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Evolution of the Quality Control Inquiry Committee of the SEC Practice Section of the American Institute of CPAs

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American Institute of Certified Public Accountants. Public Oversight Board

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Preface

The SEC Practice Section was founded in 1977 as a voluntary organization of CPA firms striving for professional excellence in the auditing services they provide to Securities and Exchange Commission (SEC) registrant companies. It is part of the Division for CPA Firms of the American Institute of CPAs (AICPA) — the national professional association of almost 300,000 CPAs in public practice, industry, government and education — and is overseen by the Public Oversight Board.

The Section (or the "SECPS") imposes membership requirements and administers two fundamental programs to assure that SEC registrants are audited by accounting firms with adequate quality control systems: (1) peer review, through which Section members have their practices reviewed every three years by other accountants, and (2) quality control inquiry, through which allegations of audit failure contained in litigation filed against member firms are reviewed to determine if the firms' quality control systems require corrective measures.

The Public Oversight Board (the "POB" or "Board") is an autonomous body consisting of five members with a broad spectrum of business, professional, regulatory and legislative experience. The Board's primary responsibility is to assure that the public interest is carefully considered when (1) the SECPS sets, revises and enforces standards, membership requirements, rules and procedures, and (2) the Section's committees consider the results of individual peer reviews and the possible implications of litigation alleging audit failure. To preserve its independence and objectivity, the Board appoints its own members, chairman and staff, and establishes its own compensation and operating procedures.

The accounting profession's self-regulatory programs are remarkably effective in ensuring quality audits. However, no method of regulation can prevent human failure, and occasional breakdowns occur. In the event of an audit failure, injured parties and regulatory agencies take steps to identify and punish those responsible. And it is the role of the self-regulatory system to assure that corrective actions are taken to prevent further harm.

The self-regulatory system should be better understood both by people who perform audits and by those who rely on "auditors' reports." The Board has published this monograph to facilitate understanding of the heretofore most confidential and controversial aspect of the self-regulatory process — the inquiry into alleged audit failures by the Quality Control Inquiry Committee. We believe the present structure of the profession's self-regulatory process cannot be fully understood without a knowledge of QCIC's history. This monograph provides that history.

Chapter 1

INTRODUCTION

The AICPA Division for CPA firms and its programs and requirements are the invention of the AICPA membership, a self-regulatory program for which that membership can take great credit. But an important part of that self-regulatory program, the Quality Control Inquiry Committee (originally named the Special Investigations Committee), is one for which the membership cannot take sole credit.[1] Establishing an investigatory process to review allegations of audit failure held the possibility of increasing the firm's risk of unsuccessfully defending its performance in litigation proceedings and thus quite properly concerned members of the profession. It is questionable whether the leadership of the profession could have succeeded in establishing such a process without outside support. In any event, that leadership turned to the independent Public Oversight Board for assistance in the task.

As early as March 1978, when the POB first met, the SEC Practice Section Executive Committee asked the Board to consider the following issues: whether member firms should be disciplined in the event of audit failure, and, if so, whether disciplinary action should proceed when litigation is threatened or pending. The POB studied these questions in depth, exploring the numerous related issues with legal counsel and with leaders of the profession. The Board's influence proved crucial. Much impressed by then POB Vice-Chairman Ray Garrett's anal-

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[1]The committee's name was changed by the SECPS Executive Committee at its December 6, 1988 meeting, because the former name was considered misleading. An investigatory committee is generally perceived as intended to pass judgment on events and the responsibility for them. That was never intended to be the primary mission of this committee which is and always has been to gain assurance in the light of adverse allegations whether a firm's quality control system is adequate and being complied with. Hence, the name, "Quality Control Inquiry Committee," more appropriately describes this mission. Nevertheless, at times in this monograph we refer to the committee as the Special Investigations Committee (the "SIC"), because throughout most of the evolving history of the committee it was called by that name. We recognize the confusion this may cause readers, but because the original name of the committee contributed significantly to the difficulty some firms faced in working with the committee, we have used Special Investigations Committee (SIC) and Quality Control Inquiry Committee (QCIC) interchangeably.

ogy to government investigation of airplane accidents, the Board proposed that the emphasis be on remedy when reviewing the allegations of audit failure rather than on punishment. This was a turning point in rallying the necessary support of the profession to establish the Special Investigations Committee and its operating charge.

Out of the POB's extensive deliberations emerged somewhat more complex conclusions. First, the public would be best served if the Section's emphasis were on prophylactic or remedial measures than on punishment. Second, a permanent committee (the Special Investigations Committee) should be formed to inquire into the implications of alleged audit failures to determine whether specific remedial measures directed to the individual auditors or their firm were necessary, and whether auditing standards and supporting literature should be revised. Third, the committee should proceed with its inquiries promptly regardless of any possible impact on litigation. Fourth, in egregious cases, the committee might inquire into responsibility for audit deficiencies and recommend appropriate punishment to the executive committee. It is surely not too much to say that the POB's participation and moral force brought the SIC into existence more quickly and in more decisive form than could otherwise have been possible.

Those involved in the POB's activities at that time recall that almost everyone concerned viewed the prospect of SIC actions with trepidation. On the one hand was the fear that the committee might do too little and thereby appear ineffective, bringing criticism to the entire self-regulatory effort. If credibility with the SEC and Congress were lost, the possible results could be most unfortunate. Yet an overly zealous committee could do much damage to the best interests of firms in litigation without contributing anything substantial to the public interest.

In the words of one of those associated with the process from the beginning:

> From my own vantage point, I look back with amazement at what has been accomplished. A carefully thought out approach was developed after much consultation and consideration of all views.

> Then, responsible men struggled with the day-to-day SIC process under the scrutiny and frequent comments of the POB and its staff. Changes were made and procedures were tightened up. But our worst fears did not come to pass. Instead, an institutionalized procedure has developed and been accepted as a fair and practical balance of interests, notwithstanding the slowness of the SEC to recognize it. In my view, it is a major achievement and both the public and the profession have been well served.

This brief monograph describes the process and some of the events by which the Special Investigations Committee of the SEC Practice Section was founded, developed, and accepted by the profession and the public.

Purpose of this Monograph

At the time of this writing, the committee seems solidly established. It is now accepted by most member firms as an integral part of the self-regulatory program, and is well thought of by those relatively few who are familiar with its activities. Why then trouble ourselves to write or read this brief history of the Quality Control Inquiry Committee? A number of reasons come to mind.

Perhaps most important to us is our conviction that the Section's self-regulatory program is still in a process of development. Efforts to improve that program are continuing and significant. Lest those who are not familiar with its history mistake legitimate attempts at improvement for criticisms of its effectiveness, or attempt modifications of the present program that are out of character with its purpose and experience, we think it well to memorialize that experience while it is still fresh in memory so it can be reviewed as a basis for further constructive experimentation.

Also, we believe that heroes should be recognized. The early members of the committee were faced with some extremely difficult assignments and occasionally their activities were viewed by many with skepticism and by some with acrimony. The first chairman of the QCIC, Rholan E. Larson, provided the capable leadership the committee needed at its inception. The names of those who served with him

are listed in the Appendix. Mr. Larson was succeeded by equally competent chairmen, Robert A. Mellin and William D. Hall. The aforementioned appendix also includes the names of all the members of this committee from inception through the date of the writing of this monograph. Each member of that committee in his own way contributed directly to the success of the committee's work; each of them served his profession well. Without general recognition or compensation, yet for the love of their profession and with a strong belief that the public was entitled to the best the profession could offer, they carried on, persevering in a task they had not asked for nor desired.

In the larger picture, the Special Investigations Committee and its evolution constitute a revealing example of how a profession, brought face to face with a problem it had not previously recognized, can adopt a solution, test it, try it, and ultimately make it work. The accounting profession was not too proud to accept both criticism and counsel. On the other hand, it was not so short of confidence or talent that it would swallow any medicine prescribed without considering the consequences. In that spirit, the accounting profession experimented with, complained about, gradually realized the importance of, became accustomed to, and has finally accepted the Quality Control Inquiry Committee.

The evolution of the Special Investigations Committee into the present Quality Control Inquiry Committee is a demonstration of how good men of strong and divergent views can, by a combination of events, personalities, necessity, and the passage of time, work out a process that serves them and others well. The profession had legitimate concerns and fears. These were dealt with in a sensitive fashion and largely overcome by persistent and thoughtful effort over a number of years by those involved, the chairmen and members of the SEC Practice Section Executive Committee, AICPA staff, special Institute review committees, house counsel for a number of the larger firms, the POB and the SEC.

Threads Running Through the QCIC's Evolution

Two threads run throughout the history of the Special Investigations Committee, and that history is more understandable if one is aware of these. The first is a continuing contest between two conflicting forces: (1) the necessity of providing for the public interest which demanded that the reason for "audit failures" be immediately identified and eliminated; (2) the importance to accounting firms of a vigorous defense against litigation arising out of alleged audit failures and a fear that the actions of the Special Investigations Committee would jeopardize that defense. The attempt to balance these two forces continues to this day.

The second thread also involves a contest and is related to the first. Critics of the accounting profession argue that regulation means discovery, identification, and punishment of those who fail to serve the public interest. Those responsible for faulty audits must be identified and punished, and that should be the role of the Special Investigations Committee.

The profession's contention has been to the contrary. It holds that the legal system is peculiarly qualified and equipped to deal with fault and punishment. The most important contribution the Special Investigations Committee can make is to investigate plaintiff's allegations to determine if they indicate weakness in the defendant firm's system of quality control. If they do, attention should then be turned to remedying those weaknesses. The best way to serve the public interest is to eliminate weaknesses in quality control so future audits will better serve their purpose. Punishment is a matter for the courts to deal with.

A third but much less important thread can also be distinguished. When the SIC was first proposed, the emphasis was on litigation in cases so important that the public became aroused and confidence in independent auditing suffered. Thus any cases that received substantial and continuing media attention should be investigated by the Special Investigations Committee. A somewhat different point of view was raised by those more interested in audit quality than in media

attention. "An audit is an audit is an audit." Any "bad" audit has implications for quality control. Should not, then, every audit in litigation be given sufficient attention to discover whether it reveals a weakness in quality control so that any weakness, if one exists, can be eliminated?

From our vantage point, looking back on an extended period of close association with the activities of the Special Investigations Committee, the progress which it has made is closely tied to the interplay of these forces. Recognizing and following these threads will help us to understand the difficulty and the nature of that progress.

Chapter 2

THE NEED AND THE SOLUTION

The Demand for Regulation

In the latter part of the 1970s, the accounting profession came under Congressional scrutiny and criticism. With the advantage of hindsight, one could readily conclude that this should have been expected sooner or later. An advanced economic society is heavily dependent on free financial markets and the easy flow of credit for the allocation of its scarce resources. This requires some mechanism for evaluating the reliability of the claims of past and future success by those seeking to obtain additional resources. Audited financial statements provided a widely accepted basis for such evaluations. The profession of public accounting performed the audits largely free of any significant government supervision. Sooner or later, however, major cases in which accountants were alleged to be at fault, and the public had suffered financial losses, were bound to attract Congressional attention.

