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Audit quality : the profession's program

American Institute of Certified Public Accountants. SEC Practice Section. Public Oversight Board

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Public Oversight Board

Audit Quality: The Profession's Program

Public Oversight Board
SEC Practice Section
Division for CPA Firms
American Institute of
Certified Public Accountants

Public Oversight Board*

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Division for CPA Firms
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Preface

The AICPA's program of self-regulation, the focus of the Public Oversight Board's responsibility, is a recent and little known addition to the activities of the public accounting profession. Many people who should do not even know of its existence. Few understand it thoroughly. Many who benefit from its activities possess but a partial knowledge of its workings.

Members of the Board, some of whom were involved in the program's development, have observed changes in the self-regulatory program of the accounting profession, both in concept and practice, as those who pioneered its implementation learned from experience what will and will not work, what is and is not needed, what can and cannot be accomplished.

Six years is little enough in the history of most enduring institutions. Yet because of the substantial efforts that preceded the present program for audit quality, the commitment of participants, and the excellence of leadership, self-regulation of the accounting profession has come a long way.

The Board believes its report for 1983-84 should include not only its report on the activities of the past year but also a full description of the self-regulatory program as it exists today and the way in which self-regulation is viewed by those involved in its oversight. This booklet fulfills the latter objective: a description of the nature, scope, and complexity of the accounting profession's self-regulatory program, and the way in which that program combines with other regulatory efforts to provide maximum protection to the financial and investing public. We do so both to clarify the extent of the Board's responsibilities, as we see them, and to draw attention to the profession's efforts and the dedication of its members. Perhaps even more important, we desire to share with others what we have learned about professional regulation.

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Introduction

In 1977, the accounting profession embarked on a program for increasing the basis for reliance by the financial public on audit opinions. It was a unique experiment because no other profession had then, or has since, adopted a comparable program.

The new program called for additional controls over the accounting profession. Those controls were self-imposed, conceived in controversy, implemented under surveillance, and exist today not without criticism. Nevertheless, the program as it now stands is an extraordinary achievement, although it is little understood by many members of the profession and virtually unknown to its major beneficiaries.

Nature of Professional Regulation

During this relatively brief period, the accounting profession has learned a great deal about the nature of professional regulation. Experiences gained during the successful operation of the program over the past six years have provided valuable insights, new perspectives, and a clearer understanding of the nature of regulation and the roles that different organizations play in attaining it.

Regulation of professional practice is applied at three levels: by the firm, by the profession, and by government. Each has the same goal—satisfactorily reliable accounting and auditing services to society. However, each of the three uses different means to achieve the desired goal. One means of reaching that goal is to punish persons found guilty of fraudulent or otherwise unacceptable service. This is usually accomplished at the government level by action in courts of law, and by authorized regulatory and licensing agencies. A second means of attaining the goal is educational in nature, and consists of the establishment of professional standards, conveying these to members of the profession, and assisting practitioners in complying with them. This is usually accomplished within the profession by professional societies and by individual practitioners and firms. Thus, punishment and education are two diverse approaches by which the goal of adequate public protection is sought.

Within a professional firm, steps must be taken to assure that its work measures up to the expectations of clients and others, or the firm will soon have diminished opportunity to serve. In large measure, such expectations are established by the general level of work of competing firms. Thus, competitive pressure, working through the firm, is the prime mover for regulation at the firm level.

Private regulation at the firm level is seldom thought of as “regulation.” Yet, more than any other influence for the improvement of professional practice, private regulation is present and working. Self-interest should lead a firm’s management to rid itself of the incompetent, the negligent, and the untrustworthy. It is at the firm level that most continuing education takes place, that practitioners learn of new standards, developments, and opportunities for improved service. It is also at the firm level that inadequate performance of professional duties is most likely to terminate a practitioner’s career.

Additional regulation takes place at the level of the profession. Professional organizations generally have as one of their most important goals the elevation of the quality of professional performance. Ethical and other standards, continuing education programs and professional meetings, and provisions for censure and expulsion from membership are educational and punitive efforts used to improve a profession’s service to its various publics. The tie between professional or peer regulation and private regulation is a close one. Through acquaintances made at professional meetings and programs, practitioners learn of new practices and procedures found useful by others and by adopting these they improve the quality of their own firm’s work.

The third level of regulation—public regulation—is imposed by government in a variety of forms. Qualifying examinations, licensing provisions, regulatory requirements, all represent efforts by governmental authorities to assure satisfactorily reliable service to the public. Additionally, government regulation is characterized by investigations, legal actions, negotiated settlements, injunctions, and punishment.

To many people, the term “regulation” brings to mind preeminently punishment of those found guilty of unsatisfactory conduct and to them regulation, to be effective, must have the characteristics of government regulation. It is much more useful and much more accurate to view regulation in its totality with private and professional regulation having roles that are equally as important to that of government in attaining the goal of meeting society’s needs.

To be sure, public regulation has unique and important capabilities not shared by private and professional regulation. The power of subpoena, the ultimate authority of government, the traditions and practices of the judicial system, and the rules for assuring fair treatment of all parties to a dispute assure effectiveness and equity well beyond the power or ability of either private or professional regulation. On the other hand, for instance, the capacity of professional organizations and private firms to provide educational opportunities far exceeds anything government is likely to find feasible. Chart A broadly summarizes the activities at the various levels of regulation of a profession.

For these reasons, regulation of a profession requires the best efforts at all three levels. No one level of regulation is adequate alone. Indeed, no one of them can substitute for any other. If society’s needs are to be served, all three must be involved and be effective.

This report describes how these regulatory efforts operate and interrelate, and summarizes the manner in which the Division for CPA Firms of the American Institute of Certified Public Accountants contributes to professional regulation.

Genesis of the AICPA Program

During the decade of the 1970s, some members of Congress and the Securities and Exchange Commission expressed concern regarding the credibility of financial statements issued by publicly-owned corporations and the reliability of audit reports thereon issued by independent accounting firms. In the resulting discussions with representatives of the accounting profession, attention was focused on the manner in which the profession was organized, regulated, and disciplined. While the adequacy of financial accounting standards and the accounting standard-setting process were also questioned, most of the criticism centered on the performance of independent accountants and the audit process.

In the view of its most vocal critics, the accounting profession was of considerable public

CHART A *Levels of Professional Regulation*

Levels	Activities
Private regulation by firms	Education Market discipline On line, real time supervision
Peer regulation by professional societies	Professional standards Education Organizational discipline
Public regulation by government	Permission to practice Civil litigation Investigation and punishment of violators of laws and regulations

importance but unregulated. On the other hand, many accountants thought adequate control existed through the SEC, state boards of accountancy, the profession’s code of ethics, and the common law governing contractual relationships. They argued that individual accountants and firms were not free to do whatever they pleased because competitive forces encouraged discipline within firms, and the judicial system appeared entirely adequate to hold accountants accountable when investors suffered losses, allegedly because of auditing or accounting failures. However, these arguments did not satisfy the profession’s critics.

Peer regulation had existed for many years, commencing in 1887 when the first society of independent accountants was formed. Named the American Association of Public Accountants, it was the direct predecessor of the American Institute of Certified Public Accountants. At that time, the public accounting profession consisted chiefly of sole practitioners operating out of single offices with few or no professional staff. Consequently, the professional organization’s rules were then and continued to be applicable to individual practitioners, not firms.

As business enterprises grew and expanded across state and national boundaries, the public accounting firms servicing their needs also expanded, many into larger and then into multiple offices, and some into complex multinational organizations consisting of hundreds of practice offices and thousands of professionals.

During this period of dramatic change in the practice of public accounting and in the size of accounting firms, the organizations concerned with peer regulation of accountants did not foresee a need for, and therefore did not create, a mechanism to regulate public accounting firms. Rules of conduct of state societies of CPAs, as well as those of the AICPA, continued to deal only with

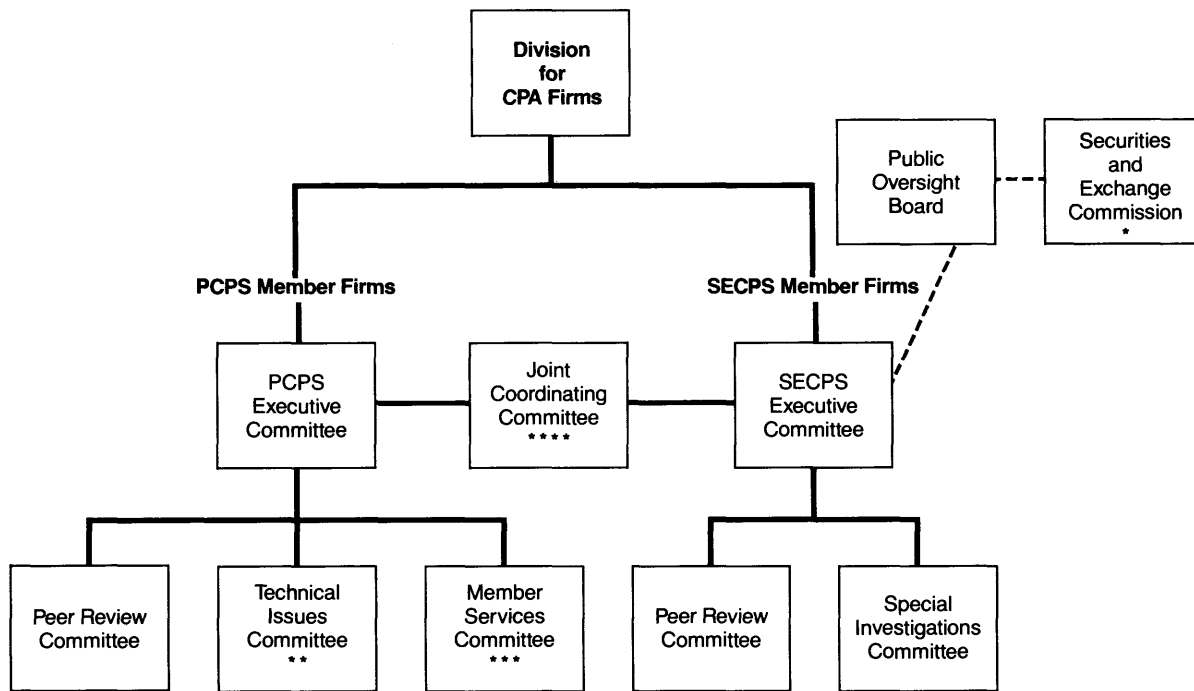
the conduct of individual members. Not until 1977 did the AICPA create a mechanism to regulate firms.

In that year, responsive to public and Congressional criticism, and over the objections of many accountants, the Council of the AICPA—its governing body—accepted the challenge and established a Division for CPA Firms. The Division consists of two sections, an SEC Practice Section (SECPS) and a Private Companies Practice Section (PCPS). Membership in either section is vol-

untary. These sections provide the organizational structure for the present peer regulation of the activities of member firms. See Chart B.

The Public Oversight Board, independent of the Division, whose members were to be “drawn from among prominent individuals of high integrity and reputation” was formed to oversee the activities of the SEC Practice Section and represent the public interest in the performance of its oversight function.

CHART B *Organization of the Division for CPA Firms*



* The SEC has oversight of the profession in general. The Public Oversight Board generally serves as a liaison between the Securities and Exchange Commission and the SEC Practice Section and coordinates access by the SEC to selected peer review and Board workpapers.

** The Technical Issues Committee monitors AICPA technical committees and develops recommendations to these groups from the perspective of accountants who serve private companies.

*** The Member Services Committee develops and administers a program of PCPS member services.

**** The Joint Coordinating Committee was recently formed to facilitate coordination between the two sections in identifying and dealing with common problems.

