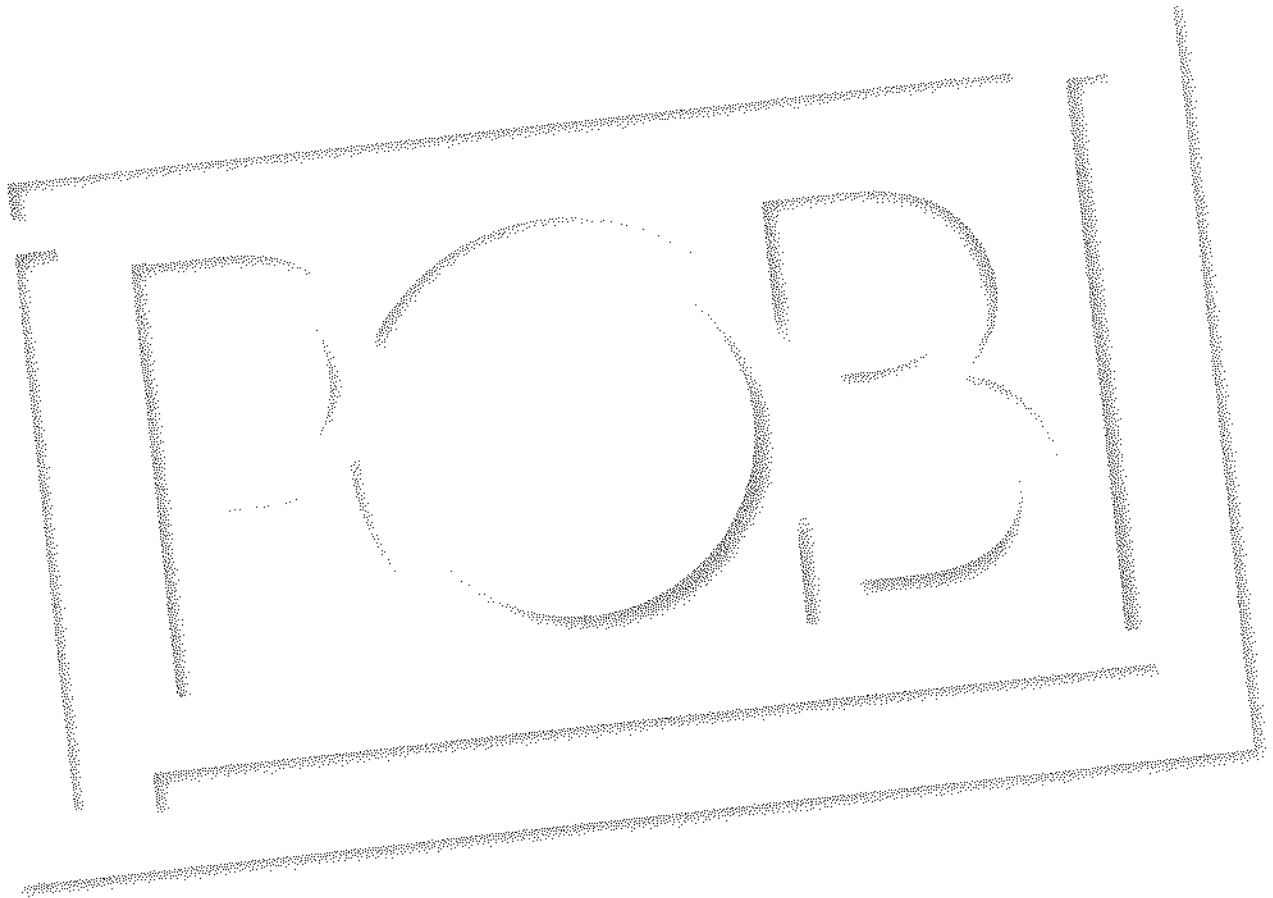

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*Annual
Report
1997-1998*



POB
Message From The Board

The Public Oversight Board was constituted to provide independent oversight of the accounting profession's self-regulatory programs for independent auditors of entities registered with the Securities and Exchange Commission. The Board over the years has informally expanded its mandate to monitor and comment on matters that relate to the quality of auditing and financial reporting in the United States, because we believe that it would ill serve the public interest if the profession's quality control programs were a model of integrity and effectiveness while other forces and circumstances destroyed the public's confidence in the credibility of financial reporting in the United States.

Panel on Audit

Effectiveness

During the past year the accounting profession has again been the target of considerable criticism. Perhaps the criticism was best summarized in the October 5, 1998 issue of Business Week which displays on its cover "Who Can You Trust?" with a subhead, "When Accountants Turn a Blind Eye." In the article relating to accountants there were recounted not only instances of fraud, such as Cendant and others, but all instances of questionable accounting under the guise of compliance with "generally accepted accounting principles." This entails such practices as writing off research and development expenses in progress as a result of a merger, and establishment of reserves in excess of expected needs to provide cushions for future earnings shortfalls, and a number of other practices sanctioned by reputable auditors.

These practices have many origins. Some believe that they are the consequences of excessive docility of auditors resulting in their unwillingness to jeopardize lucrative consulting business, or simply to save the audit engagement. Some attribute them to the changes in audit procedures intended to streamline the process and reduce the cost. And there are others who see in these shortcomings elements of a

decline in professionalism, often again related to the increasing dominance of consulting and other services in the service mix of major firms.

