluation is based in part on the review, conducted by the committee's staff members, of some or all of the review team's workpapers and reports. In addition, the Board actively monitors the committee's follow-up of corrective actions.

Peer Review Oversight Activities

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

Visitation and Workpaper Review Program. This involves observation of the performance of field work, attendance at the exit conference during which the review team reports its findings and recommendations to the management of the reviewed firm, and review of the review team's workpapers and reports and the reviewed firm's response.

Workpaper Review Program. This consists of the review of the review team's workpapers and reports and the firm's response.

Report Review Program. This entails review of selected portions of the review team's workpapers, its reports, and the firm's response.

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 1991 peer reviews is substantially complete, and the Board expects the SEC to again endorse the process in its annual report.

Commentary on Peer Review

During the 1991-92 year, 300 firms had their initial peer review. These peer reviews resulted in a 25% rate of qualified or adverse reports and the finding that over 5% of peer reviewed audit engagements were seriously flawed. Consequently, the firms involved were required to undertake substantial corrective measures to improve their quality of practice and eliminate the deficiencies on the flawed engagements. Since the inception of the peer review program in 1977, firms undergoing reviews subsequent to their initial review have had a 7% rate of qualified and adverse reports and a percentage of flawed engagements approximating 1%. The high rate of qualified or adverse reports for first time reviews indicates clearly the wisdom of the AICPA in requiring that all firms with AICPA members which audit publicly-held companies must join the SECPS. The contrast with the number of qualified or adverse reports and flawed engagements resulting from subsequent reviews indicates plainly the remedial benefits of the peer review program.

The Board identified two areas of concern in its 1990-91 annual report: the length of time taken to process certain reviews and the clarity of peer review letters of comments in communicating review findings.

The Board's staff worked closely with the Peer Review Committee and its staff in developing a system to identify, on a timely basis, those peer reviews with issues that may be difficult to resolve. This year in those cases, active intervention by committee members resulted in more timely resolution of problems and the identification of corrective actions. Unfortunately, the system employed by the committee and its staff to monitor whether these firms had timely taken the required actions was not as effective. We urge the committee to implement a more effective monitoring system to avoid the possibility of delay by firms in taking required corrective action in the future.

The Peer Review Committee has formed a task force to consider the Board's concerns about the clarity of letters of comments. Several meetings attended by the Board's staff have been held. The Board urges that reconsideration of the standards for preparing letters of comments be completed expeditiously.

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), 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. A copy of each complaint alleging such substandard performance by a member firm is required to be reported to the QCIC. The QCIC's task is to determine whether the allegations indicate possible deficiencies in the firm's quality controls. In addition, the QCIC's job is to analyze such

	11/1/1979 through 6/30/1991	7/1/1991 through 6/30/1992	Totals
Results of QCIC Activity			
Actions Related to Firms:			
<i>Either a special review was made, the firm's regularly scheduled peer review or inspection was expanded, or other relevant work was inspected</i>	45	7	52
<i>A firm took appropriate corrective measures that were responsive to the implications of the specific case</i>	61	10	71
Actions Related to Standards			
<i>Appropriate AICPA technical bodies were asked to consider the need for changes in, or guidance on, professional standards.</i>	39	1	40
Actions Related to Individuals			
<i>The case referred to the AICPA Professional Ethics Division with a recommendation for investigation into work of specific individuals.</i>	16	4	20
Total	161	22	183

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

litigation to determine whether professional standards, quality control standards, or the Section's membership requirements need revision or whether additional guidance is needed.

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 1991-92 year, all QCIC meetings were attended by one or more Board members and staff. Additionally, the Board's staff actively participated in virtually all of the forty QCIC task force meetings with representatives of the firms reporting litigation. The Board receives reports from its staff on the activity concerning each case to evaluate whether the QCIC properly fulfills its responsibilities. Based on these activities, the Board believes that appropriate consideration was given to the 41 cases closed this year, and that the QCIC adequately complements the peer review process.

The SEC also oversees the QCIC process and the POB oversight of it. For each closed case, the SEC is provided with a "closed case summary" which describes the allegations and the quality control implications thereof and the actions taken by the QCIC to ascertain whether there are shortcomings in the firm's quality controls or compliance therewith. In addition, the SEC is provided with the POB's oversight program and the POB and QCIC staff meet with the staff of the Office of the Chief Accountant to provide further information if necessary to indicate the basis for QCIC's conclusions concerning the adequacy of quality controls. While SEC staff review of cases closed in 1991-92 has not yet been completed, preliminary indications are that the SEC continues to be satisfied with the QCIC process as a complement to the peer review process.

Commentary on the QCIC

At the end of last year, the Board had identified several initiatives to improve the effectiveness of QCIC activities and had 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 sufficient data about the firm's quality controls and the environment in which the allegedly faulty audit was conducted to enable the committee to conduct its inquiry

more efficiently and effectively. The Board also urged the QCIC to more frequently inspect selected audit workpaper documentation to corroborate firm representations and to review firm guidance in areas relating to the allegations rather than rely on general descriptions of it. The QCIC activity in 1991-92 reflected implementation of these recommendations.

During the year, the QCIC increased its access to the workpapers of contested engagements by reviewing portions of the workpapers relating to eight allegedly faulty audits. Additionally, for five other engagements QCIC task forces met with engagement supervisory personnel to obtain a firsthand understanding of the audit environment in which the audit was performed and the extent to which the audit plan responded to it. These investigatory procedures increase

the effectiveness of the QCIC process. The Board urges the committee to continue this trend.