Components of the Regulatory Process

A full program of regulation of accountants and accounting should include provisions for the following:

- Admission of qualified people to professional practice.
- Establishment of generally accepted accounting principles and professional standards for accounting and auditing services and quality control.
- Continuing education for practicing accountants in accounting principles and professional standards.
- Periodic and regular determination of compliance with professional standards.
- Investigation of alleged deficiencies in complying with professional standards.
- Punishment of those found guilty of unacceptable practices.
- Maintenance of adequate competition.

Chart C illustrates how all these varying requirements are provided for. Note that all three levels of regulation are required if these goals are to be achieved.

Private Regulation

The management of a public accounting firm has the responsibility to prescribe appropriate operating policies and practices. To be viable, the firm must be competitive in its market area and ensure that its policies and practices are in accordance with standards established by rule-making bodies such as the Auditing Standards Board of the AICPA, the Financial Accounting Standards Board, and the Securities and Exchange Commission.

In addition, the AICPA Quality Control Standards Committee in 1979 established a set of quality control standards governing the accounting and auditing practices of accounting firms. Each section of the Division for CPA Firms requires its members to adhere to these standards. Thus, each member firm must establish, maintain, and enforce quality control policies and procedures that provide reasonable assurance of compliance with professional standards in the conduct of its accounting and auditing practice. These quality control standards are discussed at some length in a later section of this report.

CHART C *Scope of Regulation of CPA Firms*

Level	Regulatory Organizations	Principal Activities
Public Regulation	Federal and State Regulatory Agencies	■ License qualified firms and individuals to practice public accounting
	Federal and State Courts	■ Regulate firms and individuals in practice of public accounting
	State Boards of Accountancy	■ Enforce laws and regulations ■ Punish violators of laws and regulations
Peer Regulation	AICPA and State CPA Societies	■ Promulgate and enforce rules of professional conduct
	AICPA Division for CPA Firms	■ Establish accounting principles and standards for accounting and auditing services and quality control
	Voluntary Associations of CPA Firms	■ Develop and offer continuing education programs
	Private Sector Accounting Standard-Setters	■ Administer peer review programs
	Financial Accounting Standards Board Governmental Accounting Standards Board	■ Investigate alleged audit failures ■ Discipline those who violate rules of professional conduct
Private Regulation	CPA Firms and Practitioners	■ Development and enforcement of quality control policies and procedures ■ Continuous training of firm personnel ■ On-line supervision

Regulation of the day-to-day actions of partners and staff members is accomplished more effectively and persuasively by firm management than by any other participant in the regulatory process. Disciplinary measures applied within a firm are rarely publicized outside the firm. Nonetheless, in our opinion, they are extremely effective. Responses to inquiries of firm representatives made by the Special Investigations Committee of the SEC Practice Section suggest that private regulation is generally direct, immediate, and aimed at improving the quality of service to clients. Control over employment and compensation provides effective authority. Persons judged to be inadequate in performance of their professional responsibilities may be demoted, transferred, or terminated. Those who do well are rewarded. In some cases, remedial measures can be instituted to improve personnel performance, to draw attention to policies and established practices, or to strengthen policies and procedures judged to be in need of improvement.

For many firms, pride and professionalism undoubtedly provide sufficient incentive to monitor performance of partners and staff members as well as to establish and implement effective policies and practices. However, added incentive is provided by competitive forces in the marketplace and by the desire to avoid the damage to the firm's reputation and the other penalties that accompany litigation alleging noncompliance with professional standards. Thus, much of the motivation for private regulation comes from within the firm and is directly related to its economic and professional success.

Peer Regulation

Peer regulation can occur only when practitioners, through firms or individually, affiliate with an organization that has as one of its purposes the upgrading of professional performance. In accounting, membership in such organizations has always been voluntary so that acceptance of peer regulation is a voluntary act. Independent accounting firms that join the Division for CPA Firms make a serious commitment to comply with all professional standards and to make public specified information about themselves. The most far-reaching membership requirement—and the one that permits both sections to obtain assurance that a member firm is complying with professional standards—requires the firm to have the adequacy of its quality control system for its accounting and auditing practice and its compliance with that system reviewed by independent peers every

three years and to make public the report issued by the reviewers.

Without question, peer review is the centerpiece of the program of peer regulation of the Division for CPA Firms. A peer review is carried out under the supervision of a carefully selected committee. In addition, peer reviews of SECPS member firms are reviewed by members and staff of the Public Oversight Board. Independent peer reviewers evaluate and test the firm's quality control system to determine whether it is suitable and appropriate for the firm's accounting and auditing practice and whether it is being complied with. In the course of the review, the reviewers examine the financial statements and the audit report and workpapers and other documentary material related to selected accounting and auditing engagements to determine whether the firm's personnel complied with professional standards in performing their work. In that connection, the firm's quality control policies and procedures must be sufficiently comprehensive to provide reasonable assurance of conformity with all appropriate professional standards. The review procedures have been thoughtfully designed and tested to enable the reviewers and the Section's Peer Review Committee to determine whether the firm has an acceptable quality control system for its accounting and auditing practice.

Members of the Section must report all litigation involving the firm or its personnel that alleges an "audit failure" with respect to an SEC registrant. A special committee (the Special Investigations Committee) reviews each such case to consider whether the allegations indicate the need for corrective action by the firm or for reconsideration of professional standards.

The programs of the Peer Review and Special Investigations Committees complement and supplement one another. Peer review determines (1) the existence and adequacy of the reviewed firm's quality control system and (2) on a sampling basis, the extent to which the firm's personnel comply with it. The Special Investigations Committee follows up when specified allegations indicate that there is possibility that a firm's quality control system and compliance with it may not be as effective as the peer review may have found them to be. Together the peer review and special investigative processes provide the public with additional assurance that member firms are applying rigorous professional standards in the conduct of their accounting and auditing practice. All activities of the Section are actively monitored by the Public Oversight Board.

Some regional and local firms band together

in associations in order to facilitate such matters as correspondent relationships, continuing education, consultation on technical issues, policy formulation, and compliance with standards. Member firms maintain their own identities, operate under their own names, and sacrifice little, if any, authority as a requirement of membership. There now are over twenty such associations, many of them international in scope. Some associations require their members periodically to subject their accounting and auditing practice to peer review by other association members. The Division accepts intra-association peer reviews as long as they meet certain requirements established by the Peer Review Committees of each section.

Like private regulation, peer regulation is positive, continuing, and effective. The peer regulatory program of the Section reaches virtually all firms that have a significant SEC practice. Its primary goal is to improve future practice, not to punish mistakes of the past. Punishment in the form of a sanction by the Section is properly limited to situations when the firm fails to undertake corrective action considered necessary by the Section. In this connection, it is well to point out that institution of the Division's self-regulatory program has not diminished in any way the already existing forms of government regulation. The Institute's program represents an addition to, not a substitute for, any regulation already existing.

Public Regulation

Government or public regulation of accountants is intended to protect the investing public from fraud, gross negligence, or failure to comply with the laws and regulations that relate to independent audits of financial statements. Persons found guilty of noncompliance with minimum standards of performance established by law are subject to punishment which generally takes the form of damages to those claiming injury, public censure, injunction, suspension, bar from practicing before the SEC, or temporary or permanent loss of license to practice.

To many people, government regulation constitutes the regulatory model. To these people, unless an organization's efforts are directed to identifying, convicting, and punishing those who have failed to meet the requirements of the law or the expectations of society, its program is not effective. But the Section's program is not designed to do that. Peer regulation properly centers on strengthening systems of quality control and improving the effective performance of audits. Those who endanger or injure the investing public

through willful fraud or gross negligence should be apprehended and punished, but that task can be left to the governmental regulators and courts who do it quite well.

Interrelationship of Private, Peer, and Public Regulation

Peer regulation is inextricably intertwined with the two other levels of regulation governing the practice of public accounting. All levels are interrelated and each derives part of its effectiveness from roles played by the other two levels.¹

Private regulation—policies and procedures dictated and enforced by firm management—plays a most significant role. Since the benefits of private regulation flow directly to the owners of the firm—and conversely since noncompliance with professional and legal requirements directly affects the owners adversely—private regulation is potentially the most effective form of regulation. It can deal with problem areas immediately and authoritatively.

The effectiveness of peer regulation is directly commensurate with the number of firms that join the program and agree to abide by its rules and to have their actions judged by peers. Peer regulation, in effect, evaluates and publicly reports on the effectiveness of private regulation. Peer regulation has several beneficiaries. The general public, and especially the investing public, benefits by receiving improved accounting and auditing services. Member firms enjoy the benefits that accrue to membership in a prestigious, quality organization, especially the constructive criticism of peers. The profession benefits in several ways: the program, by upgrading the quality of practice, reduces the possibility of future audit failure and the resultant negative effects not only on the firms involved but on the entire profession. Governmental regulatory agencies are also direct beneficiaries of peer regulation. As SEC Chairman John S. R. Shad recently remarked:

*"Improvements in the implementation of these programs are enabling the [accounting] profession to assume greater self-regulatory responsibilities and permitting the Commission to limit its involvement to an oversight role."*²

¹ Robert K. Mautz, "Self-regulation—criticisms and a response," *Journal of Accountancy*, April 1984.

² John S. R. Shad, *Self-Regulation of the Accounting Profession*, an address before the Eleventh Annual Conference on Current SEC Developments, sponsored by the AICPA, January 10, 1984, Washington, D.C.

Quality Control Standards

The quality of services of a CPA firm is dependent in large part on its system of quality control. In 1979, the AICPA established quality control standards governing the conduct of audit engagements.³ Thus, a firm of independent auditors should establish quality control policies and procedures to provide it with reasonable assurance of conforming with generally accepted auditing standards in its audit engagements. Generally accepted auditing standards relate to the conduct of individual audit engagements; quality control standards relate to the conduct of a firm's audit practice as a whole.

Early in the formation of the self-regulatory program, the importance of quality control standards was recognized and adherence to them was made a membership requirement of both the SEC Practice Section and the Private Companies Practice Section.

Elements of a System of Quality Control for CPA Firms

A system of quality control for a CPA firm has nine elements. They are:

- Independence
- Acceptance and continuance of clients
- Hiring
- Assigning personnel to engagements
- Supervision
- Consultation
- Professional development
- Advancement
- Inspection

A system of quality control for a firm encom-

passes the firm's organizational structure and the policies adopted and procedures established to provide the firm with reasonable assurance of conforming with professional standards. The nature and extent of a firm's quality control policies and procedures depend on a number of factors such as its size, the degree of operating autonomy allowed its personnel and its practice offices, the nature of its practice, its organization, and appropriate cost-benefit considerations. The policies and procedures with which peer review is concerned are those that apply to all auditing and accounting services offered by the firm, typically a significant part of its total services. The standards are broad in nature, covering all of the firm's activities that have a bearing on the quality of its accounting and auditing services.

The Section's *SECPS Manual* provides considerable information on how a firm might establish policies and procedures that will comply with the quality control standards relating to each of these components. Illustrative models of quality control systems for firms of varying sizes are available from the AICPA. The following discussion includes only sufficient explanation of each element of quality control to provide an understanding of its nature and importance and the emphasis each receives during a peer review.

Independence

The essence of an audit is the *independent* examination of a company's financial statements for the purpose of providing a professional opinion regarding their conformity with generally accepted accounting principles. Without independence, the opinion and the examination have little validity or usefulness. Compliance with quality control standards therefore requires member firms to establish appropriate policies and procedures to accomplish the following:

- Instruct all professional personnel about the independence rules, regulations, interpretations, and rulings of the AICPA, state CPA society, state board of accountancy, state statutes, and, if applicable, the Securities and Exchange Commission and other

³ The elements of quality control were identified in Statement on Auditing Standards No. 4 and incorporated in Statement on Quality Control Standards No. 1, *System of Quality Control for a CPA Firm*, issued by the Quality Control Standards Committee, the senior AICPA technical committee designated to issue pronouncements on quality control standards.

regulatory agencies; and require personnel to adhere to such rules and regulations in the performance of their duties.