Whatever the cause, once again the value of audit services is under intense examination. The Public Oversight Board has repeatedly emphasized the importance of the audit process to our capital markets. Without the assurance of the integrity of financial information afforded by the auditor's certificate, loans would be priced at higher interest rates, many enterprises would be unable to secure financing, and stock prices would be based, not on reliable financial reports, but upon surmises about what the true earnings of enterprises were. If the accounting profession loses the reputation it has for providing the assurance necessary to an efficient capitalistic economy, then the profession will have perished and no longer have a place or an economic value in our society. And it is not only the auditors who will lose; all of us will.

Chairman Arthur Levitt of the Securities and Exchange Commission in a major address at the NYU Center for Law and Business on September 28, 1998, "The Numbers Game," asked the Public Oversight Board (POB) to form a panel representing major constituencies to review and evaluate the way independent audits are performed and assess the impact of recent

trends in auditing on the public interest. Mr. Levitt observed:

"I don't think it should surprise anyone here that recent headlines of accounting failures have led some people to question the thoroughness of audits. I need not remind auditors they are the public's watchdog in the financial reporting process. We rely on auditors to put something like the good housekeeping seal of approval on the information investors receive. The integrity of that information must take priority over a desire for cost effectiveness or competitive advantage in the audit process. High quality auditing requires well-trained, well-focused and well-supervised auditors.

As I look at some of the failures today, I can't help but wonder if the staff in the trenches of the profession have the training and supervision they need to ensure that audits are being done right. We cannot permit thorough audits to be sacrificed for re-engineered approaches that are efficient, but less effective. I have just proposed that the Public Oversight Board form a group of all the major constituencies to review the way audits are performed and assess the impact of recent trends on the public interest."

On that same date Lynn E. Turner, Chief Accountant of the SEC, in a letter asked the POB to convene a panel of investors, auditors, audit committee members, corporate executives, and former regulators to examine whether recent changes in the audit process serve and protect the interest of investors. More specifically, Mr. Turner expressed concern about whether the current audit model with its emphasis on risk assessment has resulted in an erosion in audit effectiveness because of the nature and extent of audit procedures performed.

Several critical issues face the profession and therefore have been and continue to be focus topics on the Board's agenda. We report here on our activities concerning those topics and in general on our oversight of the Section's self-regulatory programs.

**Period Covered
by this Report**

In previous years, the Board's annual reports have covered its oversight activities for a twelve-month period ended June 30th primarily because the Section's peer review and quality control inquiry committee (QCIC) programs track performance on twelve month cycles ended June 30th. This report is a transition report. It covers the Board's oversight activities since our last report and through the year ended December 31, 1998. In the future, our report will report activities on a calendar year basis.

However, insofar as the peer review and QCIC programs are concerned, our report will report oversight activities for the twelve month cycles ended June 30th under which those programs operate. Accordingly, this report covers all activity relating to peer reviews initiated and all QCIC cases closed during the cycle year commencing July 1, 1997 and ending June 30, 1998.

The Board members discussed the SEC request extensively and concluded that an objective in-depth review of the audit process and related practices followed by the large firms would be in the public interest. The Board observed that in recent years, auditing firms have made significant changes to their audit processes (audit "re-engineering") in response to (a) advancements in information technology, both in the auditor and client environments, and (b) major changes in the economic environment, such as the use of complex financial instruments, globalization, just in time inventory systems, and the emergence of service industries, to cite a few.

Accordingly, the Board appointed a panel on audit effectiveness that includes investors, auditors, regulators, audit committee members and corporate executives. The Board also appointed a staff to assist the Panel in conducting its work. The Panel members and its staff are identified in an accompanying letter from Shaun F. O'Malley, the Panel's Chair.

The Panel's staff is highly competent and well versed in the audit process and the Section's self-regulatory programs. David B. Pearson, Staff Director, is a recently retired senior partner of Ernst & Young, former Chair of the SECPS Peer Review Committee, and a former member of the Auditing Standards Board. Edmund R. Noonan, a recently retired partner of KPMG Peat Marwick, was Chair of the Auditing Standards Board for the three years ended September 30, 1998, and is now a member of the Section's Quality Control Inquiry Committee. Thomas M. Stemplar, recently retired from Arthur Andersen, was formerly that firm's director of accounting and auditing

PUBLIC OVERSIGHT BOARD

PANEL ON AUDIT EFFECTIVENESS

January 6, 1999

PANEL MEMBERS

CHAIR
SHAUN F. O'MALLEY
Former Chair of Price Waterhouse LLP

DENNIS H. CHOOKASZIAN
Chair and CEO of CNA Insurance Companies

PAUL KOETON
Former Chairman and CEO of the American Stock Exchange and currently Chairman of the Steering Committee of the FASB's Business Reporting Research Project

REVIS LONGSTRETH
Counsel to Debevoise & Plimpton and former Commissioner of the SEC

LOUIS LOWENSTEIN
Simon H. Rifkin Professor Emeritus of Finance and Law at Columbia University

ZOEVONNA PALMROSE
Ph.D., CPA, PricewaterhouseCoopers Auditing Professor, University of Southern California

AULANA L. PETERS
Partner of Gibson, Dunn, & Crutcher and former Commissioner of the SEC

RALPH S. SAUL
Former President of the American Stock Exchange and CEO of CIGNA Corp.

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Public Oversight Board
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Members of the POB:


We are pleased to submit this letter outlining how we propose to address a project to examine whether the audit processes of large-firm members of the SECPS adequately serve and protect the interests of investors. Such a project was requested by Mr. Lynn E. Turner, Chief Accountant of the Securities and Exchange Commission, by letter of September 28, 1998 to Mr. A. A. Sommer, Jr., Chairman of the POB.