When Congressional investigators "discovered" independent auditing, found it wanting, and proposed regulation to correct alleged deficiencies, the profession was taken by surprise. Nevertheless, the profession's leadership proved equal to the "emergency." In effect, the profession negotiated a suitable response working closely with the Securities and Exchange Commission which in turn had to satisfy the profession's Congressional critics. From the profession's point of view, a self-regulatory program was clearly preferable to government regulation. The story of that negotiation is undoubtedly a fascinating one, and one yet to be fully told. But that is not our purpose here. Suffice it to note that government regulation was forestalled; the profession's self-regulatory proposal was given a trial period to demonstrate its worth under the scrutiny of the SEC. If self-regulation served the public interest in adequate fashion, it would be accepted. If not, Congress would supplement the program as necessary.

The profession's proposal included (1) expansion of the AICPA to include a Division for CPA Firms with two Sections, (2) membership

rules in each section that held the member firms to rigorous requirements including triennial peer reviews of each firm's quality control system and its audit performance in compliance with that system, and (3), for the SEC Practice Section, an independent Public Oversight Board to assure that the public interest in independent auditing received appropriate consideration at all times.

Self-Regulation Through Peer Review

The heart of this system was to be a triennial peer review. The emphasis in peer review was on the specific firm's *system* of quality control and the firm's compliance with it. There was explicit recognition that personnel failure was always a possibility. Compliance with a satisfactory system of quality control made audit failure by a conscientious and adequately trained auditor unlikely. Yet, no system could, at acceptable cost, completely eliminate the potential for human error or assure that a wayward partner or staff member might not fail to perform in accordance with the requirements of the quality control system.

To assure that the system was effective, a peer review was to include examination not only of the system itself—that is the employment practices, guidance manuals, other instructions, checklists, training programs, reference facilities, and other components of the system—but was also to include review of the application of that system as documented in the workpapers of recently completed audit engagements. Discussion with the responsible auditors was a regular feature of this review of workpapers.

At the conclusion of a peer review, the review team's findings were discussed with the reviewed firm's representatives in an exit conference. Thereafter, an opinion was to be issued by the peer review team, accompanied by a letter of comment if necessary. The reviewed firm was expected to respond to the letter of comment in writing. A copy of the opinion, letter of comment, and the firm's letter of response were included in a public file at the AICPA open for inspection by anyone interested.

Traumatic as the idea of peer review may have been, the profession went forward with the program. Early on, the Securities and Exchange Commission was assigned the responsibility to report annually to Congress on its evaluation of the functioning of the self-regulatory program of the accounting profession. The SEC was provided "access" to the functioning of the peer review program, including review of selected peer review and POB workpapers masked as to the identity of the specific audit engagements for which audit workpapers were reviewed. The SEC staff's review has resulted in acceptance of the quality of the peer review process and strong endorsement of the peer review program by the SEC in its report to Congress each year.

Litigation — The Fatal Flaw

Shortly after the self-regulatory program was instituted, Congressional critics perceived what they considered a "fatal flaw" in the process. Although peer review might be a satisfactory way of evaluating a firm's system for conducting its accounting and auditing practice, it did not deal with specific alleged audit failures. Peer review standards permitted the exclusion of engagements in litigation so that the reviewer's findings could not become a matter for discovery by the plaintiff. Yet allegations of audit failure in litigation at least implied that the quality control system had not succeeded in its purpose. Unless something was done immediately, it might fail again. This was the asserted "fatal flaw" in the system as it stood then.

The critics reasoned, what good is a peer review program if audit failures continue? What good is a self-regulatory program if those guilty of substandard work are not punished? "One CPA in jail is worth more than all the peer reviews ever made" was one critic's comment.

The SIC As a Solution

This led the Public Oversight Board, very early in its existence, to urge that a committee be appointed to investigate the quality control implications of such litigation. As Vice-Chairman Garrett had analogized: "Was the crash the result of 'pilot error' or 'equipment failure'?"

The question was not "*Who* was at fault?" so much as "*What must be done* to assure the public that similar errors (if any had occurred) would not be repeated in the future?" The Board reasoned that litigation filed against a member firm suggested the possibility that either the firm had a quality control weakness of some kind that peer review had not discovered, or that the profession's guidance was inadequate in some respect. And the public interest required that the profession take prompt steps to determine if either of these possibilities was true.

Of course, there were other possibilities. The auditors could have been misled by collusive action on the part of the auditee's staff or management, action that would have required investigatory work well beyond that included in a normal financial audit. Or there might have been an audit deficiency that resulted from a personnel failure that had nothing to do with the firm's system of quality control. Yet, because the possibility of system weakness or inadequate guidance could not be denied, something more in the way of investigation was required. From the point of view of the Public Oversight Board, the public interest required the profession to provide for such investigations as part of its self-regulatory program.

To its credit, the Executive Committee of the SEC Practice Section responded affirmatively. The Special Investigations Committee was created and appointed, but not without serious misgivings on the part of some accountants at the highest levels in the SEC Practice Section.

The Special Investigations Committee and Litigation Risk

The fears of those members of the Executive Committee of the SEC Practice Section who opposed formation of the Special Investigations Committee were genuine. Litigation against firms had become a substantial and increasing burden. The potential loss in class action suits was staggering. Many accountants believed that the legal system was biased in favor of plaintiffs, and that damages assessed against accounting firms bore little or no relation to their responsibilities for

investors' losses. The cost of litigation in time, undesirable publicity, and uncertainty was painful to all concerned. With the balance already weighted in favor of the plaintiff, why should a defendant firm be put further at a disadvantage by investigation of its quality controls and audit practice by the Special Investigations Committee? And who knew how far the committee might go and whether its work might be used by plaintiff's bar?

Traditional AICPA Policy Re Cases in Litigation

It may be well to point out here that the AICPA had a well established policy of not investigating cases in litigation. Ethics charges against a member might be made in connection with the suit, but the Ethics Committee would wait until any litigation had been settled and then proceed as seemed appropriate in the circumstances. The reasons for this policy were twofold. First, the system of justice in this country provides litigants with rights and rules of procedure designed to facilitate full and fair investigation and settlement of issues and disputes. A professional body like the AICPA has few of the powers of our judicial system to proceed effectively in obtaining all the relevant information available without infringing on the rights of those involved. Second, any action against a person by his professional peers, regardless of the ultimate outcome of that action, conceivably could be used by plaintiff's attorneys to a defendant's detriment in either civil or criminal proceedings. Thus the establishment of the Special Investigations Committee included at least the suggestion that the AICPA might be modifying its traditional policy, a policy most members thought was essential to their welfare.

Chapter 3

IMPLEMENTING THE SOLUTION

The Special Investigations Committee's Organizational Document

A careful reading of the Organizational Document will reveal:

1. Considerable care to assure that member firms would not be sanctioned without due process and ample opportunity for defense.

2. Strong emphasis on the importance of confidentiality for all Special Investigations Committee activity. Concern was expressed that the work of the committee might become known to plaintiff bar and be used against member firms engaged in litigation.

3. A need to balance the public interest with the prejudice to a firm, or individuals within the firm, that could occur if the SIC were to commence and continue an investigation while the firm or individuals in it were involved in litigation.

The Organizational Document provided for a nine-member committee of experienced auditors, each eligible for two staggered three-year terms. The purpose of the committee was threefold, to:

1. Identify corrective measures, if any, that should be taken by a member firm involved in a specific alleged audit failure.

2. Determine whether facts related to specific alleged audit failures indicated that changes in generally accepted auditing standards or quality control standards needed to be considered.

3. Recommend to the Executive Committee, when deemed necessary, appropriate sanctions with respect to member firms.

Member firms were required to report to the committee, within 30 days of service on them of first pleading, any litigation against them or their personnel, or any proceeding or investigation publicly announced by a regulatory agency, commenced on or after November 1, 1979, if that litigation alleges deficiencies in the conduct of an

audit or reporting thereon in connection with any required filing under the Federal securities laws. The initial notification was to be accompanied by a copy of the complaint or indictment or other charges filed.

Instructions to the Special Investigations Committee

On receipt of such information, the committee was obliged to "screen," that is review, the information and to determine what the committee's further procedures would be. These procedures were identified in the Organizational Document as "(1) to 'monitor' developments in the case without investigation of the firm or the case, pending the conclusion of litigation or other proceeding or investigation; (2) to 'investigate the firm' without investigating the case; (3) to recommend 'investigation of the case' to the Executive Committee; and/or (4) to close its files on the case."

Monitoring was a holding action in anticipation of developments or disclosures that would provide the committee with additional information that would help it choose among its other options. Investigation of a firm was to be initiated if the complaint or other information implied strongly that the public interest required:

1. A review of certain of the firm's quality control policies and procedures, and/or a review of compliance with those policies and procedures by certain offices or individuals.

2. A review of other engagements performed by the firm's office(s) or personnel involved in the case or of other engagements in the same industry.

3. Interviews of the firm's personnel with functional responsibility for a specialized industry if the case involved such an industry.

Obviously, investigation of a firm was not something desired by any member firm. The implications of such an investigation were that either the firm or some of its personnel may have fallen short of professional standards. No member of the Section looked forward to the possibility of being the first firm so investigated.

The Ultimate Action — Investigation of a Case

Investigation of a case was the most severe treatment that a firm could receive, short of a sanction. The clear implication of such an investigation was that a serious failure in complying with quality control standards was suspected, that someone was at fault, and that despite the AICPA's traditional policy regarding litigation, immediate action was necessary for the protection of the public and the good of the profession. The decision for so extreme an action was not to be trusted to the Special Investigations Committee by itself. If the committee thought that a case should be investigated, it would recommend such action to the Executive Committee, and could do nothing more without express authorization from the Executive Committee.

And before making such a recommendation to the Executive Committee, the SIC "shall advise the firm of its intention to make such a recommendation and shall give the firm (through counsel or otherwise) an opportunity to present its views in writing as to whether such recommendation is appropriate in the circumstances. If the recommendation is made to the Executive Committee, the firm shall be given an opportunity to express its views in writing to the Executive Committee."

Precisely what would be included in an investigation of a case was never specified. The general belief seemed to be that the committee would set out to find what went wrong and who was responsible. The fact that such an investigation would be undertaken only "in the most egregious cases," implied rather strongly that the firm or individuals responsible would have a difficult time in establishing their innocence or the propriety of their actions.

To say that some members of the SEC Practice Section thought the Section had gone too far in giving such powers to its new Special Investigations Committee is an understatement. Considerable concern was soon expressed that the committee had far too much authority and might well increase the already substantial risks of litigation in ways detrimental to the entire profession.

Efforts to Provide Additional Guidance to the SIC

An early response to the fears expressed by some members of the Section was an attempt to devise and establish operational procedures to specify more clearly than did the Organizational Document the process to be followed by the new Special Investigations Committee. In attempting to work out a set of operational guides for the Special Investigations Committee, the AICPA staff found the leadership of the SEC Practice Section so opposed to any procedure that might increase litigation risk as to make the task a most difficult one. However, hours and days of thoughtful work in drafting proposed rules and negotiating terminology differences ultimately resulted in the "Decision Tree and Criteria for Acting on Reported Cases," which was adopted by the Special Investigations Committee in March 1981. From the outset, the approach called for in these guidelines provoked profound concerns among Executive Committee members who feared that the SIC might implement them in ways that would unwittingly escalate the litigation risk to member firms.