- Confirm, when acting as principal auditor, the independence of another firm engaged to perform segments of an engagement.
- Monitor compliance with policies and procedures relating to independence.

Acceptance and Continuance of Clients

Prudence suggests that a firm be selective in determining its professional relationships. To minimize the likelihood of association with a client whose management lacks integrity, a firm should adopt policies and procedures for deciding whether to accept new clients or continue existing clients. This usually includes:

- Procedures for evaluation of prospective clients and for their approval as clients.
- Evaluation of clients upon occurrence of specified events to determine whether the relationship should be continued.

Hiring

The quality of a firm's work ultimately depends on the integrity, competence, and motivation of personnel who perform and those who supervise the performance of the firm's services. Thus, a firm should adopt appropriate policies and procedures regarding the following:

- Maintaining a recruiting program designed to obtain qualified personnel by planning for personnel needs, establishing hiring objectives, and setting qualifications for those involved in the hiring function.
- Establishing qualifications and guidelines for evaluating potential hirees at each professional level.
- Informing applicants and new personnel of the firm's policies and procedures relevant to them.

Assigning Personnel to Engagements

Like other professional organizations, accounting firms include within their professional staffs practitioners possessing varying degrees of experience, knowledge, and skill. Policies and procedures for assigning personnel to engagements therefore need to be established to provide the firm with reasonable assurance that work will be performed by persons having the degree of technical training and proficiency required in the circumstances. Policies related to this important function generally cover:

- The firm's approach to assigning personnel, including the planning of overall firm needs and the

measures employed to achieve a balance of engagement manpower requirements, personnel skills, individual development, and utilization.

- Designation of an appropriate person to be responsible for assigning personnel to engagements.
- Provision for approval of the scheduling and staffing of each engagement by the person with final responsibility for the engagement.

Supervision

Audits are typically performed by teams, and members of those teams generally have different levels of experience and skill. However, one member of the team is assigned final responsibility for the engagement. While that individual is responsible for the supervision and review of individual engagements, the firm is responsible for establishing policies and procedures for the conduct and supervision of work performed by professional staff members at all levels to provide reasonable assurance that the work performed meets the firm's standards of quality. The extent of supervision and review required depends on many factors, including complexity of the subject matter, qualifications of the persons performing the work, and extent of consultation available and used. Firms need to consider providing guidance on the following broad matters:

- Procedures for planning engagements; this covers matters such as background information to be obtained, development of work programs and time estimates, and assignment of responsibility for audit planning.
- Procedures for maintaining the firm's standards of quality for the work performed; this includes matters such as audit procedures manuals, standardized forms and checklists, and procedures for resolving differences of opinion.
- Procedures for reviewing engagement workpapers and reports; this includes, among other things, consideration of the need for review by a second partner.

Consultation

The great variety of professional skill, knowledge, and experience within a CPA firm is matched by the variety and complexity of the accounting and auditing problems faced by staff members. When a member of the professional staff, including partners, meets with a problem that is new or involves unusual complexities, consultation with more skilled, knowledgeable, or experienced associates helps avoid the possibility of error or other inadequacies. Quality control standards

require that appropriate policies and procedures for consultation be established to provide the firm with reasonable assurance that its personnel will seek assistance, to the extent required, from persons having appropriate levels of knowledge, competence, judgment, and authority.

The nature of arrangements for consultation within a firm depends on a number of factors including the size of the firm and the levels of knowledge, competence, and judgment possessed by the persons performing the work. In deciding on the consultation policies and procedures appropriate for its practice, a firm is expected to give consideration to the following objectives:

- Identification of areas and specialized situations where consultation is required, and encouragement of personnel to consult with or use authoritative sources on other complex or unusual matters.
- Designation of individuals to serve as authoritative sources, with definition of their authority in consultative situations.
- Establishment of procedures for resolving differences of opinion between engagement personnel and designated consultants.
- Specification of the nature and the extent of documentation necessary to record the results of consultation in those areas and specialized situations where consultation is required, and for other consultations as well.

Professional Development

Because business and accounting are both dynamic activities involving innovation and change, continuing professional education is a necessity to keep practitioners abreast of new developments and to assist staff members to acquire the knowledge and skills they need for advancement. Appropriate professional education and training activities enable a firm to provide its personnel with the knowledge required to fulfill responsibilities assigned to them and to progress within the firm. Because of the importance of continuing education to the continued performance of quality product, a firm should:

- Establish guidelines and requirements for the firm's professional development program and communicate them to all members of the professional staff.
- Supply personnel with information about current developments in professional technical standards and encourage personnel to engage in self-development activities.

- Provide, to the extent necessary, programs to develop expertise in specialized areas and industries in order to meet the firm's needs for such personnel.
- Provide adequate and effective on-the-job training during the performance of engagements.

Advancement

Practices in promoting and otherwise rewarding personnel for satisfactory performance have important implications for the quality of a firm's work. Quality control standards require a firm to give consideration to its needs for measures that

- Establish the qualifications deemed necessary for the various levels of responsibility within the firm.
- Evaluate performance of personnel and periodically advise personnel of their progress.
- Maintain personnel files containing documentation relating to the evaluation process.
- Assign responsibility for making advancement decisions.

Inspection

Inspection is a review program conducted within a firm under the direction of management. Compliance with policies and procedures related to the eight other elements of the quality control system is tested, and engagements from the firm's accounting and auditing practice are reviewed to determine whether firm policies and procedures have been applied appropriately. Such reviews are typically conducted by partners or experienced managers and constitute an important feature of quality control. In multioffice firms, offices should be inspected by teams from other offices. When deviations from established practices are discovered, steps should be taken to assure that compliance is obtained in the future.

To assure that inspection is adequate, a firm should establish policies that:

- Define the scope and conduct of its inspection program.
- Provide for reporting inspection findings to management and for monitoring any actions intended to strengthen quality control.

The Peer Review Process

Each member firm is required to subject its quality control system to review by independent peers at least once every three years. A peer review is intended to evaluate (1) whether a firm's system of quality control for its accounting and auditing practice is appropriately comprehensive and suitably designed for its needs, (2) whether its quality control policies and procedures are adequately documented and communicated to professional personnel, (3) whether such policies and procedures are being complied with, and (4) whether the firm is complying with the membership requirements of the Section.

A member firm is required to provide to the review team the following background information: (1) documentation that describes or summarizes the policies and procedures constituting its quality control system, (2) a description of the firm's organization (including an organization chart), and (3) other descriptive material relating to the elements of quality control and the firm's operations.

General Considerations in a Peer Review

Administration of the peer review program is the responsibility of the Section's Peer Review Committee. A peer review is conducted with due regard for requirements of confidentiality imposed by the rules of conduct of the code of professional ethics of the AICPA. Care is taken to assure that none of the reviewed firm's clients are identified in the workpapers or in any way made public.

The Review Team

A review team may be appointed by the Committee, may be formed by a member firm engaged by the firm under review, or may be formed by an association or state CPA society authorized to administer peer reviews. The review team captain directs the organization and conduct of the review, supervises other reviewers, and is responsible for preparation of a report on the review and, where applicable, suggestions for improving the firm's quality control system. Only

partners currently involved in the audit function are eligible to serve as review team captains.

All members of the review team must be independent with respect to the firm to be reviewed. Reciprocal reviews between firms are not permitted. Any relationship between the reviewed firm and members of the review team that implies a lack of independence is considered by the Peer Review Committee.

Review teams must have knowledge of the type of practice to be reviewed, including expertise in specialized industries in which the firm practices. In the case of firms with SEC practices, review teams must consist of persons who are knowledgeable about current SEC rules and regulations.

The review team is expected to carry out the review in a professional manner similar to that of an independent accountant examining financial statements.

Performing the Field Review

A peer review has four distinct phases:

1. Study and evaluation of the firm's quality control system.
2. Review for compliance with the firm's quality control policies and procedures at each organizational or functional level within the firm, including review of workpaper files and reports for selected accounting and auditing engagements.
3. Review of the firm's compliance with membership requirements of the Section.
4. Preparation of a written report and, where applicable, a letter on matters that may require action by the firm.

Chart D provides an overview of the peer review process.

Extent of Review Team's Tests

In a review of a multioffice firm, the selection of practice offices for review needs to be sufficient to evaluate whether the firm's quality control policies and procedures are adequately communicated to professional personnel and whether

they are being complied with. While the number and location of practice offices to be selected requires the exercise of judgment, guidelines to aid the review team captain in making that judgment are contained in the *SECPS Manual* as follows:

Number of offices in reviewed firm	Approximate number of offices to be selected for review
2 to 15	Largest office plus 1 to 3 offices
Over 15	15% to 25% of the reviewed firm's offices (the selected offices should contain similar percentages of the firm's professional personnel and the firm's accounting and auditing hours)

The number of offices and the accounting and auditing engagements to be selected for review, which reflects, among other things, a judgment as to the percentage of accounting and auditing hours to be reviewed, is affected by the size and nature of the firm's practice. The objective is to obtain a reasonable cross-section of the firm's practice although greater weight is given to publicly-held clients, to large and complex clients, and to initial audit engagements. The review team's evaluation of the firm's inspection program also affects the selection process.

In evaluating the firm's inspection program, the review team considers such factors as whether the inspection team's workpapers adequately document findings and conclusions, and whether the report of the inspection team is consistent with those findings and conclusions. The review team tests the findings and conclusions of the firm's inspection team in order to determine whether the firm is adequately monitoring its quality controls and whether reliance can be placed on the inspection function. These tests may be accomplished by comparison of the findings of the review team with those of the inspection team, by direct observation of inspection procedures, or by follow-up review of one or more offices inspected by the inspection team.

The objectives of the review of engagements are to evaluate (1) whether there has been compliance by personnel of the firm with its quality control policies and procedures in the performance of accounting and auditing services and (2) whether the quality control policies adopted and procedures established by the firm are appropriately comprehensive and suitably designed. Guidelines for determining the extent of engagement testing are provided in the *SECPS Manual*:

Number of offices in reviewed firm	Percentage of reviewed firm's total accounting and auditing hours to be reviewed
1 to 15	5% to 10%
Over 15	3% to 6%

Chart D depicts the peer review process as it relates to the review of selected accounting and auditing engagements.

Review Team Workpapers

The review team members document in workpapers the review procedures performed and their findings, including matters that indicate deficiencies in the firm's quality control policies and procedures or significant lack of compliance therewith. At the conclusion of the fieldwork, a summary review memorandum is prepared that, among other things, covers (1) the planning of the review, (2) the qualifications of the review team members, (3) the scope of the work performed, (4) the findings and type of report to be issued together with reasons supporting the report, (5) whether a letter of comments is to be issued and if not, why not, and (6) comments communicated orally to management of the firm that were not deemed of sufficient significance to include in a letter of comments.