The purpose of the project is to make a comprehensive review and evaluation of the way independent audits are performed and assess the effects of recent trends in auditing on the public interest. The project will include, among other things, evaluating the adequacy of the professional development of auditors, how audits are planned, staffed, and supervised, whether firms' quality control systems encompass the necessary elements and guidance, and whether audit documentation is appropriate. It also will consider the overall "tone at the top" and performance measures used by firms in evaluating audit personnel. Furthermore, the project will include assessing the need for possible changes in professional standards and the profession's self-regulatory process. In carrying out the project, we will consider users' expectations about the auditors' responsibilities and the relationship between audit and non-audit services.

We anticipate that, as part of this undertaking, we will gather information and consider guidance materials recently issued or currently under development by the large-firm members of the SECPS and the AICPA. For example, the *Horizons* project of the Auditing Standards Board, we understand, contemplates evaluating the efficacy of the auditing standard relating to the detection of fraud and assessing the impact of audit reengineering on standards.

We envision that the project will be carried out in phases as described in the work program prepared by the Panel's staff members, culminating in a report that will be issued by the Panel. The report will identify the process undertaken, the resultant findings, and the basis for recommendations made to accounting firms, the AICPA, the Securities and Exchange Commission, audit committees, and managements.

Very truly yours,



Shaun F. O'Malley
Chair

The Panel was established by the POB at the request of the SEC to evaluate the current effectiveness of independent audits in protecting investor interests.

practice review, and is now a member of the Section's Quality Control Inquiry Committee. As the Panel's work progresses, its staff will be expanded to include senior managers of large firms and the Panel will be assisted by large firm "peer review" teams in conducting certain portions of its program.

In a letter to the Panel, the POB requested that they and their staff undertake a top to bottom review of the audit process used by the auditors of public companies, taking into consideration recent developments, such as those described above, with the critical objective of enhancing investor confidence in the assurance provided by independent audits of financial information. Among other things, we asked the Panel to evaluate the adequacy of the training of auditors, how audits are planned and supervised, whether firms' quality control systems provide the necessary elements and guidance, and whether audit documentation is sufficient. The Panel may wish to invite public comment and hold public hearings to assist it in developing its report.

The Board also asked the Panel to consider whether its work and findings suggest changes that can be made to the SEC Practice Section (SECPS) peer review program to enhance the important role that program plays in providing assurance about SECPS member firms' quality control systems. Prior to the Chairman's speech, the Board had discussed and determined to do a thorough review of the peer review program in the light of the passage of more than 20 years since its design in 1977. We believe that the work which is to be done by the Panel can, without unduly delaying or complicating its primary mission, also advise the Board and the Section with regard to the continuing relevance and effectiveness of the peer review program.

SECPS

and Other Special Task Forces

Established in 1998

Concurring Partner Review

The Public Oversight Board has been a strong advocate through the years of an enhanced role for the concurring partner who ostensibly takes a fresh look at the financial statements before the firm signs off on them. A recent decision by an administrative judge in a SEC proceeding, now affirmed by the Eighth Circuit Court of Appeals, would significantly expand the role of the concurring partner beyond what the profession believes to be the appropriate role of such person. The Public Oversight Board believes that the holdings of the SEC administrative law judge and the Eighth Circuit Court of Appeals go beyond what is the proper role of a concurring partner. We endorse and encourage the effort of a task force to develop an appropriate set of guides for partners performing their role. We believe that the concurring partner should be expected to provide additional assurance about audit quality but should not in effect duplicate the audit or the work of the engagement partner and result in the concurring partner having a detection responsibility for compliance with professional standards. Striking a reasonable performance standard in this important area is a challenging but important undertaking.

International Quality Control

The SECPS quality control standards, membership requirements and peer review program do not extend to SECPS member firms' international audit components and affiliations. At the present time, no foreign jurisdictions have a

peer review program comparable in scope to that of the Section. The long range objective of this task force is to encourage the adoption of peer review internationally in recognition of the expansion of global securities markets and in particular the large and increasing number of foreign registrants trading their securities in the US markets.

The task force's short range objective is to develop Section quality control standards for US member firms that will provide additional assurance that US auditing standards and US GAAP are appropriately followed by member firms' international components and affiliates in the audits of foreign registrant financial statements used in the US securities markets.

Alternative Firm Practice Structures

With increasing frequency accounting firms, including members of the SECPS, are being acquired by consolidators such as financial service providers. Typically, the owners of the acquired accounting firm form a new "shell" to provide attest services to SEC registrant clients and non-public companies. To render attest services, the new "shell" firm leases employees, space and equipment from the multi-service financial service acquirer for which it pays a percentage of revenues and profits. There are a number of significant quality control issues raised by the practices. For example, whether the personnel management policies of the consolidator (hiring, advancement and assignment) will continue to assure the competence of the personnel assigned to conduct attest engagements, whether the consolidator will make available resources to train personnel in subject matter that is critical to the conduct of attest engagements, and whether the consolidator will have in place quality control systems that can be tested to assure that quality

controls are appropriately designed and implemented and that independence standards are being adhered to both by the consolidator and the CPA firms with whom they have allied.

SEC Disciplinary Standards

The SEC, after being rebuffed twice by the Court of Appeals for the District of Columbia in a disciplinary proceeding under its rule 102(e) against an accountant, proposed a new disciplinary rule for accountants that would permit the SEC to proceed with a disciplinary action in the event of certain acts of negligence on the part of the accountant. The Board believed the proposed standard was excessively stringent. While the Board did not file a formal comment on the rule proposal, it did discuss it with SEC officials and expressed concern about the harshness of SEC proceedings and penalties based upon charges of simple negligence.