Criteria like "significant reasonable public demand for prompt discipline of the firm for alleged gross violation of generally accepted auditing standards" calling for investigation of a case, and "high public interest or reasonable possibility of future audit failures" as justification for investigation of a firm posed risks they considered too great to be accepted.

Looking back on that crucial period in SIC history, one can have some sympathy for the fears expressed by the members of that Executive Committee. The "decision tree" was intended to be a working tool to be applied with judgment by SIC members. But the members of the Executive Committee—which included several of the firms serving the predominant majority of public companies and therefore having much of the litigation the SIC would have to consider—had had no experience dealing with these SIC members who were about to apply the procedures of the decision tree to their cases. Rigid application could be disastrous, consequently, a joint task force of Executive Committee and SIC members set out to prune the "decision tree."

That effort led to the scrapping of the "decision tree" in favor of a document developed by the joint task force which was titled "Guidelines and Considerations Relevant to Actions on Reported Litigation." The guidelines in this document were intended to be less rigid. However, certain Executive Committee members still found aspects of the guidelines objectionable. They were adopted by default by the SIC in February 1983, because the SIC had to get on with its business. In any event, a blue ribbon committee had only recently been formed to study the objectives and activities of the Section, including the SIC.

According to the guidelines, SIC members carefully had to weigh the public interest in a case and the possible prejudice that SIC activity concerning a case could cause to a member firm's defense in litigation. SIC members were provided with a list of factors relevant to their assessment of public interest. In addition, the guidelines provided for possible inquiries of member firms. Except for inquiries specifically related to the alleged audit failure, firms were expected to provide information in response. The guidelines included the *caveat* that a decision to investigate a firm could result in significant prejudice to pending litigation or other proceedings of a firm. Accordingly, a feature was added to the process to protect the interest of firms, namely—before the SIC would vote on whether an investigation of a firm should be ordered, henceforth, a member firm would be given the opportunity to appear before the committee to hear the reasons for such a motion and to present its views.

Early Difficulties Facing the Committee

Establishing the Special Investigations Committee and appointing its first members did not assure its success. Few committees in the history of the AICPA faced as much opposition or carried such heavy burdens.

The requirement of absolute confidentiality, intended to protect members of the profession in litigation, stood like a wall between the committee members and their professional colleagues. Very few people

in the profession had any idea what the committee did, how it operated, or what influenced its decisions. Although the committee was composed of reasonable men who went about their difficult task sensibly and responsibly, the committee was forbidden to make this information known. Only committee members, the POB, and a few AICPA staff members knew that the "decision tree," and later "the guidelines," existed. Almost unavoidably, therefore, the knowledge that such a committee had been appointed but operated in secret resulted in greater concern about its activities than was justified.

The strong feeling that the committee should not investigate specific cases except in the most unusual circumstances and then only with permission of the Executive Committee of the Section, together with the concern that the committee would exceed its authority, meant that any questions by committee members during screening or monitoring that were related in any way to a reported case were met with a cold rebuff: "Now you are investigating the case."

At the same time, critics of the profession and its self-regulatory apparatus were eager to have a case investigated. In effect, they challenged the profession to prove that it would identify and fix responsibility for audit deficiencies. To many of them, regulation meant finding and punishing the guilty. Until the SIC did exactly that, its credibility would not be established. Indeed, the entire self-regulatory program remained under a cloud.

Even some friends of the profession had doubts that it would ever go so far as to permit investigation of a case. Some of them asserted that including the possibility of investigation of a case in the Organizational Document was a mistake. They firmly believed that the established policy of the AICPA would withstand modification, and that the kind of investigation necessary to establish responsibility in specific sets of circumstances should be left to the judicial system. Thus, including provision for investigation of a case was unrealistic and would lead to expectations that could never be fulfilled.

Early Work by the Special Investigations Committee

Yet, even during this period of unsuccessful negotiation, concern, and seeming frustration, progress in establishing the SIC as an important factor in the self-regulatory program was made. The members of the committee were in place, litigation was reported, task forces were appointed and assigned to instances of litigation reported to the Section. The committee members read the allegations, discussed them with other members of the committee, inquired of the firms involved, closed some cases, monitored others, and gradually developed working procedures.

When one line of questioning failed, another was tried. Some firm representatives were much more forthcoming than others; some committee members were more skilled and more persistent in their pursuit of information than others. Strengthening one another in their committee meetings through reports of inquiries during the screening process; refusing to close cases when responses to inquiries were unsatisfactory; the first members of the committee deserve great credit for developing procedures and standards, however informal, that have served the committee and the profession well. By going about their work with diligence and persistence, yet with an awareness of the sensitivity of the matters they dealt with, the early members of the committee slowly began to overcome some of the fears of those involved in the cases reported to the committee.

Chapter 4

TESTING THE SOLUTION

The Credibility Issue

One of the purposes in establishing the SEC Practice Section was to convince Congress that governmental regulation of public accounting was unnecessary, that the profession was both responsive and responsible, and was better able to police its members' activities than anyone else. To persuade Congress that such was the case, the profession needed the support of the SEC. The SEC staff was able to satisfy itself through review of selected peer review workpapers that the peer review program was working satisfactorily. The confidentiality requirements imposed upon the SIC made any such arrangement with respect to SIC activities much more difficult to establish. Liaison efforts between the SEC staff and POB representatives continued for some time in the hope that some form of "access" to SIC activities could be worked out. The confidentiality requirement for the committee's activities frustrated every effort.

SEC staff members took the position that they could not "approve" the work of the SIC unless they knew what that work consisted of. Could the SEC staff send a representative to SIC meetings as an observer? The answer had to be negative. Would the SEC staff be willing to rely on oral or written assurances from members of the POB that the SIC was performing its task satisfactorily? Again, the answer had to be negative. The SEC staff could not approve the performance of the Special Investigations Committee without direct information as to the nature of the allegations against a firm and how the committee satisfied itself that anything about those allegations having any relevance to the reliance the public placed on audited financial statements had been dealt with satisfactorily.

The litigation-related fears of the member firms that led directly to strict confidentiality, and the need of the SEC staff for "access" sufficient to provide direct information, resulted in an impasse. Considerable time was to be spent in exploring such possibilities as oral briefings by POB members and staff to SEC staff members, review of

POB workpapers, and the development of closed case summaries. The difficulties each party to the difference has had in conceding enough to satisfy the other have seemed insurmountable. However, as of the date of this writing, while the SEC has yet formally to express satisfaction with the work of the SIC, there is reason to be optimistic that the Commission will soon recognize the role of the SIC in the self-regulatory program.

The First "Investigation of a Firm" — Three of Them!

But the ultimate question remained: What will happen if and when the committee finds an investigation beyond screening and monitoring necessary? Unavoidably, that question was finally faced, and the circumstances could hardly have been more difficult for the committee.

A single auditee had been the client of three major firms in succession. The client failed. A regulatory agency in the client's industry had made information available while the SIC had the case "in monitoring" that convinced the committee investigations of the firms were required. Thus the committee had not one but three investigations in mind. But there was a catch, one of the firms contended that litigation involving it had been commenced before the November 1, 1979 cutoff date. Hence, on technical grounds, that firm raised an objection to being investigated. It contended that the Special Investigations Committee lacked jurisdiction because the date of the first litigation in the case preceded the November 1, 1979 date on which the SIC's authority commenced. The technical questions of whether the other firms could then claim the same exemption and whether the first firm's claim was valid had never been faced before.

The Special Investigations Committee reconsidered its reasons for recommending the investigations and decided to proceed. Legal representatives of the AICPA and the three firms involved met to discuss the legalities at issue. No resolution of the disagreement emerged. The committee decided to take its case to the Executive Committee

and requested permission to investigate the firm that claimed jurisdictional protection at the same time it investigated the other two firms.

Under the terms of the Organizational Document, the Special Investigations Committee had the right to initiate an investigation of a firm on its own authority. But to get the November 1, 1979 cutoff date waived so it could treat the three firms alike, the committee had to come to the Executive Committee for its permission

The session with the Executive Committee was not a pleasant one for the representatives of the Special Investigations Committee. Restricted by the requirement of confidentiality for the committee's work, they were unable to present a complete explanation. Unavoidably, the fact that the committee proposed to investigate three firms, each a national firm, surfaced during this discussion. Some members of the Executive Committee seized upon this as evidence that the committee, in its zeal, had gone much too far and now constituted a threat to the profession. The Executive Committee decided to wait until its next meeting to resolve the issue, thereby giving all involved time to cool down and think the problem through.

POB Support and Professional Criticism

During this waiting period, the chairman and other members of the Special Investigations Committee met with the POB to present their case. The POB also met with the Planning Committee of the Executive Committee and stated its support for the Special Investigations Committee. The Planning Committee of the Executive Committee at this point was persuaded to approve the SIC's request. The firm that relied on the cutoff date for its defense then agreed to waive that defense and to accept an investigation of the firm along with the other two firms.

The investigations then went forward. They served the purposes of the committee, but left some Executive Committee members much disturbed. Some time later, one of them wrote a widely circulated seven-page letter to an AICPA staff member denouncing the establish-

ment of the Special Investigations Committee. Among his comments were the following:

> From having participated in most of the meetings that led up to the formation of the SIC, I know that the drafters would have preferred not to provide for investigations of a case, or even of a firm, while litigation is in process. They yielded on this point because of pressure from the Public Oversight Board and the SEC, but I know that they did not expect many investigations under those circumstances. This expectation is proving to be completely unrealistic... Specifically, it sounds as if the investigation of the firm is far enough removed from the specifics of a particular case to make it substantially less risky. As a practical matter, however, the fact that the investigation has been initiated as a result of a case is in itself prejudicial.

The concern about the undesirable effect that an "investigation of a firm" might have on the ultimate outcome of litigation expressed in the letter was shared by many others in the profession and constituted the environment in which the first investigations were conducted.

Nature of the First Investigations

The investigations included reviews of the manuals, checklists, and other practice aids the firms used in the conduct of audits in the industry of the alleged audit failure. In addition, the workpapers for a sample of engagements in that industry were reviewed in various practice offices including work performed by the office and the engagement team responsible for the alleged audit failure for each firm.

The firms that had performed the previous peer review of each firm under investigation were requested by the SIC to conduct the investigations under supervision by SIC representatives. Those making the investigations were careful to avoid any action that might be construed as investigation of or inquiry into the specific case in litigation.

Through these investigations, the Special Investigations Committee satisfied itself that the three firms had fundamentally sound approaches to conducting audits in the industry in question, and were

applying those approaches in an appropriate manner. One of the firms was found to have inadequate documentation in its workpapers of important audit conclusions on one client. Nevertheless, the investigators were satisfied with that firm's conclusions and the bases on which they were founded.

Lessons Learned from These Investigations

If we try to summarize the lessons learned through these first three investigations of firms, we might make statements like the following:

1. Performance of the review did not subject the firms to any observable litigation risk not already present.
2. Investigations performed by the firms' peer reviewers under the supervision of representatives of the SIC were completely satisfactory to the SIC representatives in charge of the investigations.
3. Useful investigations could be performed without intrusion into the case in litigation that caused the investigation. Yet information about the case in litigation, obtained from whatever source, could be crucial in determining whether additional investigation is needed.
4. A special investigation could uncover matters of sufficient importance to require the firm in question to take remedial action.