Reporting on Peer Reviews

Peer Review Report

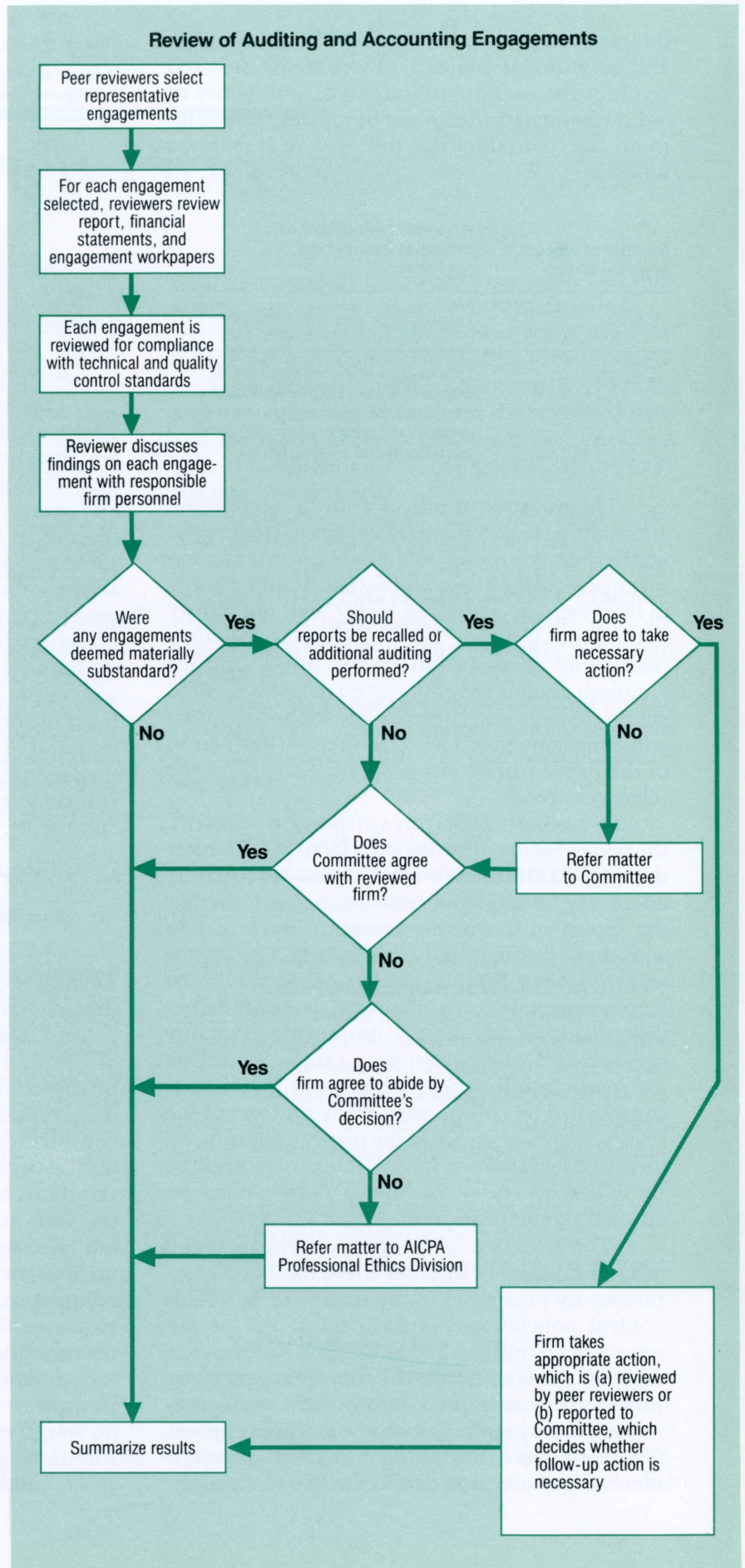
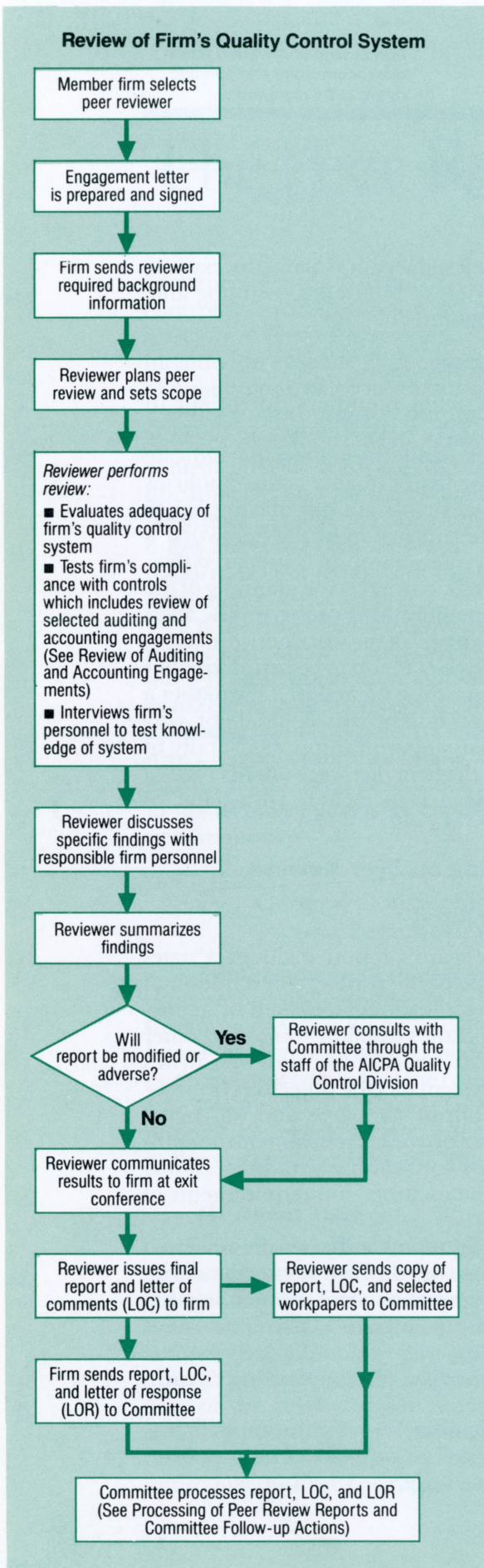
The review team's report includes a statement of the scope of the review, a description of the general characteristics of a system of quality control, and the team's opinion—or a disclaimer of opinion—as to whether the reviewed firm's quality control system met the objectives of established quality control standards and was being complied with to provide the firm with reasonable assurance of conforming with professional standards and the membership requirements of the Section.

An *unqualified* report indicates the reviewed team's satisfaction with the firm's system and with compliance with the system and the membership requirements of the Section. Most reports have been unqualified.

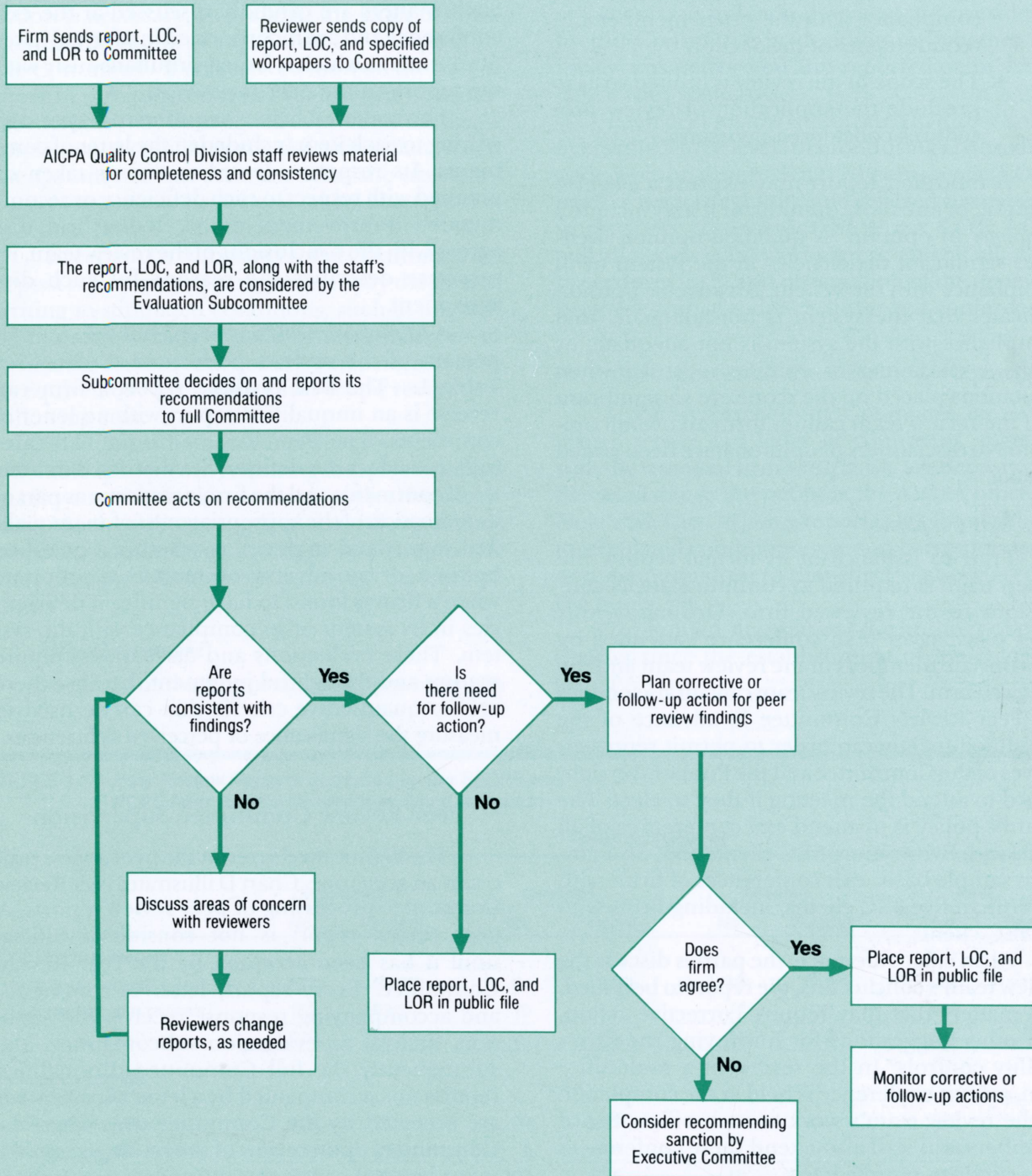
A report is *modified* in the following circumstances:

1. The review discloses significant deficiencies in the firm's quality control policies and procedures.

CHART D Overview of Peer Review Process



Processing of Peer Review Reports and Committee Follow-up Action



2. The review discloses a significant lack of compliance with the firm's quality control policies and procedures.
3. The review discloses a significant lack of compliance with the other membership requirements of the Section.
4. The scope of the review is limited so as to preclude the application of review procedures considered necessary.

A modified report may express a *qualified* opinion, or an *adverse* opinion, or it may include a *disclaimer* of opinion. A qualified opinion identifies significant deficiencies in the system or in compliance with the system. An adverse opinion indicates that the system is not adequate, that compliance with the system is not adequate, or both. A disclaimer of opinion is issued when limitations placed on the scope are so significant that the review team cannot form an overall opinion. No disclaimers of opinion have been issued to date.

Exit Conference

Prior to issuance of its formal report, the review team is required to communicate its conclusions to the reviewed firm. Ordinarily, this takes place at an "exit conference" attended by appropriate members of the review team and the reviewed firm. The review team captain also notifies the Peer Review Committee in advance of the scheduled meeting in order to permit representatives of the Committee and the Public Oversight Board to attend the meeting if they so elect. The Board's policy is to attend exit conferences of all firms with five or more SEC clients and, on a random sample basis, exit conferences of firms with fewer than five SEC clients, including firms with no SEC clients.

At an exit conference, the parties discuss the review team's conclusions, the report to be issued, any matters that may require corrective action, and other suggestions for improving the firm's quality controls. In the review of a multioffice firm, an exit conference is held at the completion of the review team's work at each office. Board members and staff also attend these conferences on a random sample basis.

