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Discussant’s Response to
Controlling Audit Quality:
A Responsibility of the Profession?

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While I have done a lot of speaking over the years, I have never participated in a meeting with this particular format. I assume that my comments are to be directed toward stimulating discussion during the period that will follow. In the interest of stimulating such discussion and to preserve my own integrity, my comments on this question will be strictly as I see it.

I have studied Andy Marincovich’s paper and it appears to me that the following points emerge:

- The title is “Controlling Audit Quality: A Responsibility of the Profession?” with a question mark. To me the question mark is the most significant item in that title.

- Andy’s paper says “. . . it may be constructive to inquire whether the programs of the profession—either in being or under study—are adequate to discharge this responsibility.” This statement appears to assume that the answer to the question is that controlling audit quality is a responsibility of the profession. Is that really so?

- Reference is made to the Beamer Committee on the matter of continuing education requirement. While Mr. Beamer was a partner of mine before his retirement, it does not necessarily follow that I agree with him on continuing education. However, I also don’t presume to be an expert in this particular area. Therefore, I will dispose of the continuing education matter by simply saying that what I have seen adopted so far is a very feeble, and perhaps unnecessary effort. I also have a bias that formal education for a practitioner has very definite limitations and that essentially a person’s continuing education is what he does in connection with researching to find solutions to particular problems occurring in day-to-day practice. To show how far I am probably away from current thinking on this subject, my own firm now has a continuing education program that is required for all persons through the age of 50. The best part of this program, to me, is that I am now 56 and therefore I am not going to be involved.

- The paper suggests that “. . . character checks on those entering the profession may be an important step in strengthening the standards of the accounting profession.” My own experience has included work for two Big 8 accounting firms, three industrial firms as the chief financial officer, and a major firm of management consultants, all of which have involved extensive executive recruiting activities. I can only say that I believe there are very real limitations to what can be accomplished through any attempt to conduct “checks of char-
acter.” In one instance a person that I was evaluating had all of the evident credentials for a particular position but subsequently turned out to be homosexual. No one is going to tell you in a character check that a person has that problem, nor is anyone going to tell you that a person is an alcoholic. Therefore, I conclude, based upon experience, that there are important limitations in any effort to elicit character representations.

- Andy refers to the Practice Review Program as “another way.” To me, practice review, however conducted, is not necessarily “another way” of getting at the quality problem, as this and other possible programs are not mutually exclusive or inclusive. Rather, one must consider the whole matter.

- In speaking of an independent audit of the auditors, the paper cites Mr. Casey, the former Chairman of the SEC, as suggesting that the profession is very much in partnership with the SEC. This poses a vital question of to what extent the profession wishes to become part of the enforcement machinery of the SEC and therefore a quasi-arm of the Government, as contrasted with the independent practice of public accountancy. This, I suggest, is a very vital matter for everyone in the profession to assess although some already say that we have been functioning in an enforcement role as an agent of the Government for some many years.

To all of these suggestions that the profession has the responsibility for the enforcement of performance—for continuing education—for some more stringent entrance requirement to the profession—it is very easy to respond with a “yes” answer. It is at first blush obvious that no responsible person within the profession could be against such actions. However, when one introspectively examines what is involved in accomplishing such objectives, one might well be concerned with the realities involved.

Reviews of Quality Performance

I have already commented to the extent I wish on the matters of continuing education and character checks and would now like to turn to the area I know most about—that of reviews of the quality of performance of accounting firms, however structured.

For some years the AICPA has had a committee to conduct quality control reviews of accounting firms. This has been generally directed toward providing smaller practitioners with an opportunity to have their procedures and practice reviewed by others in the profession. However, this program has been quite limited—consisting of a review of only 2 or 3 days, of selected engagements, and conducted on a voluntary basis.

It was not until the SEC proposed that quality control reviews of major firms be required as a consequence of proceedings under Rule 2(e) of the rules of practice of the SEC that this matter really heated up. Subsequent to the considerations of the AICPA to assess how the profession might accommodate the wishes of the SEC, a program was developed for the AICPA to structure a voluntary quality review program which would be extended to multi-office firms.

As you know, I have been chairman of the committee to consider the SEC’s request for accommodation with respect to reviews required under Rule 2(e). The charge to our committee was to consider the SEC’s request and to negotiate the best accommodation that could be achieved so that the Board of Directors
could reach a conclusion as to whether the AICPA would participate in the SEC’s program or not. The result of our committee effort was the “Tentative Program for an Inspection of the Quality Control Standards and Procedures of an Accounting Firm Pursuant to 2(e) of the SEC Rules of Practice.” This program outlines the ground rules for conducting such an examination and was adopted by the Board of Directors with the understanding that the AICPA would participate in the examination of the first firm so charged under rule 2(e) and would also cooperate in what we call the “front end” of the next two or three firms to be so charged.