Another lesson of quite a different kind came out of the committee's experience with these first investigations. The committee had been following the three reported cases since February 1980 and had discussed issues related to them with the reporting firms. However, it was not until November 1981, when the SIC obtained a copy of a report prepared by a Special Examiner appointed by the U.S. Bankruptcy Court, that the SIC finally obtained information sufficient to identify the relevant quality control issues involved and to determine that investigations of the firms were called for. One wonders if these investigations would have occurred if there had not been an examiner's report available to the SIC.

These three cases raised anew the question of whether the SIC could properly perform its function without some discussion with firms reporting cases. These investigations were launched long after the litigation had been reported, and only after details of what might have gone wrong were made public as a result of investigations performed for a trustee in bankruptcy. If any of the three firms had had serious quality control deficiencies related to its work in the relevant industry, a considerable period of time would have elapsed before any action resulted from the SIC's involvement.

The SIC could not always count on other interested bodies to provide key information. Neither could it wait until such information became publicly available. As a minimum, the SIC representatives needed to discuss the allegations in reported cases with firm representatives to be in a position to determine whether significant quality control issues were present. Following the completion of these investigations, members of the SIC task forces were much less reluctant to direct questions to firm representatives about the specific allegations in reported cases.

Equally important, as time passed, firm representatives became perceptibly less defensive in their responses to such questions. By June 30, 1984, member firms had reported almost 100 cases to the SIC. Firms were gradually losing their fear of this new committee that could intrude on what had heretofore been the firm's most private business. Also, the conduct of the SIC representatives had been found not to add significantly to any firm's litigation risk. We have yet to learn of any instance in which conduct of an investigation by the Special Investigations Committee has had any direct or indirect bearing on the outcome of litigation against a firm or individuals.

Chapter 5

STRENGTHENING THE SOLUTION

The Chetkovich Committee

At about this time, the Special Investigations Committee received crucial support from a Special Review Committee formed by the AICPA's Board of Directors in 1983 to study the structure, operation, and effectiveness of the SEC Practice Section's self-regulatory program. After a thorough study of the work of the Section's committees, the Special Review Committee, informally referred to by the name of its chairman, Michael N. Chetkovich, made the following recommendations, among others:

1. That the Special Investigations Committee be continued with much the same responsibilities.

2. That the possibility of an investigation of a case be struck from the SIC Organizational Document.

3. That the SIC be enabled to obtain information directly from reporting firms in order to discharge its responsibilities promptly.

In effect, each of these recommendations recognized what already existed in fact. The Special Investigations Committee had proved its worth, and although the Securities and Exchange Commission had not yet given the committee any formal approval, any attempt to discontinue the SIC and its work would have met with great resistance. Also, the nature of the Special Investigations Committee's work, always directed toward remedial measures leaving punishment to the courts, meant that an investigation of a case was very unlikely ever to take place.

Finally, some of the more aggressive members of the SIC had already begun to direct questions to member firms about specific cases in litigation. Such questions were not an attempt to find fault or to fix blame; they were a relatively economical way to get at possible quality control weaknesses. "How did the firm respond to the allegations? Was the office involved included in the last peer review? What

were the findings? Were the members of the audit team covered in the last inspection program? How did they come out in the evaluations? How had the firm evaluated the client as an audit risk? Were any special steps taken in selection of the audit team? Did the client's industry present any special problems? What measures were taken to assure that the audit team received any special help needed to deal with industry problems?"

Almost unavoidably, these kinds of questions were finding their way into the operating procedures of the committee. And as firm representatives became persuaded that committee members were not interested in judging the adequacy of the audit through the information received in such exchanges, they became less concerned about the possibility that the committee was obtaining information that might ultimately be used against the firm in litigation. Indeed, the cooperation of some firms in the work of the committee clearly indicated that those firms were as anxious to discover and correct any weaknesses in their quality control systems as was the committee.

So the recommendations of the Chetkovich Committee were far from revolutionary. Nonetheless, they were extremely important. An objective review of the activities of the Section by an independent and high quality committee did much to strengthen the acceptance and position of the Special Investigations Committee. Criticisms by representatives of member firms now had to be supported by something more than vague assertions that the committee was a threat and a menace.

The "Second Round" of Investigations

Just about the time the committee was launching its first round of investigations, and doing so in the face of considerable criticism, two additional cases were reported that were unrelated except that both involved the same member firm. In both cases, the client companies and their managements would be severely censured for "cooking the books" to mask financial difficulties. These cases raised the question: Where were the auditors? Less than two months from

the date of the regulatory complaint against the company and its management in the first of these two cases, the Special Investigations Committee decided that the public interest required an investigation of the firm. It did so even though the CPA firm was not named in the complaint.

Having fought its way through the opposition to its first investigations, the committee was prepared for whatever might be necessary to investigate the firm in question in the current cases. But the situation turned out to be substantially different. The firm representative was very open and forthcoming. The cases received heavy media attention. The committee would likely have been criticized both within and without the profession if it had not moved quickly to commence appropriate investigations.

The first three investigations were conducted by member firms, in each case the firm responsible for the last peer review of the firm under investigation. For the next investigation, the SIC selected a team of reviewers under the direct supervision of a practitioner whose reputation for personal integrity and whose other professional credentials were well known. The committee maintained overall supervision and review responsibility through two of its members. The team selected and reviewed 13 audit engagements of publicly-held clients in the four offices that participated in the two allegedly substandard audits, including work supervised by the partners and managers responsible for the audits under question.

The review uncovered serious quality control deficiencies in one of the four offices and the need for extensive corrective action. This included but was not limited to (a) appointing a new partner in charge of one office, (b) requiring in-depth concurring partner review on future engagements by qualified partners from outside the office, and (c) both reassigning and terminating audit personnel, including partners. The SIC required the firm to develop a comprehensive remedial action plan, evaluated its comprehensiveness and adequacy and, finally, monitored its implementation.

The member firm in question was ultimately named in a regulatory action, which required the firm to undergo another review of its audit

practice. This did not occur until after the SIC had conducted the extensive investigation.

Strict confidentiality was maintained by the committee over the conduct and results of the investigations of the four offices. Neither the public nor the SEC staff was aware of them. The fact that the investigations had resulted in prompt correction of quality control deficiencies was clearly in the public interest. These investigations were undertaken and completed while litigation was in progress and without any apparent harm to the firm's litigation status. This action showed responsiveness to Congressional criticism, namely, that the self-regulatory program should not wait until litigation was settled before dealing with alleged audit failures. Additionally, it demonstrated that litigation damage did not necessarily result from doing so.

The Executive Committee of the SEC Practice Section could have authorized public disclosure of information concerning the investigation of the firm for those two cases but decided against it. Considerable sentiment to the contrary existed at the time because of the public criticism of the profession that the two cases had attracted. The Executive Committee was still sensitive to fears about damage to a firm's defenses in litigation. It argued further that other firms faced with a similar set of circumstances might be less cooperative in agreeing to corrective action if they felt such actions would be made public.

The POB's 1982-83 annual report was factual and brief on these matters:

> To date, the committee (Special Investigations) has conducted investigations of select aspects of the quality control systems of four member firms...These investigative teams generally examined other engagements supervised by personnel involved in the alleged failure and engagements in similar industries and with similar accounting and auditing issues to those involved in the reported litigation...Three of the four investigations resulted in recommendations for improvement in the firm's quality control system or compliance therewith, all of which were voluntarily implemented by each of the firms...the committee is keeping its file open on the fourth investigation pending the receipt of the findings of an ongoing review to determine whether the suggested improvements have in fact been implemented.

Other Progress by the Quality Control Inquiry Committee

Much of the committee's accomplishments through June 30, 1984 was related to the four investigations described, yet the committee grew in stature and effectiveness for several other reasons. Its accumulating record of dealing with each reported case in a professional manner, not hesitating to close cases when it found no public interest aspects to be pursued, helped member firms to develop confidence in its objectivity. Without any significant jurisdictional conflict, the committee added three important cases to its agenda, notwithstanding the fact that not one of the three was required to be reported under the SEC Practice Section requirements.

Each of the cases involved an alleged failure in the audit of a financial institution. The evident importance of such cases to the profession's reputation and the public's interest in them convinced the committee members that they required attention. These cases established a precedent for including similar cases in the future.

Dialogue with the Auditing Standards Board

In combination with other cases of alleged failure to properly audit the financial statements of banks, two of the cases caused the committee to question the adequacy of available professional guidance for the conduct of such audits. As a result, the Public Oversight Board on September 2, 1983 wrote the committee expressing its support for a reconsideration of the adequacy of current professional guidance. The letter noted the recent spate of bank failures and suggested that these were likely to undermine the public's confidence in the profession's ability to audit banks satisfactorily. It encouraged the committee to open a dialogue with the AICPA's Auditing Standards Board.

As a consequence, the committee initiated such a dialogue with the Auditing Standards Board and with the Institute's Banking Committee. This proved to be the first of a series of dialogues with the Auditing Standards Board; these now occur as necessary but no less frequently than annually.

The exchange with the Banking Committee resulted in valuable additional guidance to auditors of banks. Published in The *CPA Letter,* this guidance alerted practitioners to some important aspects of bank auditing. For example, practitioners were urged to consider carefully the possible implications of insider loans, loan participations purchased and sold, and undue loan concentrations in evaluating the adequacy of the allowance for loan losses.

Other Results of the Financial Institutions' Audit Cases

In addition to recommending attention to guidance for bank auditing, the committee's work with the three cases focused attention on questions about the effectiveness of quality controls and compliance therewith in the three firms that audited the financial institutions. Each firm gave its total cooperation.

One of the cases clearly exemplified the mutuality of interest between private regulation (actions taken within firms) and the self-regulatory program (peer review and the special investigations process). While the Special Investigations Committee had previously caught glimpses of the actions taken by firms to study and strengthen quality controls when litigation raised a question about them, this case provided dramatic evidence of such action. The firm literally investigated itself.

An extensive review of its banking practice was performed including an evaluation of controls and a testing of compliance with firm policy. Top people from other offices were brought in to provide an objective and thoroughly professional review. The SIC was made privy to the nature and scope of the review while it was in process. On completion of the review, the committee was given access to all the findings, made its own evaluation, and helped to shape the corrective action plan implemented by the firm. The experience gained in this case provided a model for QCIC action in a number of subsequent high profile cases.

In the second of the three cases, the committee, in a meeting with representatives of the firm and its peer reviewing firm, ascer-

tained that the engagement partner had not recently supervised audits. The committee satisfied itself through inquiry concerning the adequacy of the firm's quality controls for audit work similar to the audit in litigation. The committee insisted that the office responsible for the alleged audit failure be included in the firm's imminent peer review, and that the peer review team test relevant quality controls.

The third case had earlier received attention from the committee including extensive discussion of the allegations of fault with representatives of the firm and review of a regulatory report which did not pinpoint any weakness in the firm's quality controls or its audit approach. The committee had then closed the case.