Letter of Comments

During the course of the review, the review team may discover matters that it believes require action by the firm, either because modifications in its practices would result in substantial improvement in its quality control policies and pro-

cedures, or in its compliance with them, or with the membership requirements of the Section. A letter of comments, therefore, is always issued when the review results in a modified report. Such matters are candidly discussed at the exit conference and are incorporated in a formal letter of comments which is issued simultaneously with the report on the peer review.

The reviewed firm is required to respond in writing to each item included in the letter of comments. Its response describes actions taken or planned with respect to each deficiency or recommended improvement noted. If the firm disagrees with the conclusions of the review team, its response describes the reasons for such disagreement.

A *letter of comments* has been issued on over 90 percent of the reviews performed to date. See Table 1. The best possible report a firm can receive is an unqualified report with no letter of comments. The Peer Review Committee carefully considers the deficiencies discussed in a letter of comments and the firm's response as part of its evaluation of the appropriateness of an unqualified report and in deciding whether a qualified opinion or an adverse opinion is appropriate when a firm is found to have significant deficiencies in its system or in compliance with the system. These evaluations and discussions require mature and thoughtful judgment, because there are no quantitative criteria that can be used to measure the significance of perceived deficiencies.

Peer Review Committee Supervision

The Committee's role in the peer review process is an active one. Chart D illustrates Peer Review Committee processing of peer review reports. A peer review report is not considered official until it has been accepted by the Peer Review Committee. Every report, letter of comments, and accompanying response receives the attention, first, of an evaluation subcommittee, and subsequently the full Committee. Unqualified reports not accompanied by a letter of comments are accepted by the Committee only when the Committee, upon review of the findings, concurs that a letter of comments is unnecessary. If there is an apparent inconsistency between a review team's findings and its report, the Committee pursues the matter until resolved. For example, the Committee may question the review team about the factors it considered in deciding on the type of report issued, may review the review team's workpapers, or may require the review team to

revisit the firm and perform additional procedures to substantiate its conclusions.

If the Committee concurs with the report issued and decides that no additional corrective action is necessary, the report, the letter of comments, and the firm's response are accepted by the Committee. If corrective action on the part of the firm is required but not yet taken, a Committee member may be assigned to monitor the firm's implementation of its corrective action plan. When the Committee has assurance that the necessary corrective actions have been taken, the report is accepted by the Committee.

In certain circumstances, the Committee accepts a report only upon agreement by the firm in writing to stipulated conditions, such as a revisit by the review team or a Committee member to review the corrective actions deemed necessary or a requirement for another full scope review the following year.

The Committee can and does exercise considerable influence in requiring improvements in quality control when it considers such to be necessary. Much of the strength of the self-regulatory program comes from the rigor with which the Peer Review Committee performs its several duties.

Board Oversight

Because of the importance of peer review in

the overall self-regulatory program, the Board and its staff devote a significant amount of time to monitoring all aspects of the process. The Board's views are sought on all proposed changes and its comments on individual reviews are considered by the Committee in deciding on whether the review was performed and reported on in accordance with standards.

Each peer review is subjected to direct Board oversight. Three levels of monitoring are used: (1) review of the report, letter of comments (LOC), letter of response (LOR), and selected review team workpapers; (2) review of the report, LOC, LOR, and all review team workpapers; and (3) all of the procedures in (2) and observation of the review in progress and attendance at the exit conference.

Public Access to Peer Review Reports

Upon acceptance by the Committee, the review team's report and letter of comments, together with the reviewed firm's response, are deposited in files available to the public at the AICPA offices in New York City. When a report is accepted subject to stipulated conditions, relevant correspondence or a memorandum to that effect is also placed in the public file.

Table 1 is a summary of the findings of peer reviews since the establishment of the Division for CPA Firms.

TABLE 1 *Peer Review Reports Accepted by the SECPS and PCPS Peer Review Committees Since Inception*

	TYPE OF OPINION							
	Unqualified		Qualified		Adverse		Total	
	No.	Percent	No.	Percent	No.	Percent	No.	Percent
SEC Practice Section								
Initial peer reviews	377	83.6%	61	13.5%	13	2.9%	451	100%
Subsequent peer reviews	152	93.3	10	6.1	1	0.6	163	100
	529	86.2	71	11.5	14	2.3	614	100
Private Companies Practice Section*								
Initial peer reviews	806	87.3	99	10.7	18	2.0	923	100
Subsequent peer reviews	54	93.1	4	6.9	—	—	58	100
	860	87.7	103	10.5	18	1.8	981	100
Combined Total for Division for CPA Firms								
Initial peer reviews	1,183	86.1	160	11.6	31	2.3	1,374	100
Subsequent peer reviews	206	93.3	14	6.2	1	0.5	221	100
	1,389	87.1%	174	10.9%	32	2.0%	1,595	100%

* The Public Oversight Board does not oversee the activities of the Private Companies Practice Section. These data regarding peer reviews of this Section were obtained from the PCPS Peer Review Committee.

Tables 2, 3, and 4 are analyses of reviews of SECPS member firms. Table 2 shows a significant decrease in the number of firms receiving modified reports in 1983 as compared with earlier years.

TABLE 2 *Summary of Types of Peer Review Reports Issued on 1983 SECPS Reviews and Since Inception of the Program*

	Since Inception		On 1983 Reviews	
	No.	Percent	No.	Percent
Firms receiving unqualified opinion with no letter of comments	51	8.3%	17	12.0%
Firms receiving unqualified opinion and a letter of comments	478	77.8	116	82.3
Firms receiving qualified opinion	71	11.6	7	5.0
Firms receiving adverse opinion	14	2.3	1	0.7
	<u>614</u>	<u>100%</u>	<u>141</u>	<u>100%</u>

Table 3 summarizes corrective actions required by the SECPS Peer Review Committee during the most recent three-year cycle regarding audit engagements found not to have been performed in accordance with professional standards. Table 4

TABLE 3 *Corrective Action Required by SECPS Peer Review Committee With Respect to Substandard Audit Engagements Identified in Peer Reviews Performed During Most Recent Three-Year Cycle*

Number of audit engagements reviewed	<u>3,247</u>
Number of audit engagements considered substandard by peer reviewers	<u>95</u> (2.9%)
Corrective Action Required	
Audit report recalled and financial statements revised and reissued	17
Omitted auditing procedures performed	12
Omitted auditing procedures—firm has not yet informed Committee of actions to be taken*	3
Cause of impairment of independence eliminated	4
Questionable GAAS and GAAP treatment to be improved in subsequent year	<u>59</u>
Total	<u>95</u>

*Engagements identified in review processed by Committee in March 1984.

summarizes follow-up actions required by the SECPS Peer Review Committee during the past three years to assure that firms made the necessary improvements in their quality control systems. Since the peer review requirement is triennial, Tables 3 and 4 summarize generally the results of all member firms except those that have joined within the past few months.

TABLE 4 *Summary of Committee Actions to Assure Implementation of Quality Control Improvements in Connection with SECPS Peer Reviews During the Most Recent Three-Year Cycle*

Type of Action Stipulated by the Committee	Number of Follow-up Actions
Firms required to undergo an accelerated peer review:	
Firms receiving adverse opinions	7
Firms receiving qualified opinions	9
	<u>16</u>
Firms required to allow a revisit by peer reviewer or Committee member to review effectiveness of corrective action:	
Firms receiving adverse opinions	1
Firms receiving qualified opinions	9
Firms receiving unqualified opinions with letter of comments	8
	<u>18</u>

As indicated, while the thrust of a peer review is to identify deficiencies in a firm's system of quality control, the process also identifies engagements which are determined not to have been performed in accordance with professional standards. These instances are reported promptly to the Committee, which follows up each instance to ascertain that appropriate action is taken. In cases where the financial statements were determined not in accordance with generally accepted accounting principles, the firm recalled its report and the financial statements were reissued, or if the report was given limited distribution, the firm agreed to cause the deficiencies to be corrected in the subsequent year's report.

In those instances where it was concluded that the audit was not performed in accordance with generally accepted auditing standards, the firm either immediately performed the omitted procedures or agreed to perform them in a subsequent imminent audit.

Investigation of Alleged Audit Failures

No system of quality control can guarantee that a firm will never issue an inappropriate report. Management fraud, mistakes of judgment, misunderstanding of instructions, carelessness, and other personal factors may result in "audit failures" no matter how rigorous the system of quality control. Neither can peer review, the heart of the AICPA's self-regulatory program, which is necessarily and appropriately performed on a sampling basis, be expected to disclose all personnel failures. A peer review is designed to provide reasonable, not absolute, assurance that the firm's accounting and auditing engagements are performed in compliance with professional standards.

Therefore, certain allegations of audit failure are assigned for investigation to the Special Investigations Committee which considers whether they result from a "people problem," a systems failure, or an inadequacy in professional standards, and considers what steps, if any, need to be taken to protect the public from a future failure. The Securities and Exchange Commission has made the following comment:

Although peer reviews provide no assurance that all audit failures will be identified or avoided in the future, any audit failures that occur should be due to isolated breakdowns or "people problems," and not to inherent deficiencies in firms' systems of quality control.⁴

The Committee consists of nine experienced auditors, some retired and some still active, whose work complements and supplements the peer review process.

Confidentiality of Committee Activities

When the Special Investigations Committee was formed, it was recognized that any public disclosure of its activities regarding a particular firm or case could be used to the prejudice of that firm. This could be unfair to the firm because the purpose of the Committee's action (i.e., to improve the quality of audits) would be quite different from that of litigation (i.e., to ascertain fault and

impose liability). Moreover, the proceedings of the Committee ordinarily would not result in authoritative findings of fact based on study of all the facts. As a result, the authorization document establishing the Committee required that all its activities be performed in strict confidence. Meetings of the Committee are open only to assigned AICPA staff members and representatives of the Public Oversight Board. Workpapers are destroyed after they have served their purposes in the Committee's decision-making process and oversight is complete. No publicity of any kind is given to any of the Committee's activities. This policy of confidentiality does not restrict the effectiveness of the Committee in carrying out its intended purpose.

Allegations of audit failure in litigation or regulatory proceedings unavoidably raise questions about the adequacy of a firm's system of quality control. Whether the allegations are well founded or not, the mere existence of such charges requires the attention of those concerned with that firm's quality controls. Provision for the investigation of allegations of audit failure is included in the membership requirements of the SEC Practice Section. Member firms must promptly report each instance of litigation or other regulatory proceeding against the firm or any of its personnel, involving clients that are SEC registrants alleging deficiencies in the conduct of an audit or reporting thereon in a filing under the federal securities laws. Although the Committee currently does not have jurisdiction under its charter for allegations involving entities that are not SEC registrants, the Executive Committee can require a member firm to comply with the Committee's request for information if the Committee feels such allegations require investigation. To date, the Executive Committee has not had to take such action because member firms have voluntarily complied with all requests of the Committee.⁵

Allegations made in litigation may or may

⁴ *Securities and Exchange Commission, Annual Report, 1982*, U.S. Government Accounting Office, Washington, D. C.

⁵ In June 1984, the SECPS Review Committee, a committee appointed by the Chairman of the AICPA to review the structure, operations, and effectiveness of the SEC Practice Section, issued its report, recommending, among other things, that the membership requirement for reporting cases to the Committee be extended to cover cases involving all entities in which there is a significant public interest.

not have any foundation in fact. If valid, they may imply deficiencies in the firm's system of quality control or in professional literature, or they may imply a failure by the firm's personnel to carry out their assigned duties in a professional manner.