Audit Committee Performance

The committee organized by the New York Stock Exchange and the National Association of Securities Dealers (on which Board member Charles Bowsler serves) to study means of improving the effectiveness of audit committees had public hearings on December 9, 1998. Board member Donald J. Kirk appeared on behalf of the Board. In his statement he urged that the committee recommend as "best practices" the communications from auditors to audit committee and boards recommended by the panel he chaired at the request of the Board in 1994. Those recommendations have been set forth in previous Board annual reports. The Board firmly believes that the implementation of the Kirk Panel recommendations would very substantially affect the quality of financial reporting.

The Board held ten regularly scheduled and four special meetings during the period ended December 31, 1998 in connection with its oversight of the self-regulatory programs of the SECPS and its consideration of matters that could impact the effectiveness or credibility of the audit profession.

As has been Board practice to assure that the Board remains informed about the key issues facing the profession, the Board again invited decision-makers in the profession, standard-setters, and regulators to Board meetings to discuss issues important to the profession and the SECPS self-regulatory programs. This year the Board's guests at regular meetings included the chief executive officers of the six largest CPA firms, the new Chief Accountant of the SEC and his predecessor, the acting Comptroller General of the US General Accounting Office, the chair of the SECPS Executive Committee, the chair and the executive director of the Independence Standards Board (ISB), the chair of the Financial Accounting Standards Board, the chair of the National Steering Committee of the six largest CPA firms, and from the AICPA, its President, its General Counsel, the Senior Vice President-Technical Services and the Vice President-Self-Regulation.

The Board also conducted educational sessions on the SECPS self-regulatory programs at the offices of the SEC for the chairman, other commissioners, and commission staff. Topics discussed in the sessions included, among others, the adequacy of the POB charter in relationship to its responsibilities, the relationship of the POB and the ISB, and the impact of major firm mergers.

The Board held an "outreach meeting" with CPA practitioners. The Board met with nineteen representatives of local firms practicing in the state of Washington, five partners from the then six largest accounting firms with offices in Seattle, Washington, and representatives of the Washington State Board of Accountancy and the Washington Society of CPAs to discuss their views on a wide variety of issues. Topics discussed included, among others, issues relating to the independence and objectivity of auditors, the relationship between the SEC and the CPA profession, and the role of the auditor in strengthening corporate governance.

In addition to the exchange of views at formal meetings, Board members and staff had numerous other opportunities to interact with others interested in the quality of audits. For example, the Board's chairman met twice with the AICPA Board of Directors. He and the Board's Executive Director addressed the World Congress of Accountants in October 1997. And Board members and staff met on a number of occasions with the chairman and chief accountant of the SEC and the chairman and executive director of the ISB.

The Board's staff participated in the deliberations of SECPS task forces on Identifying the Effects of Audit Re-engineering, Improving QCIC Operations, Assuring that Peer Reviews Focus on Systems of Quality Control, Identifying "Best Practices" Relating to Corporate Governance, Improving Reporting on Peer Reviews, and Developing Guidance to Improve Firm Monitoring of Quality Controls.

Independence

Standards Board

The POB is pleased to note that in February 1998, the SEC issued Financial Reporting Release No. 50 which formally recognizes the ISB as the standard-setting body for independence issues with respect to auditors of companies whose securities are registered with the SEC. Our Board in recent years has requested the profession to evaluate the adequacy of its Code of Professional Conduct to deal with present day independence questions and therefore has a keen interest in the effectiveness of the ISB's efforts.

Standards and interpretations issued by the ISB will be considered by the SEC to have substantial authoritative support. However, the SEC continues to have authority over auditor independence matters and will provide direct oversight over the ISB. Unlike the other components of the SECPS's self-regulatory program, our Board has no formal responsibility for the activities of the ISB. Nevertheless, we will follow closely the ISB's progress in developing a "conceptual framework" for resolving auditor independence issues and dealing with the difficult topics on its agenda. Our Board has assured ISB Chairman Allen that it will expend whatever energies are necessary to assist the ISB in its important undertaking.

A Board member and staff attend each meeting of the ISB. Three members of the Board participated in an educational session on the self-regulatory programs for the ISB and our staff prepared a compendium of independence materials, *Background Materials on*

Independence Issues, for the ISB. Our Board recently commented on the ISB's proposed recommendation to the Executive Committee of the SECPS, *Confirmation of Auditor Independence*.

In our comment letter on that proposal, we applauded the intent of the proposal to improve the understanding of members of corporate boards of directors about corporate governance issues related to the quality of financial reporting and strongly endorse efforts that focus directors on the fact that they are the independent auditor's client and they carry a fiduciary responsibility to protect shareholders' interests. But the POB believes that the initial ISB recommendation needed to be expanded to achieve its objective.

We stated in our comment letter that auditors should be required to communicate to audit committees specific matters relating to the client-auditor relationship that the directors should be aware of, and evaluate, when reaching a conclusion that the auditor's objectivity with regard to the audit of the client's financial statements has not been impaired or that the relationship does not create the appearance of a conflict of interest. The ISB incorporated the substance of our comment in the standard it adopted.

Following our April "outreach meeting" with Washington State practitioners, we communicated to Chairman Allen several matters bearing on independence that those practitioners urged be considered: independence rules relating to family relationships, the implications on auditor independence of a variety of non-audit services, the effect of partner and management level personnel joining audit clients, and client record-keeping.

The Executive Committee of the SECPS is responsible for establishing the membership requirements with which member firms are expected to comply in conducting their audit practices. And it is ultimately responsible for all the activities of the self-regulatory programs, the goal of which is to promote the quality of audit practice before the SEC. These programs include a mandatory peer review program, inquiry into the quality control implications of litigation against member firms, and a program for developing technical information to aid in conducting audits of SEC registrants and other companies.