Prompted by sharper and more specific criticism of the firm's audit in a new complaint based on additional investigation by a different regulator, the case was reopened by the committee fourteen months later. The committee's work convinced it that an investigation of the office responsible for the audit was desirable. The investigation required by the SIC was performed by firm personnel from outside the office and was subjected to review and testing by the firm's regular peer reviewing firm and by a two-member task force of the committee. The office was found to be practicing at an acceptable level of quality.

As a result of its work on this case, the committee asked the AICPA's Professional Ethics Division to review a specific aspect of the profession's independence rules. The Ethics Division review resulted in the issuance of a clarifying interpretation.

Confidentiality and SEC "Acceptance" of the Special Investigations Process

When the Chetkovich Committee reviewed the special investigations process in 1983, it focused on the fact that the SIC's activities, on advice of legal counsel, were to be conducted under the constraint of complete confidentiality. Counsel had urged total confidentiality to avoid possible prejudice of the defenses of member firms in litigation. As noted earlier, member firms were very sensitive to the danger any breach of that confidentiality might impose on them.

Almost no detail about the activities of the committee and especially no information about specific cases had ever been released. As a result, regulatory bodies, the Congress, and the public had little basis for evaluating the effectiveness of the committee and its activities. The hope of those establishing the committee in response to the Public Oversight Board's recommendation was that the stature of the Board, which did have unlimited access to SIC activity and said so in its annual report, would be sufficient to give the SIC necessary credibility. This was not to be. The SEC insisted it could not give its approval to the work of the Special Investigations Committee based solely on second-hand information, no matter how reputable those providing it.

SEC Commissioner Barbara S. Thomas was publicly critical of the protective confidentialy surrounding the SIC. In a January 12, 1983 address before the AICPA's National Conference on Current SEC Developments, she chided the SEC Practice Section leadership.

> ...it is well for the Section not only to take decisive action, but also to assure the public that it has done so. Actions that are shrouded in secrecy can only reinforce an attitude that the profession's own interest is being placed before that of the public.

It was now clear that something more extensive and timely in the way of information about SIC cases than appeared in the annual reports of the POB was necessary if the Special Investigations Committee were to be perceived as fulfilling its purpose. At the request of the SEC Practice Section Executive Committee, one of the members of the POB undertook to work with the Chief Accountant of the SEC in an effort to devise a plan that would provide the SEC with the information it felt necessary for evaluating work of the Special Investigations Committee without unduly jeopardizing the litigation defenses of member firms.

After a number of proposals failed to gain SEC support, the POB proposed that its staff would prepare and submit to the SEC a quarterly statistical report of SIC activity that would include every case reported to the SIC from initial reference until the case was closed.

This report was to be supplemented by two summaries, neither of which would identify any case by name:

- Closed case summary, prepared by the POB, which would anonymously report the reasons for closing each case
- Investigations summary, prepared by the SIC, to briefly and anonymously describe the focus and scope of the investigation, the composition of the investigating team, and the committee's conclusions.

In addition, the POB undertook to report any differences of judgment that might eventuate between its staff members and the SIC. The reasoning underlying this proposal was that a continuing series of reports on SIC activity would persuade the Commission that the SIC played an important and effective role in the Section's self-regulatory activities. In April 1983, the Chief Accountant told the POB representative that the information to be provided under the proposal was not sufficient to enable the SEC staff to evaluate the effectiveness of the SIC. What the SEC staff needed was "access" to SIC activity similar to its access to peer review workpapers.

Reducing the Confidentiality Requirement

Among other matters, the Chetkovich Committee addressed the question of whether the confidentiality surrounding SIC activities should be relaxed to provide the SEC staff direct access and to permit public disclosure of the remedial and corrective measures resulting from those activities. In contemplating the answer to this question, Chairman Chetkovich and his colleagues pondered the significance of the following advice from AICPA counsel:

> ...it would appear highly unlikely that corrective actions undertaken by a member firm on its own initiative, or as a result of SIC procedure and recommendations, would be admissible as evidence in Federal court litigation to prove negligence or culpability.

Their conclusion was that some information about the special investigative process should be made public to enhance its credibil-

ity. However, confidentiality should continue with respect to actions taken on specific cases because of the "...possibility of substantial and often unwarranted prejudice against member firms." Thus the Chetkovich Committee recommended that the Section should:

- Provide periodic public reports on the SIC's activities that would include aggregated data and statistics on its cases and information on remedial and corrective actions taken by member firms in connection with those cases.
- Make available in a manner appropriate for educational purposes information about unusual or recurring problems encountered in the SIC process.

The Section implemented these recommendations when it publicly issued the first report of the SIC in 1985 covering its activities from inception through December 31, 1984.

The commencement of public reporting on SIC actions and the results thereof was an important but measured first step to improve the SIC's credibility. Such reporting would not be sufficient to gain SEC endorsement.

Investigations of Firms as "Special Reviews"

The Chetkovich Committee also made another very significant suggestion to enhance the credibility of the SIC. It noted that the committee's Organizational Document provided for two types of investigation, the "investigation of a firm" and the "investigation of a case." As explained previously, the Chetkovich Committee had observed that the Special Investigations Committee, by natural constraint, could investigate a firm but not a case. Thus it concluded that provision for investigation of a case when the SIC would never undertake to perform one was unrealistic; therefore, the presence of such a provision was an impediment to the SIC's credibility.

The term "investigation of a firm" was replaced by "special review" without any intent to make the contemplated procedures any less comprehensive. The revised Organizational Document calls for a

"special review" whenever the committee reaches one of the following conclusions:

- There is a reasonable likelihood that the firm might need to take specific corrective actions beyond what the firm may have already undertaken, and a special review is deemed necessary to determine the nature and extent of such actions.
- There is a reasonable need to obtain timely assurance about compliance by the firm, or a segment (office or function) thereof, or by certain of its personnel, with one or more of the firm's quality control policies and procedures.

Thus, subsequent to September 1984, an "investigation of the firm" became a "special review." Whatever the label, the contemplated procedures were intended to be equally protective of the public interest in the reliability and credibility of audited financial statements. The term "investigation" was considered to have undesirable implications. The new designation, "special review," was considered to be more descriptive of the supplementary role the special investigations process had vis-a-vis the peer review process in the total self-regulatory program.

As AICPA Vice President Kelley observed in early 1984 in connection with the Chetkovich Committee's work:

> It is essential to take reasonable steps to enhance the credibility of the SIC because the SIC is essential to the credibility of the peer review process. Criticism of the peer review process revolves around the continued existence of alleged "audit failures" and the fact that peer review is not specifically designed to deal with the "people problems" that are likely to be at the root of real audit failures.

The change from "investigation of a firm" to "special review" represented a logical evolution at the time it was effected. The deemphasis of "investigation" and the use of "review" related the intended study to the peer reviews it supplemented. The review was "special" only in the sense that peer reviews took place on a regular triennial basis, while "special" reviews differed from peer reviews not in nature or

substance but in that they occurred on an "as needed" basis and had a scope solely dictated by the circumstances. To emphasize the difference, the adjective "special" was added.

To some member firms, that adjective also implies "something not often done." Thus a special review is unusual and from this idea it draws attention and concern. Some member firms believe the new term also has a negative connotation.

Chapter 6
IMPROVING THE PROCESS

SEC Views on Special Reviews

A consistent criticism voiced by the SEC staff is that the Quality Control Inquiry Committee should conduct more special reviews. Members of the SEC staff note that peer review emphasizes the design of and compliance with quality control systems, and that if the system is satisfactory, then failure must be a "people problem." They argue that whenever allegations of failure, if valid, could indicate serious noncompliance with quality controls, a special review should be conducted to assure the public that the problem is not indicative of a pattern of noncompliance or substandard performance by engagement personnel. If a pattern is found to exist, the solution is to take remedial steps to assure that the same person or persons will not make the same or other mistakes in the future.

Thus the SEC staff contends that when the circumstances of a reported case suggest that substandard work may have been performed, a special review should be directed at other work of the auditors concerned to determine whether they should be permitted to continue in practice, and, if so, on what terms.

"Internal" Reviews

The discipline inherent in a quality control system should encourage firms to make their own "people problem" reviews on an internal basis. They should do so without prodding from the QCIC whenever they have reason to question the performance of one or more of their professionals. Such internal reviews should provide the most realistic answers to whether the practitioners under scrutiny should be permitted to continue in practice. After all, no one has more incentive to weed out incompetent practitioners than their partners. As we have already noted in the discussion of the financial institutions cases, the SIC during its investigative procedures at times becomes aware that such an internal review has occurred and is made

privy to both the findings and the firm's corrective actions. In such instances, review by the SIC of the documentation of the internal review may obviate the need for a special review or at least enable the scope of a special review to be less comprehensive than it otherwise would have been.

Special Reviews — A Considerable Variety

Internal reviews and special reviews have a common purpose. Although few in number and varying in nature, the special reviews performed to date constitute an interesting and unusual part of the QCIC's activities. Overall they reflect with considerable accuracy the evolutionary development of the committee's policies, practices and concerns.

Twelve special reviews have been performed to the date of this writing; they considered the allegations of 16 reported cases. In view of the number of firms included in the SEC Practice Section and the fact that those firms have reported 382 cases from inception of the SIC through June 30, 1990, one would have difficulty in arguing that the committee has ordered special reviews excessively. Of course, it should be taken into consideration that a number of special reviews were obviated because the firms in litigation had conducted "internal reviews" which, as we noted earlier, closely approximate the requirements of a special review.

The special reviews completed to date vary considerably in the circumstances that caused the reviews to be made, in the methods followed, in the extent of QCIC involvement, and in the matters of primary interest. No pattern seems to emerge. Some reviews were performed by teams of qualified experts having no previous association with the reviewed firm, either as investigators or as peer reviewers. Some were performed by members of the QCIC and its staff. In other cases, the firm's peer reviewers undertook the special review reporting their activities to the committee. In every case, the committee both specified the purpose and extent of the review, and through its task force, supervised and reviewed the conduct of review proce-

dures and thus satisfied itself that the objective of the review had been attained.

Five of the twelve reviews have already been discussed; three focused on quality controls relating to audit practice in a specialized industry, another focused on the firm's quality controls relating to complex public engagements in the four offices which conducted two engagements in litigation, and the fifth focused on quality controls in the office that had conducted an engagement that resulted in litigation and included audits performed in the same industry as that engagement, including audits performed by the personnel who were responsible for it.

Of the remaining seven, three were completed prior to adoption by the SIC of a more structured approach as described later in this paper. One focused on office quality controls and included engagements which were conducted by the personnel who supervised the engagement in litigation and which had characteristics similar to that engagement; another focused on office-wide quality controls and on engagements with characteristics similar to and conducted by personnel who performed four engagements on which audit failure was alleged; and the third review involved the evaluation of quality controls over engagements conducted in various offices on which significant portions of the audits were performed by personnel from other CPA firms. The first two of these resulted in changes in office management, additional education, and expanded engagement review procedures. The latter caused the establishment of additional firm-wide quality controls and monitoring procedures as well as the performance of auditing procedures on certain engagements that were included in the special review and found to be substandard.

These special reviews were well done and resulted in corrective actions by the firms that were clearly in the public interest. Even the SEC so acknowledged, having had access to the results of the three reviews just discussed. The concern expressed was why so few special reviews had been conducted—particularly reviews of other audit work performed by personnel responsible for conducting an allegedly faulty audit. The threshold for requiring a review seemed to be too high.