The possibilities with respect to a set of allegations are several and varied. From the standpoint of quality control:

1. They may be based on misunderstanding by the plaintiff of accounting and/or auditing standards.
2. They may represent a failure attributable to the independent accountants—
 - a. Because of a personnel deficiency.
 - b. Because of a systems deficiency.
3. They may indicate the need for reconsideration of professional standards.

If the charges are determined to represent a misunderstanding of accounting and/or auditing standards, the case is closed. If it appears that there may have been a failure by specific members of the firm's professional staff to follow established policies and procedures, rather than weaknesses in the firm's system of quality control, the Committee considers whether corrective action taken by the firm is appropriate to guard against the possibility of a future failure. However, it will leave the task of fixing responsibility and punishment to the courts and regulatory bodies which are much better equipped to do so.

If the Committee identifies system weaknesses as a result of its investigative procedures and these have already been eliminated by corrective action taken by the firm, the case will be closed. If weaknesses in the firm's system of quality control have not yet been corrected, recommendations for improvement will be discussed with the firm. If agreement cannot be reached with the firm on appropriate improvements in the system, the facts will be reported to the Executive Committee for appropriate action, which might involve the imposition of sanctions.

Chart E depicts the process of investigation of allegations by the Committee. The Board has complete access to all Committee files and actively monitors the Committee's decisions on individual cases. The Board's staff reads all pertinent documents, financial information, and correspondence related to reported cases. Summaries of each case are distributed to Board members and serve as a basis for discussion at Board meetings.

Representatives of the Board attend all Committee meetings and, at the Board's discretion, meetings between firm representatives and Committee members, as described below.

The Investigative Process

For each reported case, the member firm is required to provide the Committee's staff with copies of the complaint, relevant financial statements, SEC or other regulatory filings, and, upon request, other public documents such as special reports of bankruptcy trustees. As part of its regular duties, the Committee's staff reads the financial press and business and SEC publications for reports of alleged audit failures. In this manner, the staff usually becomes aware of matters to be reported before member firms formally report them and identifies alleged audit failures involving non-SEC registrants that may have significant public interest. The staff prepares a summary of such documents, identifying the accounting, auditing, and quality control issues involved, and includes a summary of or references to relevant professional literature. The staff summary and copies of the documents are supplied to all Committee members.

At the Committee meeting following the reporting of a case, a task force of one or two Committee members is appointed to consider the allegations and relevant documents and to recommend what other investigative procedures should be applied.

The task force carefully(1) reviews all materials relevant to the case such as the complaint, the financial statements, and filings with the SEC and other regulatory agencies; (2) considers the results of the most recent peer review; and (3) reads available public information ranging from newspaper articles to court documents. The task force reports on its activities at each Committee meeting.

In some instances, a thoughtful reading of the complaint and related financial statements permits the task force to conclude that the allegations are without merit and that no further action by the Committee is warranted. For example, this conclusion might follow when the complaint alleges inadequate financial statement disclosures although all required disclosures are clearly evident from a reading of the statements. However, a decision to close a case requires formal action by the Committee, an action which the Committee does not take lightly. The task force proposing such an action presents supporting facts and rea-

soning to the Committee and is often questioned at some length. Even though a majority of the Committee may agree with the task force's recommendation, it is not unusual for the Committee to defer action on a recommendation to close a case and to ask the task force to obtain additional information regarding some aspect of the charges.

The task force may decide that it needs additional information in the course of its work or, as indicated above, the Committee may require that additional information be obtained. Conferences with representatives of the firm and with the captain or members of the latest peer review team are common means of obtaining such information. The specifics of each case influence the kinds of information sought in such conferences, but the most commonly requested information includes:

- The firm's general assessment of the allegations and its basis for such assessment.
- The current responsibilities of the partner(s) and manager(s) who supervised the audit engagement involved in the litigation.
- Whether the audit team on the engagement sought consultation with others within the firm regarding matters that are the subject of the litigation.
- Current policies and procedures regarding aspects of the quality control system challenged by the litigation.
- Whether the office issuing the report in question had recently been subjected to (a) peer review or (b) the firm's internal inspection program, and, if so, whether the work of the supervisory personnel involved in the engagement under litigation had been subjected to review or inspection.
- The nature and scope of supervision and guidance in specialized industries, if relevant to the case.
- The issues underlying matters mentioned in a peer review report or letter of comments.

After thorough consideration of the information gathered, the Committee decides if there appears a need to continue or expand its inquiry. In a significant number of cases, the information gathered through the procedures described above has enabled the Committee to conclude that the case can be closed.

Moreover, in a number of cases, the Committee learns that the firm itself has already reviewed the matter, and, if desirable or necessary, has strengthened or emphasized relevant quality control policies and procedures and/or reassigned certain responsibilities. In large measure, experience to date has provided convincing evidence that private regulation by individual firms is effective

in implementing timely and appropriate corrective action—that is, once litigation or some other proceeding alerts a firm to possible weaknesses, it acts on its own initiative to discover and correct any deficiency in its quality control system.

Monitoring

When the Committee decides that relevant additional information may be forthcoming, a case may be placed in monitoring to await the results of certain activities then in process. In effect, monitoring represents an extension of time to complete the investigation, an extension made necessary by indications that additional information may become available. For example, the Committee may decide that the input from the results of a firm's then in-process peer review or the imminent report of a bankruptcy trustee may be relevant to deciding the Committee's future course of action. The Committee may also decide to keep the case in monitoring status until it can evaluate the effectiveness of relevant corrective actions by the firm. As further information becomes available, the task force assigned to the case will generally discuss these developments with representatives of the member firm or the peer review team.

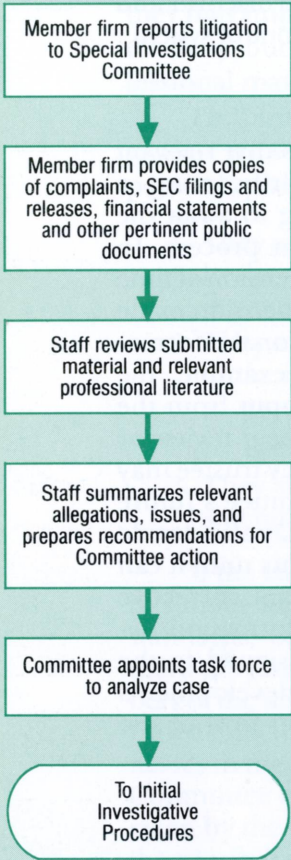
Special Reviews

The Committee's concern with a specific set of allegations always runs to their possible implications with respect to the firm's system of quality control, not to the validity of the allegations in the case. The Section recognizes that the courts, the SEC, and others which possess relevant statutory powers will ultimately decide the merits of the allegations and impose a formal penalty, if one is called for. The Committee's responsibility is to gain assurance that the firm remedies any deficiencies in its quality control system or in its compliance with that system that might lead to future failures.

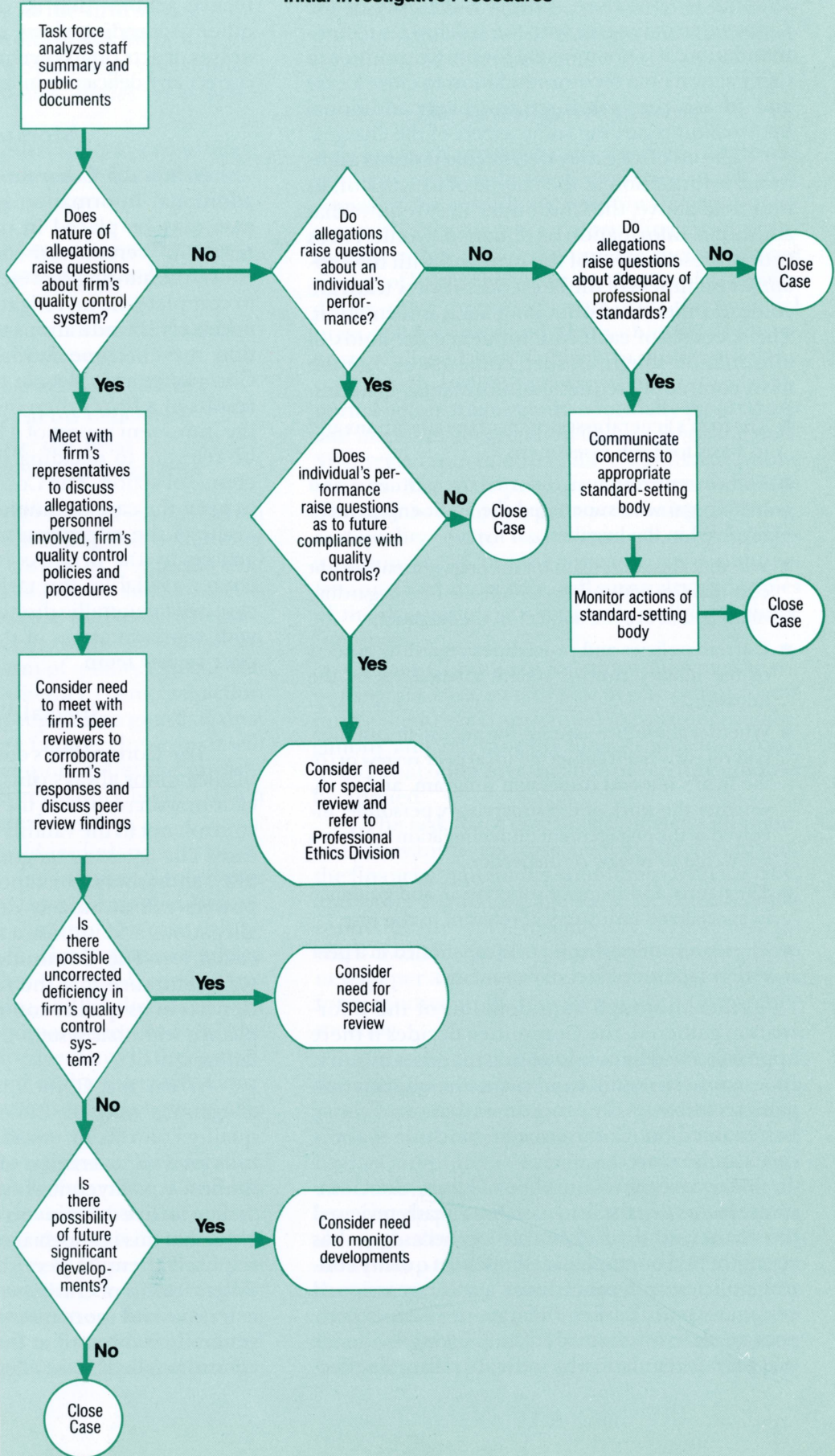
When the Committee concludes that the allegations may be indicative of unsatisfactory quality controls or unsatisfactory compliance, it calls for a special review of one or more aspects of the firm's quality control system. This has occurred, to date, in five cases involving four different firms. Note that this is a special review in addition to the required triennial peer review. A special review differs from a peer review in that it is typically less extensive and more intensive. The special review generally is directed at those elements of quality control implied by the allegations to have deficient