A board member and staff attend each meeting of the SECPS Executive Committee and its Planning Committee and participate as appropriate.

In addition, the staff participates in each meeting of the Professional Issues Task Force (PITF), which accumulates and considers practice issues that appear to present audit concerns for practitioners and disseminates guidance in the form of practice alerts on those matters. The PITF issued three important practice alerts in 1998 that auditors would be well advised to consider as they conduct future audits. These and previously issued alerts are available on the SECPS web site. In May 1998, an alert was issued with guidance on analytical review as an audit tool; in September, guidance was issued on the need for professional skepticism and the review of non-standard journal entries and original and final source documents; and in November, guidance was issued for auditing the critically important area of revenue recognition.

Peer review is the principal component of self-regulation which demonstrates to the public that firms are functioning at a level that meets or exceeds the standards established by the profession. It is a vigorous evaluation of a firm's system of quality control over its accounting and auditing practice by CPAs who are independent of the reviewed firm. Based on a risk assessment of the firm's practice, the peer reviewers carefully select accounting and auditing engagements which are subjected to an in-depth evaluation to determine the extent of compliance both with the firm's system and with professional standards.

POB Oversight of Peer Review Process

During the peer review year, the Board's staff conducted its oversight program by direct participation in the peer review as it was performed on all reviews of firms with more than thirty five SEC clients. The staff also directly participated in the performance of peer reviewers at more than 20% of the remaining firms with SEC clients, including 50% of the firms with five through thirty-five SEC clients and 70% of the firms that received a modified report on their system of quality control during their prior peer review. On all other peer reviews of firms with SEC clients, the staff reviewed peer review working papers, reports, letters of comments and firms' responses. The staff also discussed significant issues with peer reviewers to satisfy itself that all such matters were properly resolved and reported on. The staff participated in all committee meetings where peer reviews were considered for acceptance and communicated all significant matters that came to their attention in applying the POB oversight program regarding either the performance of peer reviewers or the reporting of peer review findings.

A Board member and the staff observed all meetings of the Peer Review Committee during the year.

Audit Re-Engineering

The previous SEC Chief Accountant, Michael H. Sutton, raised questions regarding audit re-engineering in early 1997. Audit re-engineering is a phrase used to describe efforts by CPA firms to improve their audit processes with a view towards enhancing both audit effectiveness and efficiency. The Chief Accountant inquired whether re-engineering of the audit process had resulted in modifications to audit workpaper documentation that might significantly reduce (1) the effectiveness of audit planning, supervision and review by engagement management, and (2) the ability of the firms' concurring review partners, internal inspection teams, and external peer review teams "to independently reach judgments about the adequacy of the work performed and the propriety of the conclusions reached."

The Peer Review Committee formed an Audit Re-Engineering Task Force which developed a *Supplemental Questionnaire for the Review of a Firm's Redesign of its Audit Processes* which was completed for reviews commencing after September 1, 1997. That questionnaire was completed

by peer review team captains in connection with 133 peer reviews. The results suggest that very few firms made modifications to their audit process that could be construed as re-engineering. In no instance did the peer reviewers conclude that audit effectiveness or documentation had been compromised as a result of the modifications made to the firms' audit processes. The Peer Review Committee has mandated that this questionnaire be completed on an ongoing basis for all future peer reviews.

The Board will continue to monitor the Peer Review Committee's efforts in this regard.

Associations of

CPA Firms

An association of CPA firms includes any association, network, or alliance of accounting firms (whether a formal or informal group) that jointly market or sell services. Some associations administer programs for peer reviews of their member firms. Under these programs, a member firm's quality controls may be reviewed by another association member firm or by a team selected from association member firms. In these instances the committee's independence rules prohibit an association from making "representations regarding the quality of professional services performed by its member firms to assist member firms in obtaining engagements unless the representations are objective and quantifiable."

Associations are required to file annual plans of administration with the committee. During the recent peer review

year, a number of associations submitted their plans of administration together with marketing brochures. The committee concluded that certain marketing representations about the capabilities of member firms were not objective and quantifiable. These associations were required to revise their brochures to eliminate the wording which conflicted with the independence requirements.

In some instances, the committee concluded that potential independence issues could not be cured and the associations were precluded from performing peer reviews of other firms in the association. In one instance, where an association peer review was already completed, the

committee required that the SEC engagement peer reviewed during the association administered peer review be re-reviewed by another firm that was not a member of the association.

Definition of a Partner

The Section has had a longstanding membership requirement for a concurring review of the audit report and the financial statements by a partner other than the audit partner-in-charge of a SEC engagement before issuance of an audit report. While not specifically stated in the membership requirements, it was presumed that the auditor with final responsibility would be an engagement partner. Recently however, several firms assigned non-partners the responsibility for SEC

engagements. The Section's membership requirements were amended to specifically require that an audit partner be assigned to each SEC engagement. The Peer Review Committee may authorize alternative procedures where this requirement cannot be met because of the size or structure of the firm. Exemptions from this requirement are expected to be rare and must be approved by the committee in advance.

Simultaneous with this revision, the Section defined a partner as an individual who is legally a partner, owner or shareholder in a CPA firm and who is a party to any partnership, ownership or shareholder agreement of a CPA firm or a sole practitioner.

NASDAQ Peer Review

Requirement

The Board is pleased with NASDAQ's recognition of the value of the peer process. NASDAQ instituted a requirement that, "All independent auditors for NASDAQ-listed companies must be subject to practice monitoring under a program such as the AICPA SEC Practice Section peer review program." NASDAQ has requested copies of all modified peer review reports after acceptance by the committee. These reports are being provided to NASDAQ on a quarterly basis.