Since then, four such reviews have been conducted concerning four cases involving as many firms. Two of these indicated adequate compliance with quality controls on other engagements; the cases were closed. The third resulted in the finding that one partner's workload was too heavy and that additional review procedures should be employed over this partner's work because documentation on his other audits was deficient in some important respects. And the fourth resulted in the finding that the firm's audit guidance relating to the consideration of audit risk and materiality was too complex. Therefore, that guidance was revised to avoid the possibility of misunderstanding by firm personnel.

"People Problem" Reviews

The variety of special reviews experienced in the past is unlikely to continue. Repeated peer reviews tend to strengthen member firms' systems of quality control by eliminating deficiencies in these systems. People problems, however, will persist. Hence we may expect that special reviews in the future will tend to be of the people problem variety.

That focus will meet the SEC's concern described above. The QCIC has successfully been experimenting with a form of special review that satisfactorily accomplishes the SEC's objectives and keeps the costs of reviews down. Such reviews have been conducted by competent firm personnel who were not involved in the alleged failure, and not from the same office, under the immediate supervision of the firm's peer review team captain and ultimate supervision by a QCIC task force. The POB has cautioned the QCIC that great pains need be taken to reduce the perception problem that this form of special review could cause, that is, that the reviewers will not be objective. Consequently the QCIC has agreed not to use either peer reviewer or firm personnel in any situation where their involvement in the previous peer review or last inspection would lead to a question about their objectivity. When such a question arises, the special review should be conducted by a completely independent review team.

At the time of this writing, the QCIC is experimenting with a special review process that balances objectivity and cost concerns by utilizing the following principles:

1. No member of a special review team should review or opine on work or matters on which that member has already reviewed or opined.
2. All members of a review team must be competent and qualified.
3. Special review procedures must be specifically designed to accomplish the purpose of the review.
4. Ultimate responsibility for the quality of special reviews rests with the QCIC.

Appropriate Bases for Sanctions

When the SIC Organizational Document was revised to incorporate the Chetkovich Committee recommendations in 1984, an important change concerned the matter of sanctions. The Chetkovich Committee formally recognized the dominance of remedy over punishment in the work of the Special Investigations Committee. The revised document made it clear that circumstances would rarely be encountered when the SIC would recommend that the Executive Committee sanction a firm. The possibility, of course, was provided for but would likely stem only from a firm's refusal to cooperate in any of several ways:

1. Failure to provide information to the committee.
2. Refusal to undergo a special review as ordered or to pay for one.
3. Failure to take corrective action that is deemed reasonable and necessary by the committee.

Increased Access for the Quality Control Inquiry Committee

The revised Organizational Document also recognized the committee's need for information more directly relevant to the allegations in the litigation reported to the committee. As suggested previously, some committee members were more aggressive and perhaps more effective in asking member firm representatives the kinds of questions that brought forth useful answers. Such questions sometimes went directly to the allegations in the case. Because there was no requirement that the firms respond to such questions, sometimes the committee members received responses to such questions and sometimes they did not.

Members of the committee felt that they were at a severe disadvantage in being totally dependent on the voluntary provision of information they needed. Relevant to this point, the Chetkovich Committee report recommended somewhat ambiguously that member firms "...should be required to furnish sufficient information (but not the working papers or other direct evidence in a specific case)..."

The revised Organizational Document included the following:

> Consideration of the nature and implications of the allegations ... which may involve meetings with representatives of the firm to discuss the allegations made, the quality control policies and procedures presently in effect, the corrective actions, if any, that have been taken by the firm, and the results of regular or special inspections undertaken by the firm.

This revision strengthened the committee's freedom to ask questions related to the case before it, a substantial improvement from the early days of the committee when such questions would likely have been rejected. Nevertheless, this did not provide the committee with as much access to information about the case at hand as some members of the committee thought they needed to perform their task expeditiously and equitably to all member firms. Consequently, the evolution in committee access to "case specific" information was not to stop here.

Increased Scope of QCIC's Jurisdiction

A major recommendation in the Chetkovich report was introduced as follows:

> ...we believe it is time to reconsider the requirement that only litigation involving SEC registrants be reported.
>
> A quality control deficiency that results in an audit failure relating to a client that is not an SEC registrant could, in the absence of some additional special safeguards, have the same result in connection with the audit of an SEC registrant. The committee, in the past, has added to its agenda a limited number of cases involving entities that are not SEC registrants. Because of the construction of the reporting requirement, it was found necessary in such instances to approach the firms involved and encourage them to report such matters voluntarily.
>
> Although that approach worked in those instances, the efficacy of the process and the public credibility it obtains would be enhanced if the reporting requirement was broadened. Ideally, it could be argued that all alleged audit failures should be reported; however, since the primary thrust of the SECPS relates to the improvement of the quality of practice before the SEC, we conclude that the requirement should be broadened to include cases involving entities, that although not SEC registrants, are of such interest to the general and financial public that a distinction between them and SEC registrants should not be made.

The recommendation reads as follows:

> The membership requirement for reporting cases to the Special Investigations Committee should be extended to cover cases involving all entities in which there is a significant public interest.

This recommendation was implemented in the revised Organizational Document with these words:

> The committee may identify a significant public interest in an alleged audit failure that is not required to be reported to the committee. The executive committee shall determine what actions, if any, shall be taken by the Section with respect to such matters.

That recommendation was also reflected in the membership requirements as a "redefinition" of an SEC client. The revised definition

recognized the substantial public interest in the quality of audits of banks, savings and loan institutions, and some other entities that do not file with the SEC. As noted previously, some cases of this type had been voluntarily reported to the SIC. The revised requirement called for reporting cases that allege failure to audit properly the financial statements of a bank or other lending institution that periodically files with a regulatory body and meets certain size tests.

In June 1989, concern for the public interest led the SECPS Executive Committee to grant the QCIC the right to inquire into litigation initiated against auditors by regulators alleging audit failure in the conduct of an audit of any financial institution. This further expansion of the QCIC process recognized that a significant number of complaints, particularly involving failed S & L's were being filed by regulators which were not reportable to the QCIC even under the redefinition.

The Continuing Search for Credibility

Credibility is a combination of an appropriate and well defined mission, a good program to accomplish that mission, and actual performance subject to independent review or testing. Because of the possibility of serious damage to member firms' litigation defenses, the work of the Quality Control Inquiry Committee is highly confidential. This makes obtaining general credibility for the QCIC difficult indeed. What people know nothing about is unlikely to impress them as credible. So an effort has been made to establish credibility for the QCIC in another way. If the SEC, an objective and independent body, can test the activities of the QCIC and find they performed satisfactorily, then the SEC's endorsement of the QCIC's activities may provide adequate credibility. In effect, SEC's endorsement has assumed the status of public credibility.

In May 1985, at the urging of the POB, the Section agreed that the activities of the Special Investigations Committee should be reported to the SEC with the POB staff acting as intermediary. In a major departure from the Section's policy on confidentiality, this pro-

posal gave the SEC staff information about each case including identification of the audit firm and the audit client. For each case the SEC staff received a summary of (a) the major allegations, (b) the investigative procedures applied by the committee, (c) the results thereby obtained, and (d) any subsequent actions of the committee (the "closed case summary"). The SEC staff was also given access to the POB's completed oversight checklist and the POB staff made itself available to respond candidly to SEC staff questions about the QCIC's actions and findings and the POB's oversight.

The first such access by the SEC staff was provided from June 30 to July 2, 1986 when the SEC staff reviewed 24 closed case summaries and discussed those cases with the POB staff. From the standpoint of relations with the SEC staff, this session marked a new level. Questions were wide-ranging but relevant and responses were candid.

Even though this first exchange of information had been a significant departure from earlier positions taken, it was not sufficient for the SEC staff to endorse the QCIC process. Yet the SEC staff now had observed at first hand that the special investigative program was one of substance and quality.

SEC Reluctance to Endorse the Process

The SEC staff expressed three concerns about the QCIC process subsequent to this first access experience. First, the SEC staff questioned whether the QCIC's credibility could ever be established if it focused solely on remedial measures to the exclusion of punitive considerations. Second, the SEC staff thought that the QCIC needed to have access to selected workpapers of the audits under litigation to evaluate the effectiveness of applicable quality controls and compliance with them. Third, the QCIC should lower its threshold for performing special reviews, especially when questions arise concerning the quality of work of the auditors responsible for the audits in question.

Soon thereafter, the members of the POB met in open session with the SEC commissioners. Among the matters discussed was the role of the Special Investigations Committee, the fact that it did not yet have the endorsement of the SEC, and the paucity of publicly available information about SIC operations and accomplishments. During the meeting, SEC Chairman John Shad expressed his opinion that the SIC's credibility was crucial to determining whether the profession's self-regulatory program was effective. He urged the Section and the POB to find a way to inform the public about the role and operation of the SIC.

Commissioner Peters urged that the SIC be given access to more information about specific alleged audit failures to further assure its effectiveness in improving the quality of audits performed by Section members. It was clear from the general tone of the meeting that these were matters of some urgency. The POB agreed to exercise its best efforts to improve the disclosure of SIC/QCIC activities, especially to the Securities and Exchange Commission, and also to gain for the QCIC more direct information about alleged audit failures.

Some Complexities in the Credibility Issue

The Quality Control Inquiry Committee's credibility problem must be seen as a mix of variables, each of which can be viewed from different and not unreasonable points of view. To be accepted as a valid part of the self-regulatory process, the QCIC had to establish its effectiveness in serving the public interest. The imposed requirement of confidentiality made evaluation of the QCIC's work by "outsiders" impossible. What did the QCIC do? Only the insiders knew. How well did it perform? Only the insiders had direct access to QCIC activities. The procedure for reporting and discussing closed case summaries was designed to provide an adequate understanding of both the QCIC's activities and the quality of its work to the SEC staff. The SEC staff found it an improvement but initially at least not totally satisfactory for the purpose.

Yet stripping the QCIC of confidentiality to provide the SEC staff with more detail could expose the firms to risks in litigation that they considered totally unacceptable. The continuing advice of legal counsel could not be ignored.

The QCIC continues to face more than one interpretation of its function. A regulatory point of view tends to emphasize identification and punishment of those who fail their duties. As one critic of the QCIC expressed it: "That's what regulators do." And the QCIC is the only element in the SEC Practice Section's program that deals with allegations of audit failure. If it fails to identify and punish, who will? How can the QCIC then be accepted as an important link in the self-regulatory process if it never identifies or punishes anyone as a wrongdoer?

But as noted previously, the members of the SEC Practice Section have a different view of the role of the self-regulatory program. They contend that the program best serves the public interest by going directly to weaknesses in the quality control systems of member firms and eliminating those weaknesses. No one else can do that as well as they. But others — the legal system and legally supported regulators — are both better equipped and better able to carry out the "identify and punish" aspects of regulation.

There are also strikingly different views on the cost of the self-regulatory program. Regulators tend to have little interest in cost, especially costs that do not impinge on their own budgets. Practitioners have a vital interest in cost. Anything that increases their cost of operations must be borne either by clients or reduce partner profits, either of which poses serious problems. The minimum costs of the self-regulatory program are considerable: peer reviews, second partner reviews on all SEC client audits, annual internal inspection programs, and special reviews. The prospect of incurring costs in self-regulation that may result in sustaining losses from litigation is both ironic and remarkably unappealing.