CHART E *Activities of Special Investigations Committee*

Reporting Phase and Summary of Issues by Committee Staff

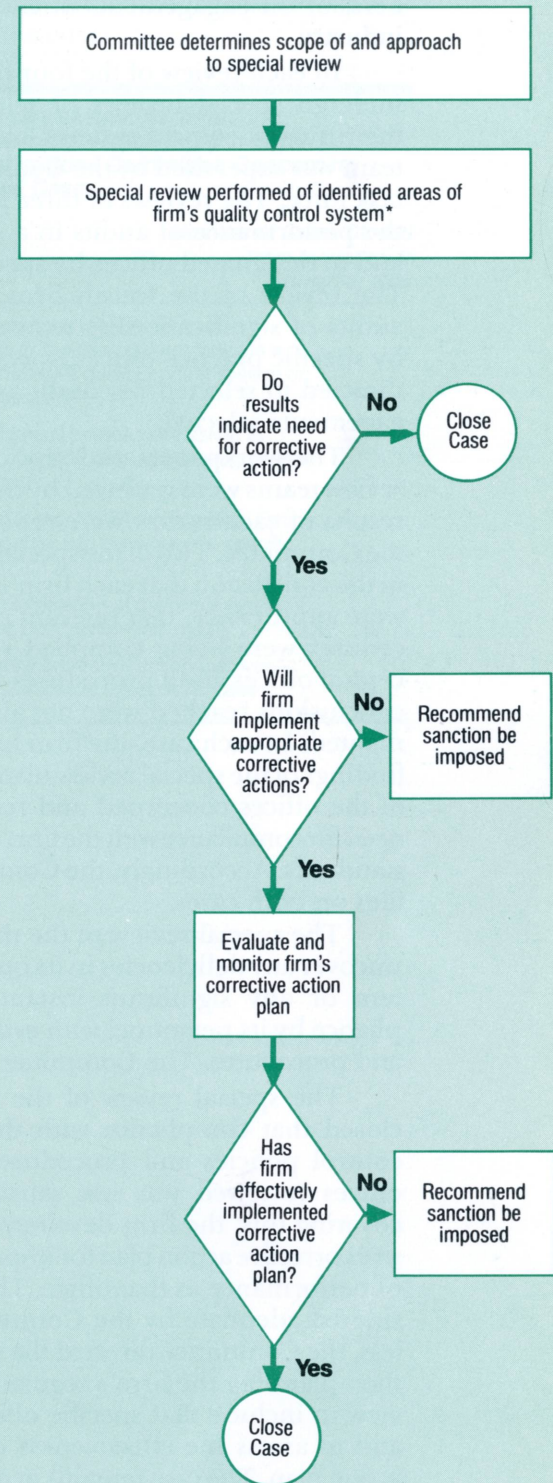
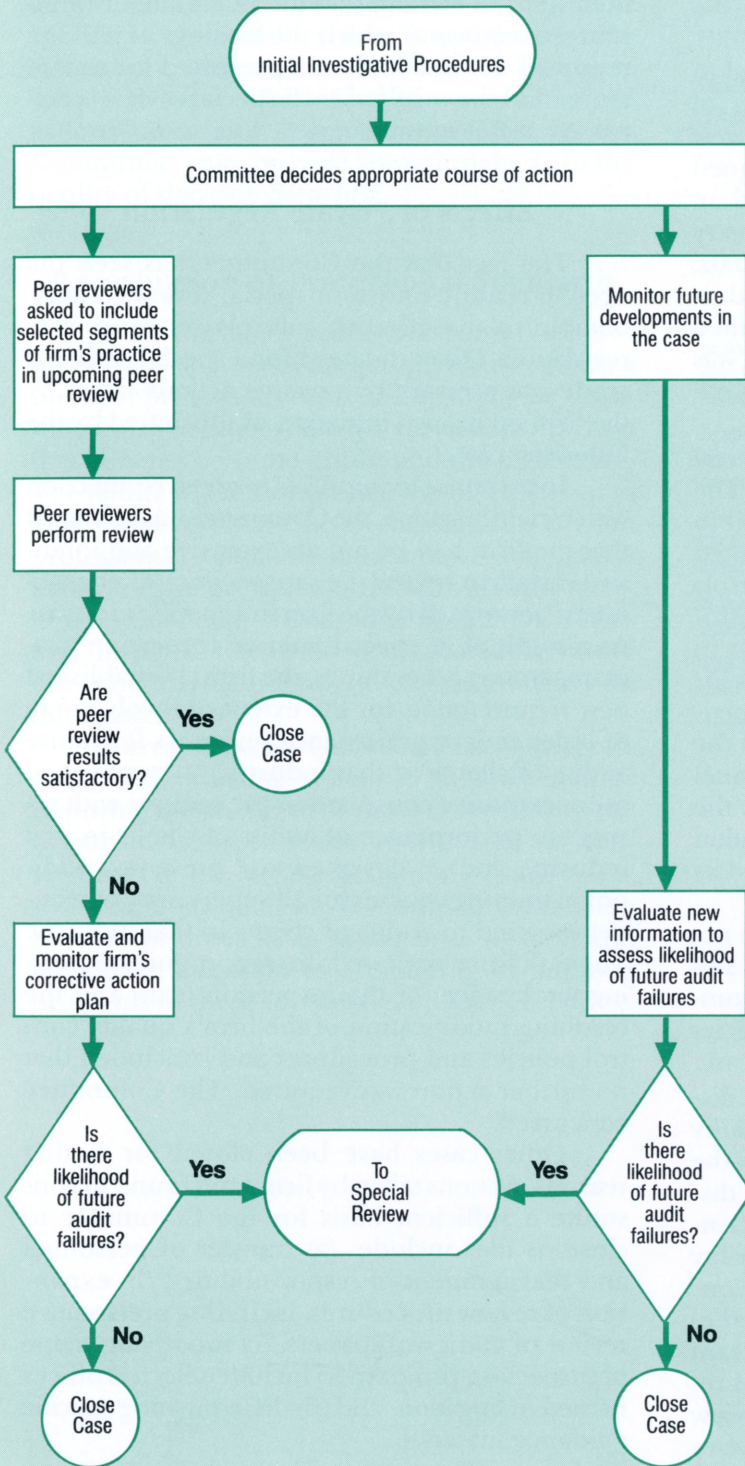


Initial Investigative Procedures



Monitoring Phase

Special Review Phase



*Process more intensive and less extensive than that of regular triennial peer review; principally focuses on specific offices, individual industries, or auditing issues.

cies. Depending on the nature of the allegations, the special review may focus on the work of specific practice offices, of specific partners or staff members, or on engagements of clients in a specific industry.

In each review of the four firms required to undergo special reviews of selected aspects of their quality control systems, the special review team was supervised by the Committee's assigned task force. The reviews of three firms focused on the performance of audits in a specific industry and in designated offices by specific individuals. The review of the fourth firm was directed at audits of significant SEC registrants performed by specific practice offices; special attention was directed to selected key audit aspects of the engagements selected.

The workpapers and reports of the special review teams were reviewed by the task force. The results of each review were reported in detail to the Committee. Two of the special reviews resulted in the conclusion that each firm's quality controls were appropriate, that relevant policies and procedures were being complied with, but that in certain offices audit procedures and the basis for conclusions reached were not always fully documented. In each case, the firm had discussed the findings of the special review team with personnel of the offices concerned and reemphasized the need for compliance with the firm's documentation standards. Accordingly, the Committee closed its files on both cases.

The special review of the third firm did not uncover any deficiencies in its quality control system or any significant instances of noncompliance by its personnel with established policies and procedures. The Committee closed the case.

The special review of the fourth firm disclosed that compliance with the firm's quality control policies and procedures in one of the offices reviewed was not satisfactory. On discovering this, the firm developed a comprehensive corrective action plan for improving the quality of performance in that office. The plan was considered adequate by the Committee. Nevertheless, the Committee directed the peer review team then planning the firm's regularly scheduled review to include that specific office in the review and to assess the effectiveness of the corrective action plan. The case remains in monitoring status pending the Committee's determination that the corrective action plan has achieved its objectives.

The involvement of the Board in special reviews is similar to that of its involvement in peer reviews. For example, the task force's workpapers

and report are reviewed in detail by the Board's staff; Board and staff members attend meetings between firm representatives and review team members; Board and staff members attend Committee meetings at which the findings of and the report of the task force are presented for acceptance; and the result of each special review is discussed at Board meetings.

Effects of Private Regulation

The fact that the Committee has seen the need to require only four special reviews is attributable to the effective role played by private regulation. Often the need for a special review is made unnecessary by positive actions taken by the firm on its own initiative, as illustrated by the following case.

In response to inquiries made in connection with certain litigation, the Committee was informed that the firm had begun an extensive and intensive intrafirm review (i.e., inspection) of engagements performed by the firm in a specific industry. As a result of its special internal inspection program, among other things, the firm (1) established new requirements for the extent of involvement of independent preissuance reviewers for future audits of clients in that industry, (2) established more extensive consultation procedures with respect to performance of audits of clients in that industry, and (3) designed and presented additional training courses for all supervisory personnel assigned to audits of clients in that industry. The task force reviewed the report and supporting workpapers of the inspection team and the resulting modification of the firm's quality control policies and procedures and concluded that no further action was required. The Committee concurred.

Other cases have been closed for similar reasons. Actions taken by firms and found to constitute a sufficient basis for the Committee to close its files include: (a) transfer of personnel and reassignment of responsibilities, (b) expansion of review procedures, including preissuance review of audit workpapers, (c) modifying scope of inspection program to include selected offices named in litigation, and (d) disseminating specific guidance material.

Summary of Bases for Cases Closed

Provisions of the charter creating the Special Investigations Committee preclude the public reporting of detailed information about individual

cases reported to the Committee. Because the Committee does not reach a conclusive determination of the merits of an allegation of audit failure, publication of its actions with respect to specific issues could result in unwarranted, substantial prejudice to member firms or their personnel. However, Table 5, which summarizes the actions taken and conclusions reached by the Committee, may provide some insight as to the quality of decisions reached.

Reevaluation of Professional Standards

While the major task of the Committee is to investigate each set of allegations made against a member firm in the course of litigation, the Committee also performs another very useful function that benefits both the public and the profession. The nature of the Committee’s work enables it to analyze and evaluate the implications for current professional standards of each piece of litigation that comes before it. It unavoidably asks the question on each case: “Does the information in this case imply that current professional literature does not provide adequate technical guidance on this matter?”

In a real sense, the Committee’s analysis serves as an early warning system to identify matters requiring the attention of those charged with the responsibility of considering the need for new standards or the reconsideration of existing ones.

The Committee has filled this valuable role a number of times in its rather brief history, and has drawn attention to accounting or auditing problems in three specialized industries. For ex-

ample, the Committee suggested that the AICPA’s Bank Audit Guide provide further guidance concerning procedures to determine the appropriate carrying value of securities whose market value is significantly below cost.

TABLE 5 *Summary of Actions Taken and Conclusions Reached by the Special Investigations Committee Concerning Closed Cases*

	<i>Number of Cases Closed from Inception to June 30, 1984</i>
The allegations misstated the requirements of professional standards or the case did not indicate a need for changes in the firm’s quality control system or for other corrective measures	66
Appropriate AICPA technical bodies were asked to consider the need for changes in or additional guidance on professional standards	9
The case was referred to the AICPA Professional Ethics Division for an investigation into the work of a specific individual	2
A special review or an expansion of the firm’s regularly scheduled forthcoming peer review was made	6
The firm took appropriate corrective action that was responsive to the implications of the specific case	10

Other Membership Requirements

A firm may join the SEC Practice Section by submitting an application for membership and agreeing to abide by the membership requirements. The requirements of membership are many and diverse.⁶ Several of them are described at length in other sections of this report, such as the triennial peer review and the need to report certain litigation alleging audit failure by the firm or any of its members. The requirements of members are reproduced in an appendix to this report, but several of them are worthy of special note:

1. The engagement partner charged with the responsibility of supervising the audit of an SEC registrant can serve in that capacity for no more than seven consecutive years. This requirement is waived for firms with fewer than five SEC audit clients and fewer than ten partners.
2. Every audit report of an SEC registrant must be subjected to a preissuance review by a partner other than the partner in charge of the audit engagement.
3. A member firm is required to maintain minimum amounts and types of accountants' liability insurance, which amounts are in direct proportion to its size.
4. A member firm is required to report to the audit committee or board of directors of each SEC audit client on the nature of disagreements with management of the client on financial accounting and reporting matters and auditing procedures which, if not satisfactorily resolved, would have caused the issuance of a qualified opinion on the financial statements of the client.