Major Corrective Measures Imposed by the Peer Review Committee to Ensure that Quality Control Deficiencies are Corrected

<i>Action</i>	<i>Number of Times</i>	
	<i>During 1997-98</i>	<i>Since Inception</i>
<i>Accelerated peer review</i>	1	53
<i>Employment of an outside consultant acceptable to the Peer Review Committee to perform preissuance reviews of financial statements or other specified procedures</i>	15	99
<i>Revisits by the peer reviewers or visits by a committee member to ascertain progress made by the firm in implementing corrective actions</i>	7	209
<i>Review of the planning for and results of the firm's internal monitoring program</i>	29	370
<i>Review of changes made to the firm's quality control document or other manuals and checklists</i>	-	43
<i>Continuing Professional Education in specified areas</i>	11	*58

* Since July 1, 1988, as data for prior years is no longer available.

SEC Request for Peer

Review Reports

The Board's staff provides the Office of the SEC's Chief Accountant with all peer review reports, after acceptance by the committee, so that the SEC may exercise its oversight of the peer review process. The peer review reports of firms with less than ten SEC clients are "masked" so that the SEC does not know the identity of these firms when reviewing individual peer review files and the names of clients reviewed are not included.

The SEC has requested that the Section routinely provide it with all modified reports so that it does not have to review the Section's public files to obtain "unmasked" copies of modified reports. Receipt of these reports on a timely basis may serve as an early warning to the Office of the Chief Accountant.

Monitoring of Peer

Review Committee

Imposed Corrective

Actions

Each peer review considered by the committee includes an evaluation of the firm's planned actions to correct deficiencies in the firm's quality control system. In certain instances, the committee requires the firm to implement remedial measures beyond those contemplated by the reviewed firm. A table summarizing the actions required by the committee is presented in this report.

The committee actively monitors the timeliness and effectiveness of compliance with its imposed corrective actions. Firms generally cooperate with the committee. During the year however, one firm failed to comply with all the corrective actions that it had agreed to undertake in connection with its 1996 peer review that resulted in an adverse report. The firm agreed, among other things, to have a concurring review by an individual acceptable to the committee in connection with its audits of SEC clients. Notwithstanding the agreement, the firm released its report on the financial statements of an SEC registrant without the required review. The committee, through its monitoring process, required the firm to engage an individual to perform a post-issuance review of the financial statements of the SEC registrant in question which resulted in significant revisions to the financial statements.

The committee voted to recommend to the Section's Executive Committee that the sanctioning process against the firm should commence. Pursuant to its rules, the Executive Committee formed a Hearing Panel to deliberate the issues. The Panel voted to admonish the firm for not complying with the SECPS concurring review membership requirements and agreed (1) if there were any further violations of the concurring review requirements the Panel recommended expulsion from the SECPS, and (2) that the admonishment be published in a publication of the AICPA.

The firm appealed the publication of its name and a second Hearing Panel was formed which concurred with the original Panel's decision.

Communications with

Standards-Setters

The peer review program is a source of information to assist standards-setters in assuring that quality control and auditing standards are relevant and effective. During the year, the committee identified several emerging practice issues and referred them to standards-setters to develop appropriate guidance. Additionally, peer review is a source of information for the Practice Alerts which are disseminated several times during the year by the SECPS to assist practitioners in addressing emerging practice problems in a timely manner.

1997 Peer Review

Reports Not Yet Accepted

by the Committee

The reports on four 1997 peer reviews have not been accepted to date by the committee due to unresolved issues.

In one case a firm undergoing peer review had utilized a partner in the peer reviewing firm to perform the required concurring partner review for its SEC clients. The committee concluded that this arrangement violated its peer review independence requirements and has required the firm to engage another peer reviewer to reperform the peer review.

In the other three instances, the committee is awaiting revisions to the peer review reports or clarification of issues from review teams. However, all corrective actions that were deemed necessary on these peer reviews relating to specific engagements have been taken.

Summary and

Conclusions

It is the Board's conclusion, based on its extensive oversight, that the SECPS peer review program has been effectively executed and contributes significantly to the quality of auditing in the United States.

The SEC, through the office of the Chief Accountant, oversees the peer review process and POB oversight of that process by interacting with Board staff and inspecting selected peer review and POB working papers. The SEC's inspection of the 1997 peer reviews is virtually complete and the Board expects the SEC to continue to endorse the Peer Review Program in its next annual report to Congress and to reaffirm its belief that "...the peer review process contributes significantly to improving the quality control systems of member firms...."

POB Reports On *Quality Control Inquiry Committee Process*

The quality control inquiry process is an essential element of the profession's self-regulatory program. The Quality Control Inquiry Committee (QCIC) determines whether allegations of audit failure against SECPS member firms involving SEC registrants indicate a need for those firms to take corrective actions to strengthen their internal quality control processes or to address personnel problems. The QCIC also identifies, through its review of the allegations and discussions with firm personnel, areas in which accounting, auditing or quality control standards can be strengthened or guidance could be helpful to accountants in applying professional standards.

During the past year, Board members and staff attended all meetings of the Quality Control Inquiry Committee and observed its consideration of each case. The Board and its staff have unrestricted access to all committee deliberations and files and actively participate in the discussions of the quality control implications of the allegations in each case with the committee members and its staff.