Finally, professional pride is a matter of no small consequence. Regulators have little inhibition about calling for additional require-

ments to protect the public. What could be more important? Their investigations into alleged and real misdeeds convince them of the necessity of those requirements. Practitioners, on the other hand, see themselves as serving faithfully and effectively in an honorable and useful activity. The overwhelming majority of them have served throughout their careers without ever having been charged with audit failure. They and their firms have a responsibility to meet client needs at reasonable cost. How much of this expensive self-regulation is really needed?

Public Oversight Board Interest in QCIC Credibility

The Public Oversight Board has a keen interest in the matter of QCIC credibility. In the first place, any weakness in QCIC credibility raises questions about the entire self-regulatory program. The QCIC was proposed and is recognized as necessary to supplement the peer review process. The review of engagements in a peer review is performed on a sampling basis. If enough bad cases occur in spite of peer review, and if nothing is done about them, then peer review will be found unsatisfactory.

Second, the QCIC was not patterned on any existing professional model. Rather it was an innovation which the POB has supported enthusiastically. The POB and the profession's leadership both recognized that a self-regulatory program that omitted review of alleged audit failures would not be accepted by Congress and other critics.

QCIC activities were not in the nature of a normal practitioner response. Peer review was sufficiently similar to internal inspection programs to be understandable and accepted. Special investigation activity smacked of outside interference, regulation, and building a case against the firm. The POB sees a real need for the QCIC to succeed. At the same time, the POB has no desire to increase the litigation risk to member firms unreasonably.

Also, the Board feels pressure from both the Securities and Exchange Commission and from member firms to bring this issue to a satisfactory resolution. The subject of QCIC credibility is always on

the agenda when the Board meets with the Commission. Likewise, it also is a subject frequently discussed when the Board meets with the Executive Committee of the SEC Practice Section or the AICPA Board of Directors.

POB Efforts to Resolve the Credibility Issue

Partly to help resolve the QCIC credibility issue and partly through its general oversight activities, the Public Oversight Board generated three proposals we believe bear positively on the matter of QCIC credibility.

The Concept of Incremental Risk. First, and primarily the result of a staff effort, the concept of incremental risk was proposed and investigated. We have already noted the great concern of member firms and their counsels regarding possible prejudice to the firms in litigation. Class action suits, joint and several liability, RICO and the generally litigious environment in which accounting firms serve combine to make allegations of audit failure difficult to defend. Information obtained through any investigatory activities of the QCIC may be found useful by plaintiff's attorneys. "Why should we make their case for them?" is the way one managing partner expressed his views.

With full understanding of this strongly held view, the POB staff raised an interesting question. Given the fact that rules of discovery and the admissibility of evidence provide certain conditions within which plaintiff constructs a case, how much would the risk of failure to successfully defend against that case be increased by giving the QCIC some limited access to information about the case?

Would plaintiff have access to QCIC documents? Would that access provide any help to plaintiff not already provided by complete access to the audit workpapers for the case and depositions of audit engagement personnel? Could QCIC members be forced to testify? Would they be required to offer opinions on fault if their investigation ran only to the possibility of systemic design or compliance deficiencies and not to fault in performance of the audit?

Expert research and advice were sought and obtained. The question of a public policy exception was explored. Grounds for the exception were that the self-regulatory program of the profession could not operate without the cooperation of member firms who likely would not provide information to the QCIC which could be discovered and used at trial against them. The calling of expert witnesses and the fact that anything QCIC members could derive from audit workpapers would already be available from other sources was also inquired into.

The result of this research provided no final answer. Too many of the questions are subject to broad judicial discretion or have not yet been litigated. Although those involved, both litigators and non-litigators, were willing to express informed opinions, as lawyers they were experienced enough to emphasize that what we received were opinions only with no assurance of ultimate vindication.

Yet the concept of incremental risk itself was useful in helping to get the problem into perspective and in increasing the understanding of those concerned.

In the final analysis, with adoption of the QCIC program, member firms accepted the risk that QCIC conclusions and any corrective actions required thereby may be subject to discovery. Thus, expansion of QCIC's investigative process to encompass review of selected workpapers or interview of engagement personnel would represent, as counsel noted, "only a change in degree of potential risk" to SECPS firms.

Proposal for a More Structured Approach for the QCIC. The cases reported to the QCIC by member firms in compliance with the Section membership requirements vary significantly from the vague to the specific, from highly visible to relatively unimportant, and from complex to straightforward. The QCIC investigation of those cases varies with the aggressiveness, experience, and ingenuity of the QCIC member assigned to the case and with the responsiveness of the member firm.

The crucial question in every case is when to close. At what point and based on what evidence should the committee conclude that

further investigation is not warranted. In theory, the answer to that question is: when the committee concludes that no corrective action needs to be taken regarding the firm's quality controls or the compliance of its personnel with those controls. Yet because of the variety of cases and of investigative approaches, some unevenness between cases is difficult to avoid.

Observation by the POB staff of QCIC action in dealing with approximately 200 reported cases convinced the staff that QCIC activity could be improved and cases could be given more even treatment if a more structured and positive approach were adopted.

The structure was provided by a sequence of procedures, each one leading logically to the next:

Analysis

Inquiry

Investigative procedures

Special review

Analysis comprehended a reading of the allegations, the financial statements to which they relate, and any other material readily available to determine if the plaintiff's charges are sufficiently specific and relevant to have quality control implications. If not, a recommendation for closing the case was in order.

Inquiry provided for direct contact with the member firm to seek answers to questions raised by the quality control implications found in the analysis phase. Questions might run to whether the audit in question had been included in the most recent peer review and inspection programs, how the firm felt about the allegations, the firm's risk evaluation of the client, and similar matters. If responses to these questions could allay the QCIC member's concerns about quality control, a recommendation for closing the case was in order; otherwise the case would be held open and subjected to investigative procedures.

Investigative procedures involved further inquiries more directly related to the case and the qualifications of the audit team, discussion with the peer reviewers, examination of inspection reports, reading

available regulatory reports, following up on questions raised by the media, and the like.

The investigation phase comes to a conclusion when the QCIC member assigned to the case recommends either that the case be closed or that a special review be undertaken. When a case has been carried this far, the other members of the committee have become familiar with it and the task force's recommendation will be the subject of comprehensive committee discussion.

Special reviews might be directed to other engagements by personnel who supervised the allegedly faulty audit, to selected engagements in the same industry on an office or firm-wide basis, to engagements with unique transactions, to a review of quality control compliance by one or more offices, or to a review of the entire system (a peer review).

The positive element in pursuing this structured approach is one of attitude. The task force assigned to the case continues with the current or next step in the process until satisfied that there is nothing to be gained by continuing further. That is, the evidence available is sufficient to persuade him that nothing significant is to be accomplished in the way of public protection by continuing the inquiry.

Discussion with House Counsels. The third contribution by the POB to resolve the issue of QCIC credibility was a roundtable discussion of that issue with the house counsels of a number of the larger member firms called by the chairman of the Public Oversight Board. He felt that a frank discussion with these people, whose advice to the chief executive officers of the member firms carried such weight, would be enlightening to all concerned. The response was encouraging.

No record or minutes of any kind were kept. The discussion was frank and open. Concerns were considered and the concept of incremental risk was explained and discussed. The importance of QCIC credibility, a matter not likely to come to the attention of the house counsels, was also explained and discussed at length. The house counsels made no secret of their determination to protect their firms from unnecessary litigation risks. They saw that as a first responsibil-

ity. At the same time, they indicated an appreciation for the importance of a self-regulatory program that made additional regulation unnecessary. The subject of QCIC access to selected audit workpapers for cases under investigation was discussed at some length.

No action was taken at the meeting nor was any anticipated. A frank airing of views was deemed to be useful. There is little doubt that all present departed with a fuller understanding of the dangers that others saw in the various courses of action discussed.

Chapter 7

ADDITIONAL EFFORTS TO IMPROVE THE PROCESS

The Rossi Task Force

As a result of its meeting with the Securities and Exchange Commission on July 29, 1986, the POB requested the SEC Practice Section to reconsider (1) providing the QCIC access to selected audit workpapers and (2) relaxing the confidentiality surrounding its activities in order to strengthen QCIC's effectiveness and credibility. The Section responded in September of that year by appointing a task force to review QCIC methodology. The chairman, Frank Rossi, was joined on the task force by a fellow SEC Practice Section Executive Committee member, two QCIC members, and the general counsels of two firms.

The task force met with representatives of a number of firms having large SEC practices, the Chief Accountant of the SEC and his staff, representatives of the POB, and members of the SIC/QCIC. On April 3, 1987, the task force issued its report, "Enhancing the Effectiveness and Credibility of the SIC Activities."

The SEC Practice Section's Executive Committee accepted the task force's report at a special meeting in April 1987. The major conclusions included the following:

- The mission of the committee should not be changed; it should continue to complement the peer review process by evaluating the quality control implications of alleged audit failures.
- The committee should adopt a more structured approach in acting on reported cases.
- QCIC task forces should be permitted to access, when appropriate, selected audit documentation prepared in the course of performing the audit in question.
- The SEC should be provided with more meaningful reports of the actions and findings of the committee on reported cases.

QCIC representatives should meet periodically with the SEC Chief Accountant and members of his staff to enhance the SEC's general understanding of the committee's activities.

Results of the Task Force's Recommendations

In June 1987, the Executive Committee modified the QCIC Organizational Document with the following additions:

I. The following provision was added to paragraph 17 in the section entitled "Investigative Procedures:" "The SIC, when it deems it appropriate and necessary, should read audit documentation, such as audit planning memoranda, summary review memoranda, audit issues memoranda, or consultation memoranda, that could enable the SIC to evaluate whether appropriate attention was given by appropriate individuals during the audit to the issues addressed by the allegations."[2] However, while access should be sufficient for the SIC to evaluate whether the member firm had suitable quality controls and whether they were operating effectively, the SIC's review should not be so extensive as to place it in a position to determine whether or not the firm had specifically complied with generally accepted auditing standards in the area under consideration. The exact extent, nature, and form of access requested depends on the individual circumstances presented by the specific case and the specific allegations.

II. The next paragraph of the aforementioned section was amended to read as follows:

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[2]A member firm will ordinarily evaluate the litigation risk against the benefit of permitting the SIC access on a specific case. Accordingly, a decision not to permit access to documentation does not necessarily mean that inappropriate attention was given to a matter. That decision would not, in and of itself, cause the SIC to recommend the imposition of sanctions, provided the firm's decision was not a general refusal to cooperate. The inability to review important evidence of quality controls would likely result in a more extensive investigation than would otherwise be required, including the greater likelihood of a special review. Furthermore, a general refusal to cooperate in the investigative process would cause the SIC to recommend sanctions.

A firm is required to cooperate with the committee by furnishing on a timely basis, upon request, the information contemplated by paragraph 17 and by authorizing its peer reviewers to comply with requests for such information. A firm is also ordinarily expected to cooperate with requests to permit SIC access, when appropriate, to certain audit documentation bearing upon the member firm's awareness and consideration of the issues addressed by allegations made against the firm. However, a firm is not required to provide the committee or its representative with information that would invade the attorney-client privilege, or with the litigation work product of the firm or any of its partners or employees.