Peer review teams use special procedures to ascertain whether the firm is complying with each membership requirement. If the review team concludes that the firm is not in substantial compliance with the membership requirements, it issues a modified report on the peer review, which, as indicated earlier, is placed in the public file.

⁶ Membership requirements of the Private Companies Practice Section are similar to those of the SEC Practice Section. The major difference is that the SEC Practice Section has additional requirements that apply only to audits of SEC registrants.

Oversight of the Self-Regulatory Process

The Role of the Public Oversight Board

The Public Oversight Board is a five-member board established to represent the public interest in the Section's self-regulatory process. It has entry to all meetings of all committees and task forces of the Section and access to all workpapers, reports, and other documents.

The Board's primary function is to monitor and comment on the Section's activities. From the beginning, the Board has taken the position that if the self-regulatory program is to be successful, all authority must be vested in the profession itself. The Board does not have line authority and does not desire it.

Individual Board members are assigned liaison responsibilities with each of the Section's committees. Members of the Board and/or its staff attend all committee meetings of the Section, and most meetings of its task forces.

The Board publishes an annual report as of June 30 each year summarizing its activities and reporting on the activities of the Section. The Board also occasionally publishes special reports as it deems necessary or desirable.

Oversight by the SEC

The SEC independently evaluates the peer review process including the effectiveness of Board oversight. The SEC inspects a sample of peer reviewer workpapers and Board oversight workpapers under an arrangement agreed to by the Section. All workpapers are masked so as not to reveal the identity of individual clients. Under a

1982 modification of that arrangement, workpapers relating to firms with fewer than ten SEC clients are masked to conceal the identity of the firm in order to further reduce the possibility of client identification.

The SEC continues to have a high level of interest in the program and has actively supported it by both constructive suggestion and public endorsement. Based on its inspection of the peer review process, as described above, the SEC has expressed satisfaction with the process and the effectiveness of the Board's oversight procedures with respect thereto.

The Board and its staff meet periodically with the chairman and staff members of the SEC to discuss the various aspects of the self-regulatory program. In these meetings, operating under the privacy requirement imposed on the special investigative process, the Section and the Board have attempted to provide sufficient information to the SEC so as to permit it to have confidence in the effectiveness of the process and the Board's oversight thereof. However, the SEC believes that it needs additional information to reach an independent conclusion regarding the special investigative process. Exploratory discussions attempting to resolve this matter are continuing between the Section, the SEC, and the Board.

⁷ In March 1979, the Board published its report, *Scope of Services by CPA Firms* based on its findings of a two-day public hearing and numerous written comments from persons both within and outside the profession.

Conclusion

As noted in the introduction, professional regulation is a complex process in which three “authorities” participate, the government, the profession, and the firm. The Board has come to realize that the most substantial, and certainly the least recognized, force for improvement of professional performance is private regulation, the discipline imposed by management of individual firms as they strive to meet the demands of competition and to comply with or exceed professional standards.

Professional standards, established at the second level of professional regulation, have a direct impact on the discipline maintained within firms.

The Board has reviewed the accounting profession’s program for audit quality, described in this report, both conceptually and in practice. The profession’s quality control standards, peer reviews of firms’ compliance with those standards, and the supporting strength of the special investigative process, with both public and regulatory oversight, combine to provide a sound, comprehensive, and effective assurance of audit quality.

The Board is aware that many responsible and respected members of the business and educational communities tend to view self-regulation as a replacement for government regulation. Their comments and criticisms, as well as the Board’s experiences in working with the AICPA program, have led the Board to reconsider both the objectives and limitations of professional regulation.

The Board is convinced that professional regulation is needed in a free enterprise society, that it makes a significant contribution to the smooth and successful operation of business activity. The essence of professionalism is a personal commitment to excellence. Yet, important as personal commitment is, it is not enough; more must be provided. The committed individual needs education, encouragement, and knowledge of how others in the profession respond to various situations, opportunities, and contingencies. A dedicated professional also needs to be mindful of the surveillance by government in order to resist the temptations that occasionally arise.

Thus, rules, regulations, guides, and enforced discipline are needed to fortify and strengthen personal commitment. The individual practitioner, the firm, fellow practitioners united in professional organizations, and government, all are a part of a structure that provides satisfactory professional services to society at a competitive price.

The Board finds a continuing dedication to improvement on the part of accounting firms that are members of the Section. Participation in peer reviews has introduced reviewers as well as those reviewed to new policies, procedures, and ideas that improve performance. These are quickly adopted and absorbed into their own practices. The Board has observed that, above all, the peer review process is a remarkably effective means of continuing professional development. Professional self-regulation, as the Board sees it working in the Section’s program, is but one part of professional regulation in the broad sense. It cannot and should not seek to replace or to emulate either public regulation or private regulation. Nor should either of these other two levels of regulation attempt to take over the role that peer regulation fills so well. The establishment of professional standards of accounting, auditing, and quality control, the work of the AICPA Ethics Division, the educational programs of the AICPA and the state societies, the peer review program of the Division for CPA Firms, and investigations of alleged audit failures by the SEC Practice Section are all effective components of the profession’s self-regulatory activities and should be accepted as such.

As long as these diverse forces continue to be effective, we can look forward to continuing improvement in the quality of professional auditing in this country.

Appendix

Excerpt from Section IV, Membership, of the *SECPS Manual*

3. Requirements of Members

Member firms shall be obligated to abide by the following:

a. Ensure that a majority of members of the firms are CPAs, that the firm can legally engage in the practice of public accounting, and that each proprietor, shareholder, or partner of the firm resident in the United States and eligible for AICPA membership is a member of the AICPA.

b. Adhere to quality control standards established by the AICPA Quality Control Standards Committee.

c. Submit to peer reviews of the firm's accounting and audit practice every three years or at such additional times as designated by the executive committee, the reviews to be conducted in accordance with review standards established by the section's peer review committee.

d. Ensure that all professionals in the firm resident in the United States, including CPAs and non-CPAs, take part in qualifying continuing professional education as follows:

- (1) Participate in at least one hundred twenty hours every three years, but not less than twenty hours every year, *or*
- (2) Comply with mandatory continuing professional education requirements for state licensing or for state society membership, provided such state or society requirements require an average of forty hours per year of continuing professional education for each reporting period, and provided each professional in the firm participates in at least twenty hours every year.

e. Assign a new audit partner to be in charge of each SEC engagement that has had another audit partner-in-charge for a period of seven consecutive years, and prohibit such incumbent partner from returning to in-charge status on the engagement for a minimum of two years except as follows:

- (1) This requirement does not apply to member firms that have less than five SEC audit clients and less than 10 partners.

- (2) An audit partner who has been the audit partner-in-charge of an SEC audit client for seven consecutive years may continue to serve in that capacity for audits for periods ending within two years from the date the firm becomes a member, or within two years from the date the firm no longer qualifies for the exemption in (1) above, whichever is later.

- (3) An application for relief is granted by the peer review committee on the basis of unusual circumstances.

f. Ensure that a concurring review of the audit report by a partner other than the audit partner-in-charge of an SEC engagement is required before issuance of an audit report on the financial statements of an SEC registrant. The peer review committee may authorize alternative procedures where this requirement cannot be met because of the size of the member firm.

g. File with the section for each fiscal year of the United States firm (covering offices maintained in the United States and its territories) the following information, within ninety days of the end of such fiscal year, to be open to public inspection.

- (1) Form of business entity (e.g., partnership or corporation) and identification of domestic affiliates rendering services to clients.
- (2) [Deleted]
- (3) Number and location of offices.
- (4) Total number of partners and non-CPAs with parallel status within the firm's organization structure.
- (5) Total number of CPAs (including partners).
- (6) Total number of professional staff (including partners).
- (7) Total number of personnel (including item 6, above).
- (8) Number of SEC clients for which the firm is principal auditor-of-record.
- (9) [Deleted]
- (10) A statement indicating that the firm has complied with AICPA and SEC independence requirements.
- (11) Disclosure regarding pending litigation as required under generally accepted accounting principles and indicating whether such pending litigation is expected to have a material effect on the firm's financial condition or its ability to serve clients.

- (12) Gross fees for accounting and auditing, tax, and MAS, expressed as a percentage of total gross fees.
- (13) Gross fees for both MAS and tax services performed for SEC audit clients, expressed as a percentage of total fees charged to all SEC audit clients.
- (14) Names of firms merged or acquired during the year and included in year-end numbers reported above and the number of offices, accounting and auditing personnel, and SEC clients of the acquired firm that were—
 - (i) Combined with practice units of the acquiring firm, or
 - (ii) Continued as separate practice units in the combined firm.
- (15) Fees for MAS Services performed for SEC audit clients, expressed as a percentage of audit fees charged to SEC clients, prepared in the following manner:

Range of MAS Fees to Audit Fees for SEC Audit Clients	Number of SEC Audit Clients
0-25%	
26-50%	
51-100%	
Over 100%	
Total number of SEC audit clients	_____
	=====

The total number of SEC audit clients reported in this summary shall agree with the number reported pursuant to the requirements of section IV 3g (8). The firm shall also report how many of the number of SEC audit clients included in the "over 100%" category fell into that category for three consecutive years, including the current year.

- h. Maintain such minimum amounts and types of accountants' liability insurance as shall be prescribed from time to time by the executive committee.
- i. Adhere to the portions of the AICPA Code of Professional Ethics and Statements on Standards for Management Advisory Services dealing with independence in performing management advisory services for audit clients whose securities are registered with the SEC. Refrain from performing for such clients services that are inconsistent with the firm's responsibilities to the public or that consist of the following types of services:
 - (1) Psychological testing.

- (2) Public opinion polls.
- (3) Merger and acquisition assistance for a finder's fee.
- (4) Executive recruitment as described in Appendix A.
- (5) Actuarial services to insurance companies as described in Appendix A.
- j. Report annually to the audit committee or board of directors (or its equivalent in a partnership) of each SEC audit client on the total fees received from the client for management advisory services during the year under audit and a description of the types of such services rendered.
- k. Report to the audit committee or board of directors (or its equivalent in a partnership) of each SEC audit client on financial accounting and reporting matters and auditing procedures which, if not satisfactorily resolved, would have caused the issuance of a qualified opinion on the client's financial statements.
- l. Pay dues as established by the executive committee and comply with the rules and regulations of the section, as established from time to time by the executive committee, and with the decisions of the executive committee in respect of matters within its competence; in connection with their duties including disciplinary proceedings, cooperate with the peer review committee and the special investigations committee established by resolution of the executive committee as set out in the Appendix B hereto; and comply with any sanction that may be imposed by the executive committee.
- m. Report to the special investigations committee, within thirty days of service on the firm or its personnel of the first pleading in the matter or within thirty days of joining the section, if later, any litigation (including criminal indictments) against it or its personnel, or any proceeding or investigation publicly announced by a regulatory agency, commenced on or after November 1, 1979 (not including additional proceedings arising out of or related to facts involved in litigation originally filed prior to November 1, 1979), that involves clients or former clients that are SEC registrants and that alleges deficiencies in the conduct of an audit or reporting thereon in connection with any required filing under the federal securities laws. With respect to matters previously reported under this subparagraph, member firms shall report to the committee additional proceedings, settlements, court decisions on substantive issues, and the filing of appeals within thirty days of their occurrence.

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