The Board's staff directly participates in the quality control inquiry process by reading the complaints, applicable financial statements and regulatory filings, trustee reports, SEC Accounting and Auditing Enforcement Releases against company personnel and accountants, and other publicly available documents on all cases considered by the QCIC. In addition, the Board's staff attends the meetings held between the QCIC members and representatives of the firms. During the past year, the Board's staff participated in 54 of the 55 QCIC task force meetings with member firms. Based on these meetings, the Board's staff prepares comprehensive reports on individual cases for the entire Board's consideration and responds to Board member inquiries about the process and individual cases.

The Board's staff is also actively involved in the identification and communication of areas that it believes should be the subject for additional professional

standards or augmented guidance to the accounting profession.

QCIC Actions on Reported Cases

The QCIC began the year with 30 open cases. Member firms reported 53 new cases, and the committee completed its work and closed its files on 45 cases. At June 30, 1998, there were 38 open cases.

The QCIC performs an initial analysis of the complaints, applicable financial statements and regulatory filings and other publicly available documents on all cases reported by member firms. On seven cases, after performing this initial analysis, it determined that there were no quality control or personnel issues to pursue and the case was closed.

For the 38 cases not closed after an initial analysis, the QCIC met as many times as was necessary with representatives of the accused firm to gain a better understanding of the basis of the allegations and the implications of the allegations for the firms' quality control systems. During the course of these in-depth inquiries, QCIC task forces questioned and received information pertaining to audit performance relating to the allegations in the complaints from representatives of the firm knowledgeable about the case, reviewed the firms'

quality control policies and/or guidance materials on six cases, reviewed peer review working papers on one case, and reviewed selected audit documentation on two cases. These detailed inquiries were concluded only when the QCIC had a sufficient basis to conclude whether or not the allegations against the firm indicated a need for the firm to strengthen quality controls or issue additional internal guidance. Thirty-six cases were closed after these in-depth inquiries.

In two cases, the QCIC could not satisfy itself after in-depth inquiries that the firm's quality control system was either properly designed or functioning as intended. In those cases, the firm was requested to provide selected audit documentation having a bearing on the allegations in the complaint for review by the QCIC task force. After reviewing the audit documentation, these cases were closed when the QCIC was satisfied that the firm took, if necessary, corrective actions responsive to the issues identified in the case.

Communications with Standards-Setters and the PITF

The committee's analysis of litigation also results in identifying matters that it believes auditors would benefit from additional standards or guidance. These matters, involving accounting, auditing or quality control issues are typically referred to the SECPS Professional Issues Task Force (PITF) which then either develops "best practices" guidance for general circulation to practitioners or refers the matter to the appropriate standard setting bodies for their consideration.

During the past year, the QCIC identified four issues in six cases where it believed the profession would benefit from additional guidance material. Those issues were referred to the SECPS PITF and included requests for additional guidance on (1) the need for professional skepticism in the review of non-standard journal entries, (2) the use of fax and other copies of documents as audit evidence, (3) the considerations that should be given to auditing the physical existence and quality of inventories in high-tech companies, and (4) the application of analytical review procedures to disaggregated financial data. As noted elsewhere in this report, the PITF issued two important practice alerts: guidance on applying analytical review procedures as an audit tool, and guidance on the need for professional skepticism in the review of non-standard journal entries and the use of original and final source documents.

The QCIC referred one issue to the AICPA Auditing Standards Board for its consideration; namely, the extent to which an accounting firm can rely on the work of a foreign affiliate that is a member of the same association to which the firm belongs.

The QCIC also noted that there is no professional or regulatory requirement to notify the public when an accounting firm withdraws its audit report. Because the public interest would be better served with this information, the QCIC, through the SECPS SEC Regulations Committee, requested that the SEC amend its Form 8-K reporting requirements to include as a reportable event the withdrawal of an audit report on a publicly held company.

Memorandum of

Understanding with the

AICPA Professional

Ethics Division

During the year, the QCIC and the Professional Ethics Division (PED) developed a Memorandum of Understanding between the two self-regulatory committees to avoid duplication of efforts and streamline the ethics process. Prior to the Memorandum, the PED opened an investigation in the majority of cases closed by the QCIC. The new agreement between the two committees was designed to focus the efforts of the PED by categorizing each case closed by the QCIC into one of four categories, ranging from frivolous with a recommendation for no action by the PED with respect to engagement personnel to an explicit recommendation that the PED open an investigation of the performance of certain engagement personnel.

Referrals of Individuals

to the AICPA

Professional Ethics

Division

The QCIC occasionally becomes aware of behavior by individual CPAs, either in the accounting firms or in the companies being audited, which warrants further investigation. In those cases, the QCIC refers such matters to the AICPA Professional Ethics Division for their consideration. During the past year, three individuals were referred to the PED, two of which were CPAs working as Chief Financial Officers in companies involved in litigation. Both cases involved individuals allegedly involved in fraudulent activities.

Communication with

Member Firms

The SECPS membership rules require every member firm to report to the QCIC and provide copies of complaints, within 30 days of being served, of litigation (including criminal indictments) against the firm or its personnel that alleges deficiencies in the conduct of an audit of the financial statements of a present or former SEC registrant and certain other entities. This rule also applies to publicly announced investigations by the SEC. New member firms are required to report within 30 days of joining the SECPS such litigation, proceedings or investigations, that may have been filed or announced within the three-year period preceding the firm's admission to the SECPS. The firm's compliance

with the membership requirement is tested in the firm's triennial peer review.

On occasion, member firms have not reported litigation to the QCIC on a timely basis. As a result, the Section recently sent a letter to managing partners of all member firms reminding them of the Section's membership rules.

Summary and

Conclusions

The Board believes the QCIC process is functioning as designed and effectively complements the peer review process.