Adoption of Working Procedures. The QCIC has adopted working procedures that include implementation of the more structured and positive approach initially proposed by the POB staff and included in the Rossi Task Force recommendations.

Access to Selected Audit Workpapers Has Been Requested and Provided. Since the revisions to the Organizational Document were made, the QCIC has requested and was provided access to selected wörkpapers as part of its investigative procedures on numerous cases. No instance of outright refusal by a firm to provide such access on request has been encountered.

Development of Closed Case Summaries. Since July 1986, when the SEC staff had access for the first time to closed case summaries and the opportunity to discuss the cases with the POB staff, they have done so nine times and have reviewed in the process approximately 180 summaries. As with other aspects of the QCIC process, the detail of the committee's considerations and conclusions on individual cases as contained in the closed case summaries prepared by AICPA staff members has evolved.

Early attempts at such summaries were described as of little use by SEC staff members who were quick to observe that their only basis for evaluating the QCIC's action on individual cases was the "case summary." In their opinion, the summary provided too little informa-

tion to enable them to meaningfully pose challenging questions for the purpose of evaluating the SIC process.

Continuing efforts to expand the summaries were met with criticism by the firms involved and their house counsels. At times, those involved in preparing the summaries were near despair concerning the prospects of satisfying both the firms and the SEC staff. The Rossi Task Force recommended in April 1987 expanding the closed case summaries to describe the specific issues considered by the QCIC, including the attention given to relevant SEC pronouncements, and to indicate the types of audit documentation reviewed, interviews conducted, decisions (if any) not to permit access to requested information and the basis for the QCIC's conclusions. As a result, although the format of the summary remained the same, the degree of detail expanded over the next two years of SEC staff access. By September 1989, the SEC staff had noted a major improvement in the information provided them and indicated a willingness to enter into a dialogue with officials of the SECPS and the POB concerning possible endorsement.

That month, an SECPS task force proposal to make the closed case summary an even more informative document for SEC staff oversight was accepted by the SECPS Executive Committee. The "new summary" would more clearly explain the QCIC action on a case in a five-step format:

- Background information on the registrant
- Litigation
- Summary of allegations
- QCIC procedures and conclusions
- Decision to close case.

The allegations of a case were to be specifically related to quality control issues to avoid any implication that the committee was addressing the merits of the allegations per se. The result would be a slightly expanded risk in litigation to member firms if the summary

were discoverable by plaintiff's bar. Recognizing, however, that the summary would only be retained for thirty days from the date the SEC staff was notified of its availability, the risk was deemed not inordinate, and was worth taking to obtain the SEC's endorsement of the process. Such endorsement would add immeasurably to the credibility of the process.

In February 1990, the SEC staff reviewed thirty-one case summaries in the new format and discussed them with POB and Institute staffs. In March 1990, SEC Chief Accountant Coulson and his staff met with SECPS officials and POB representatives to provide the staff's reactions to the new summary. The SEC staff's reaction was most positive. Based on the information provided, the staff had concluded that the QCIC process provides added assurance, as a supplement to the peer review process, that major quality control deficiencies in the SECPS members firms' quality control systems, if any, are identified and delivered in a more timely fashion.

Sharing the SEC staff's convictions concerning the importance of "internal reviews" performed by firms which focus on possible "people problems" (see SEC *Views on Special Reviews* and *"Internal" Reviews* on page 45), the Executive Committee of the SEC Practice Section in September 1990 approved a procedure recommended by the QCIC and endorsed by the POB whereby a firm would be requested in certain cases to perform a timely inspection of audits of specific personnel whose work has been alleged in litigation to be substandard. This possibility would exist when QCIC analysis and in-depth inquiry leave open the possibility that engagement personnel may not have fully complied with their firm's system of quality control. The decision to request such an inspection would be one made by the entire QCIC after taking into account the information the committee has gathered through the application of its investigative procedures. The committee will explain in the closed case summary the consideration it gave to invoking this new procedure whenever a case is closed in the investigative (in-depth inquiry) phase.

In addition, the POB is considering an SEC staff request to provide more narrative information concerning its oversight of QCIC ac-

tivity on individual cases in its oversight workpapers which are accessible to the SEC staff. Before reaching a decision, the Board is carefully weighing the SEC's need for such documentation to evaluate the process and the possible adverse effect such documentation might have on the member firms' rights concerning their legal defenses.

Chapter 8

CONTRASTING VIEWS OF THE QUALITY CONTROL INQUIRY COMMITTEE

As Seen by the POB

A review of the documentary evidence showing the evolution of the QCIC during its ten years of activity plus an intimate acquaintance with its activity and procedures lead to the following conclusions.

1. The committee has come a long way; it serves a useful and vital role in the self-regulatory process.

2. It has not exceeded reasonable use of the powers extended to it.

3. Member firms have, some very reluctantly, increased the committee's powers from time to time until these far exceed anything contemplated at the time of its establishment.

4. Based on the extent and quality of its work, the QCIC has earned credibility as an essential and effective part of the self-regulatory program. Endorsement by the SEC is certainly desirable but in no way essential to its importance and effectiveness.

The success of the QCIC lies in its emphasis on the public interest in improving audit service through the elimination of quality control deficiencies and identification of professional standards which need reconsideration. It has wisely avoided the task for which it is not adequately qualified or well designed, the identification of fault and imposition of punishment, although it has not hesitated to recommend investigation of the work of specific individuals by the AICPA's Professional Ethics Division. A review of a summary of the results of QCIC activity in carefully considering the implications of 349 cases from inception, November 1, 1979, through June 30, 1990, amply demonstrates the vital role that the committee has come to play in the self-regulatory program.

Results of SIC/QCIC Activity

	Number of *Actions*
ACTIONS RELATED TO FIRMS	
A special review was made or the firm's regularly scheduled peer review was expanded	38
The firm took appropriate corrective measures that were responsive to the implications of the specific case	53
ACTIONS RELATED TO STANDARDS	
Appropriate AICPA technical bodies were asked to consider the need for changes in, or additional guidance on, professional standards	36
ACTIONS RELATED TO INDIVIDUALS	
The case was referred to the AICPA Professional Ethics Division with a recommendation for an investigation into the work of specific individuals	14
	141

Note: Frequently, more than one action is taken by the QCIC or the firm in a single case.

The Public Oversight Board has repeatedly complimented the Quality Control Inquiry Committee on the quality of its performance of an important and difficult task. But quality and credibility differ. Many important and difficult tasks are performed valiantly without public notice or recognition. So it is with the QCIC. Operating as it must in complete confidentiality, there is no opportunity for the public to learn of its work or to grant the QCIC the credibility it deserves.

As Seen by the Member Firms

Member firms tend to see the QCIC as a latent threat and a very real concern. The hazards of practice in a litigious environment unavoidably make firm management and in-house counsel reluctant to participate in any effort, however worthy, that might increase litigation risk. Because QCIC activities are confidential, few members of any firm have direct knowledge of the quality and nature of QCIC personnel or activities. Questions such as why certain information is needed, how it will be used, and what precautions are taken to keep it confidential, if asked, can seldom be answered in specific terms. Hence there is a natural reluctance on the part of the firms to volunteer information. On the contrary, the general feeling is that the less we have to do with the QCIC, the better. A constant fear exists that the committee may fail to see the danger to a defendant firm in the information that has come to its attention.

As Seen by the SEC Staff

An SEC staff member, concerned with regulation, is unlikely to have great enthusiasm for confidentiality and the destruction of records. Full and fair disclosure of all information obtained, no limitation on questions that might be asked or leads that might be pursued, and a deemphasis on the audit firm's interests compared with the public interest are expected. How is the SEC staff to know whether the QCIC personnel asked all the questions they should have asked, pursued every lead to a satisfactory conclusion, and overlooked no possibilities of deficient auditing?

A Reconciliation of Views

Given these different points of view, one need not be surprised that the SEC has had difficulty in "endorsing" the QCIC process. Through the efforts of the SEC Practice Section and the POB, originally expressed concerns about this process were eliminated. The value of a QCIC whose vision was focused on remedial rather than punitive

measures became clearer to the SEC. The granting to the QCIC by the Executive Committee of the right to access selected audit documentation relating to audits under litigation eliminated still another concern of the Commission about the effectiveness of the committee's process. Finally, the lowering of the threshold for special reviews in combination with the recently adopted procedure for the conduct of "internal reviews" by member firms at the QCIC's request, when questions arise concerning the quality of work of the auditors responsible for the audits in question, has virtually eliminated another of the SEC's concerns. (See *SEC Reluctance to Endorse the Process* on page 50.)

Information contained in 180 closed case summaries, which have recently been expanded in information content, has persuaded the SEC staff that firms have taken quality control corrective actions in response to QCIC recommendations including transfer, termination and remedial training of personnel. The SEC staff is also aware that professional standards have been improved as a result of QCIC recommendations.

Because the QCIC deals with sensitive litigation matters that require strict confidentiality, it has been difficult to reach an accommodation with the SEC Chief Accountant's office in a way that respects both the concerns of member firms and the Chief Accountant's need for information. Thus it is truly significant that the Chief Accountant of the SEC has indicated that his staff has received sufficient information to conclude that the QCIC process provides added assurance, as a supplement to the SECPS peer review program, that major quality control deficiencies, if any, are identified and addressed in a more timely fashion, and thus the QCIC process benefits the public interest.

In our view, both the QCIC and the SEC staff are to be commended for the diligence with which each has pursued its goals. The two organizations have different purposes and these are pursued in different ways. Neither can substitute for the other. Both are necessary. Based on our own rather intimate experience with QCIC personnel and activities, we have no reluctance in citing it as a remarkable and

remarkably effective effort by the members of the SEC Practice Section to provide the public with the quality of service that the public deserves. Would that all professions might do as well.

APPENDIX

INDIVIDUALS WHO HAVE SERVED ON THE QUALITY CONTROL INQUIRY COMMITTEE

From Inception Through June 30, 1990

	Period of Service
Thomas E. Byrne, Jr.	1987-Present
David C. Cargill	1990-Present
Mark J. Feingold	1980-1986
Edwin P. Fisher	1979-1985
Mario J. Formichella	1986-Present
Robert E. Fleming	1985-Present
John J. Fox	1983-1988
James L. Goble	1987-Present
Gerald E. Gorans	1983-1987
William D. Hall, Chairman 1987-Present	1987-Present
John G. Henderson	1985-1987
Joseph Herbst	1985-1987
Thomas B. Hogan	1980-1983
George M. Horn	1985-Present
James I. Konkel	1989-Present
Harry L. Laing	1979-1983
Rholan E. Larson, Chairman 1979-1981	1979-1981
Leroy Layton	1979-1985
Charles W. Maurer	1988-Present
Robert A. Mellin, Chairman 1981-1987	1981-1987
J. David Moxley	1987-1988
Leon P. Otkiss	1979-1985
John B. O'Hara	1979-1983
Larry J. Parsons	1988-Present
Harry F. Reiss, Jr.	1979-1980
Lawrence J. Seidman	1979-1980
Fred S. Spindell	1990-Present
David Wentworth	1979-1985
Joseph A. Zulfer	1983-1988