Essentially, the proposed program provides that the AICPA assemble a panel of persons from firms engaged in SEC practice; the SEC will select a chairman of a review team; the chairman will assemble, from the list, a team of reviewers; the reviewers will assess the quality standards and practices of the defendant firm; and subsequently—some 15 months later—will conduct a review to determine that firm’s compliance. This is a very abbreviated statement of the plan.

This program is in the process of application at the moment with respect to Laventhol Krekstein Horwath & Horwath and is also to be applied to Touche Ross & Co. I also understand that two other members of the Big 8 are in the process of negotiating a similar deal. Of course, you realize that this program was proposed by the SEC as an alternative to a suspension from practice before the SEC which could be disastrous for any firm if the suspension was for any significant period of time. I should say that throughout all our deliberations, our committee never had any reason to question the sincerity of SEC staff motives in advocating this program.

Our committee “backed into” a recommendation that the AICPA should accommodate the SEC in the first of such reviews, recognizing the onerous alternatives, and also recognizing that a major firm had already made a commitment to accept this treatment.

Legal and Other Problems

Now you should realize that there are very many difficult, unique legal questions involved in this type of exercise. I don’t intend to attempt to identify or discuss all these legal questions except to point out that they involve matters of confidentiality, matters of discovery in litigation involving any of the clients of a given firm, the legal position of those serving as quality control reviewers, the legal problems of the AICPA, etc. The SEC staff has been largely disinterested in our legal problems associated with the program, and has expressed the attitude that we should forget our legal problems and get on with the job. In our committee’s final report to the Board of Directors in January 1974, we expressed a number of serious reservations regarding this program. Among these reservations were:

- The SEC provides, in the LKH&H case, that a quality control review is to be conducted by persons selected from a panel put up by the AICPA, or by accountants selected by the SEC from the total population of accountants, or by the staff of the SEC. Our committee concluded that a peer review by persons practicing in the accounting profession and selected by the AICPA was by far the preferable approach.
The SEC provides that a quality assurance review may result from:

—A Court Order and Consent Decree as provided in the LKH&H case,
—By a negotiated settlement of a 2(e) proceeding with a given firm without benefit of a court order and consent decree, which is the Touche Ross situation, or
—Simply by the SEC advising a given firm that while they do not intend at the moment to initiate a 2(e) proceeding, their view of the quality of performance of that firm would suggest that they voluntarily submit themselves to such a review.

You should recognize that the legal problems involved in these three types of reviews are most significant and any review without the benefit of participation of the Court leaves the reviewed firm and other parties in a significantly vulnerable legal situation.

Our committee was quite concerned with the fact that the profession has never established generally accepted quality control standards of practice. This is a most complex subject considering the differences in type and size of practice among accounting firms and makes it quite difficult to establish universally applicable generalizations. The Auditing Standards Executive Committee of the Institute has this item on their agenda, but based upon past experience with Institute projects I would not expect to see any final product very soon. In the LKH&H case the consent decree includes by reference a statement of the quality control organization, procedures, and methods that they agree to apply. I must say that I have read this document and it prescribes about all the apparatus anyone could visualize. The tentative program negotiated by our committee with the SEC prescribes that in the future cases the review team will inspect the firm coincident with the 2(e) action to develop the prescribed quality practices applicable in that firm's situation and then return some 15 months later to inspect for compliance. We had considerable concern with the SEC prescribing quality control procedures from the standpoint that each successive case could add layer on layer of quality control procedures that could constitute a body of precedent that could prove to be unreasonable and could be applied against any given firm in a matter of litigation. We suggested that qualified practitioners are the ones that should prescribe quality control practices and remedies.

Our committee had a fundamental concern whether the proposed program would in fact accomplish the objective of improving the quality control performance of a given firm. We concluded that in the first instance, quality of performance depends on a firm establishing a conscientious policy of high standards—a professional rather than a commercial attitude toward its practice. In the last analysis, quality of performance is attributable to the competence of a staff accountant and his supervision in performing all aspects of an audit and whether such competence, if it existed, was conscientiously applied. Therefore a program such as that proposed, consisting of a post-review of working papers, reports, etc., has inherent limitations in assessing the fundamentals of a firm's quality of performance.
Problems and Limitations of Review Programs

What I am trying to convey is the feeling of our committee that a post-review of performance may be more of a facade than an exercise of substance. In fact, during our committee's deliberations we adopted the code name "chicken soup." (For those of you who have not come from Brooklyn, chicken soup refers to a Jewish mother's practice of preparing chicken soup whenever a member of the family is ill—not because chicken soup is going to do any good, but at least she is doing something, and it is not going to do the patient any harm.)

Many aspects of the audit process are essentially predictive and therefore judgmental in nature. Our committee concluded that an analysis of the causes of audit or reporting failure would disclose that such failures are generally a matter of the judgments applied during the process rather than procedural matters, and a quality control program *per se* would have limited effect in curing the causes of poor results.

We concluded that good control procedures do not necessarily insure good audits and good auditors may function effectively in an environment with poor quality controls.