The Securities and Exchange Commission also actively oversees the QCIC process and the Board's monitoring thereof. The committee's staff prepares a comprehensive summary of each QCIC case which includes the results of the QCIC

inquiries and investigative procedures, corrective actions undertaken by the firm, and the basis for any committee actions. In addition, the POB staff prepares a comprehensive memo and oversight program documenting the results of their oversight procedures on each case. On a regular basis, the staff of the SEC's Office of the Chief Accountant visits the Board's offices and reviews the QCIC prepared case summaries on each individual closed case and the corresponding POB files. In addition, the SEC staff discusses the individual cases in considerable detail with the POB and QCIC staffs.

In its recently released 1997 Annual Report to Congress, the SEC noted that based on its review "the QCIC process is an effective supplement to the peer review process."

QCIC Activity

	Inception through 6/30/97	7/1/97 through 6/30/98	Totals
Actions Related to Firms			
<i>Either a special review was made, the firm's regularly scheduled peer review was expanded, or other relevant work was inspected</i>	69	1	70
<i>A firm took appropriate corrective measures that were responsive to the implications of the specific case</i>	116	11	127
Actions Related to Standards			
<i>Appropriate AICPA technical bodies were asked to consider the need for changes in, or guidance on, professional standards</i>	45	1	46
<i>The Professional Issues Task Force was asked to consider the issuance of a practice alert</i>	14	7	21
Actions Related to Individuals			
<i>The case was referred to the AICPA Professional Ethics Division with a recommendation for investigation into the work of specific individuals</i>	29	3	32
	273	23	296

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

The John J. McCloy

Award

Each year the POB awards the John J. McCloy Award for Outstanding Contributions to Audit Excellence. In December 1997, the Board selected Vincent M. O'Reilly as the recipient of the award and Dan Guy was selected in December 1998.

In selecting Vincent M. O'Reilly in 1997, the Board recognized his role as a thoughtful and outspoken leader of the SEC Practice Section Executive Committee whose views were always respected by his peers.

Mr. O'Reilly was also a leader in exploring the development of a new conceptual framework for auditor independence. His efforts were significant in the establishment of the Independence Standards Board. Among his other contributions, he chaired the SECPS Detection and Prevention of Fraud Task Force and led the team of the Committee of Sponsoring Organizations of the Treadway Commission that wrote the landmark study on *Internal Control – Integrated Framework*. Before retirement in 1997 Mr. O'Reilly's long career at Coopers & Lybrand included the positions of Deputy Chairman, Accounting and Auditing; Chief Operating Officer; and, most recently, Executive Vice Chairman, Professional Practice and Service Quality.

In selecting Dan Guy in 1998, the Board recognized his leadership in auditing standard setting in the United States over the past twenty years. During Mr. Guy's tenure as Vice President, the AICPA issued more than 40 Statements of Auditing Standards, and all of the Statements on Standards for Attestation Engagements. His contributions to auditing standards are acknowledged and respected by present and former Auditing Standards Board members, academicians, regulators and practitioners. His hallmark as a standard setter has always been his unwavering commitment to the public interest. Time and time again his analysis, counsel and advice relating to contentious standard setting debates have always been grounded in this commitment.

About the SEC Practice Section

and the Public Oversight Board

SECPS

The SEC Practice Section was founded in 1977 as part of the Division for CPA Firms of the American Institute of Certified Public Accountants and is overseen by the Public Oversight Board. The Section imposes membership requirements and administers two programs to help insure that SECPS members are audited by member firms with effective quality control systems. The first is peer review, a process to review the practices of Section members every three years by other accountants. The other major program is quality control inquiry, which reviews allegations of audit failure contained in litigation filed against member firms involving SEC clients.

Membership in SECPS

About 1,300 firms belong to SECPS including virtually all accounting firms that audit publicly held companies. The requirements of SECPS affect more than 127,000 professionals at member firms that audit more than 15,600 SEC clients.

Member firms of the SECPS must adhere to quality control standards established by the AICPA; have a peer review every three years, the results of which are maintained in a public file; and report to the SECPS Quality Control Inquiry Committee litigation against the firm that alleges deficiencies in the audit of an SEC client and regulated financial institution. Among other membership requirements, firms must periodically rotate the partner in charge of each SEC audit engagement and conduct a concurring, or second partner, preissuance review of each SEC audit engagement.

The Public Oversight Board

An independent private sector body, the Public Oversight Board was created in 1977 for the purpose of overseeing and reporting on the self-regulatory programs of the SEC Practice Section. The POB is responsible for monitoring and commenting on matters that affect public confidence in the integrity of the audit process. Funded by dues paid by SECPS members, the Board's independence is assured by its power to appoint its own members, chairperson and staff, set its own budget and establish its own operating procedures. The Board consists of five members, primarily non-accountants, with a broad spectrum of business, professional, regulatory and legislative experience.

Public Oversight Board

One Station Place
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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 F. FROEHLKE

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

Vice Chairman, 1997 – present, 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.

DONALD J. KIRK

Joined Board in 1995; Chairman of the Financial Accounting Standards Board, 1978-1986; Partner of Price Waterhouse & Co., 1967-1973

CHARLES A. BOWSHER

Joined Board in 1997; Comptroller General of the United States and head of the General Accounting Office, 1981-1996; Partner of Arthur Andersen & Co., 1971-1981; Assistant Secretary of the Navy-Financial Management, 1967-1971

STAFF

JERRY D. SULLIVAN

Executive Director

JOHN F. CULLEN

Assistant Technical Director

CHARLES J. EVERS

Technical Director

ALAN H. FELDMAN

Assistant Technical Director