In the year ended June 30, 1991, the QCIC formulated a policy that requires the review, in certain circumstances, of other engagements performed by individuals who supervised the allegedly faulty audit to determine if any corrective action is needed to improve compliance with or design of quality controls. In four instances, cases were closed in the current year based in part on knowledge the QCIC obtained on screening documentation of the findings of recently completed internal reviews. However, the QCIC did not participate in the planning or the conduct of any of these internal reviews. To be most effective, the Board believes the committee should have such involvement.

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.

The liability crisis that now threatens the survival of the accounting profession as we know it carries with it equally ominous concerns about its effects on the future reliability of financial reporting and capital formation. The following portions of a recent speech by our Chairman A. A. Sommer, Jr., delivered at the annual meeting of the American Accounting Association, addresses these concerns in the context of a tentative proposal the POB is presently researching, along with many others, in its reevaluation of the effectiveness of the profession's self-regulatory programs. As mentioned earlier, the POB will issue a special report early next year that will not only address the liability crisis, but will also include the results of its research and specific recommendations about regulation of the accounting profession and other means to improve the attest function.

The present litigation crisis in the profession is, in the eyes of many, life-threatening to one or more of the major firms; it has already contributed heavily to the demise of one of the larger firms, leaving innumerable human tragedies in its wake. God willing that will not be the fate of the thousands who depend upon any one of the major firms. The POB has at a recent extended meeting determined it will lend its support to the effort to secure the enactment of legislation that will restore the balance between accountability and liability because it believes that is fair and because we believe it is in the public interest.

The Board has taken this position in part because of the very topic we are focussing upon - accountability. The Board, and I believe all of us, believe that a person, a body, an entity should be accountable for its conduct; by the same token, it should not be accountable for someone else's conduct. The fault in our litigation system today as it affects auditors is that too often they are held accountable for someone else's failures and shortcomings and accountability faults. Auditors, as I have indicated earlier, should be accountable for the harm caused when they fail to meet their responsibilities, but they should not be accountable for the frauds, the failures, the shortcomings of others, and for, yes, the failures of government policies.

However, I have a further concern that I think is shared by the other members of the Board. That is that the present crisis has so dominated the thinking of leaders of the profession that it has left no time, no energy, no desire to think beyond the present legislative agenda and tackle the other rough problems that confront the profession. I mentioned a moment ago the very small number of failed audits. That statistic, of which the profession

can justly be proud, however, must not breed a complacency or satisfaction.

The safety statistics of the airline industry are even more impressive and one of the reasons may be the way in which failures in that industry are dealt with. When there is a crash there is a painstaking investigation of the tragedy by the National Transportation Safety Board. The findings and conclusions of the Board are not admissible in any proceeding, thus the Board is not inhibited by the airlines' liability concerns from studying the evidence and publishing a report. And often significant new safeguards are mandated as a result of these reports: no smoking in lavatories, improved deicing procedures, indicator lights in the aisles - all these safety measures were the results of such investigations. The extremely low incidence of failure does not make the typical airline executive depart a whit from his or her commitment to zero failures.

I think that if the profession is able to secure legislative relief from the laws that today make its members often accountable for wrongs they did not commit and if it were able to secure appropriate legislation, similar to that governing the NTSB, barring the introduction of the report in any proceeding, it should, within the structure of the SEC Practice Section, consider amending the charter of the Quality Control Inquiry Committee, which presently limits that body's inquiry to whether the allegations in cases reported suggest a flaw in the accused firm's quality controls or compliance with them, or a fault in the profession's standards, to permit inquiry into whether indeed there was a failed audit, and if there was, the reasons for it. Thus, like the National Transportation Safety Board, skilled and experienced auditors and insightful academics would examine the records of the firm to determine whether the allegations reported to the QCIC indicate there may have been a faulty audit, if so what caused it, what measures should be taken by the profession to avoid a recurrence, how similar problems can be avoided in the future. The entire airline industry learns from the NTSB inquiries; the entire accounting profession could learn from a similar inquiry into audit failures.

This will strike many as a radical proposal. The accounting profession today, sadly, is litigation driven. Any proposal looking toward reform is viewed with suspicion by the firms and their counsel - and as a lawyer, I can certainly understand their conservatism and their concern. It may be that to achieve the objective of such an inquiry without unduly burdening the firms this

proposal would need to be refined. The Board stands ready to discuss those refinements. But I urge the firms and their counsel to understand how imperative it is that the profession, notwithstanding the urgency and reality of the litigation crisis, see this proposal as a powerful means of identifying the problems which are creating the present crisis of confidence the profession is experiencing and remedying them.

There is so much to be considered, so much to be done. Gene Freedman, the head of Coopers and Lybrand, was quoted as saying the accounting profession must accept the fact that it must accept more responsibility. That is true. Like it or not, auditors are going to be more responsible for opining on internal controls; they are going to be called upon to be more vigorous in pursuing fraud; they are going to be under a stronger mandate to see to it that hanky-

panky is not hidden or concealed. They are going to accept some measure of mark-to-market accounting or have it shoved down their throats. And they must examine with the rigor of a skilled pathologist what has brought on the present crisis. Is it accounting principles? Is it audit procedures? Is it timidity in the face of demanding clients? Is it excessive competition? Is it the erosion of professionalism? Is it the historic form in which financial statements and the opinions on them are cast? Is it the increased complexity of financial transactions? Is it difficulty in training people to deal with this complexity? These questions cry out for answers. In finding those answers all of you can, through research and dialogue among yourselves, make enormous contributions, and I urge you most strongly to renew and reinvigorate your efforts to find those answers.

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. Froehke,
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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