The Committee's Views on Quality Control Review

We were quite positive in our contention that a quality control review of selected audits in a given organization should be to establish whether there is confidence that the firm is applying the procedures it agreed to apply, rather than to second-guess the actions of the reviewed firm in a given instance; also, the environment of the review is one where the applicable rules and standards are in a constant state of flux. In other words, we were not disposed to offer the SEC a service wherein the reviewers would be expected to second-guess audit results and report them to the SEC.

During the early discussion with the SEC our committee proposed that a more regular procedure for quality control reviews would be for the SEC to select a firm of CPAs to review the practices of the defendant firm on the basis of a regular professional engagement between firms for that purpose. Our committee continues to believe that the firm-to-firm approach has distinct advantages in providing a professional level relationship wherein reviewers would have access to the resources of their firm as in any other engagement; participants would function under the usual protection of their firms regarding legal liability and other matters; and the organizational and administrative problems associated with such an exercise would be minimized. Firms have greater strength as professional performers than do individual practitioners. Separating reviewers from their firms for purposes of these special reviews, weakens rather than strengthens the effort. However, the firm-to-firm approach was not acceptable to the SEC and I suspect that attitude reflected a desire to strengthen their public relations posture.

As a practical matter, the use of a panel of practitioners from various firms put up by the AICPA represents an inherent problem wherein, in due course, panel members will come from firms that have previously been subject to quality reviews. I believe it is realistic to recognize that in today's environment all of
the major firms with a substantive SEC practice will in due course get "hit" with a quality control review.

We recognize that today every relationship in our society is suspect of a conflict of interest. However, we would like to think that not everyone's motives are so suspect that the more normal and professional approach of a firm-to-firm review should not be acceptable.

There was considerable discussion with the SEC concerning the responsibilities of the reviewers, should they encounter what appeared to be errors in a particular engagement inspected during the course of a review. We proposed that the reviewer's responsibility would be to report such apparent errors to the firm under review and that they should have the responsibility to assess their course of action regarding disclosure to the SEC as they would in the event they themselves discovered an error. This approach was not acceptable to the SEC and the tentative program provides that such errors, should they be material with respect to adequate disclosure to the investigating public, must be reported to the SEC by the reviewers. This is but one aspect of the larger problem of whether the AICPA quality review program is to become a part of the SEC enforcement apparatus or not.

There was also discussion and negotiation about whether the reviewers would be asked to select and pursue engagements of a firm that were of particular interest to the SEC. We hope that our understanding is that the review of any particular engagement is a matter of selection by the reviewers and their purpose is to review the engagement to assess the application of a firm's quality control procedures rather than to second-guess the appropriateness of the accounting and reporting resulting from a given audit.

Confidentiality and Legal Problems

Our early discussions with the SEC and with AICPA legal counsel were concerned with matters of confidentiality and the legal position of the various parties involved. As the discussions progressed, the legal protections applicable in this program became more and more vague and less and less protective—but then we are in an unexplored area, so I can understand why the legal questions are so much in doubt. You can be sure that once this type of inspection process is initiated a standard question in any legal action involving CPA firms will be whether a given firm has been subject to a quality review and there will be an attempt to disclose the reviewers' report and their working papers even though the particular case at hand involves a particular client rather than the overall practices of a firm. The SEC has said that the working papers and reports resulting from a quality review can never be destroyed without their permission and that they would be disposed to disclose this material to any litigant who has, in their judgment, a legitimate interest in the performance of the firm. This has got to be a new adventure, which added to all of the legal action currently going on involving accounting firms must cause some of us to pause. Our committee believes that this quality control exercise could certainly not be expected to lessen the legal actions against accountants but only add grist to the mill. In my view, the severe penalties associated with any firm's failure to perform effectively are already so onerous that no additional motivations are
required to encourage firms of accountants to give priority attention to the quality of their performance.

Conclusion

So this is where we stand at the moment. The Board of Directors has authorized the AICPA to set up a panel of reviewers to conduct the first review of LKH&H and to do the front end of the next 2 or 3 cases. A panel has been established, and one of my partners has been selected as the chairman of the first review team. What the motivation for this selection was, I do not know, but I would like to think that my partner was selected because our firm is not now high on the list of those to be reviewed. In any event, the first review will be conducted, and the Board of Directors has reserved the right to reassess this whole exercise in the light of the experience gained on the Laventhol matter.

I should also add that our committee was asked to consider the formulation of a voluntary review program of multi-office firms sponsored by the AICPA. For many of the reasons already noted, our committee rejected this proposal out-of-hand. Subsequently, a new committee was appointed under the chairmanship of Tom Holton of Peat, Marwick, Mitchell & Co., which has now developed a voluntary program which is under consideration by the Board of Directors. Whether or not such a voluntary program will fly remains to be seen. I really don't know how much “chicken soup” the Institute should be brewing on the quality control matter, but if anyone thinks that a voluntary program established by the AICPA is going to blunt the thrust of the SEC’s interest in demonstrating that they are performing the regulatory role, I believe they are “whistling Dixie.”