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Self-Regulation: How It Works

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So that the academics in the audience may have some understanding of the impact of the peer review process when it was rather suddenly self-imposed on the accounting profession, I suggest you stretch your imaginations and consider the following analogy to the peer review process as if it were a reality.

An Analogy to the Peer Review Program

Every three years, your department must engage an accounting department from another school, or an AAA appointed team, to review your department's quality control system. In preparation for that review, you must first file a quality control document that includes:

1. Factual information about the size of your department, students, and faculty.
2. A statement of the goals of your department and how these reconcile with and are supported by the goals of the college and university.
3. Your department's policies and practices with respect to:
 - a. Recruiting faculty and students.
 - b. Faculty promotions, pay, and allocations of other resources.
 - c. Content of course outlines.
 - d. Selection of textbooks, including provisions for avoiding any conflicts of interest.
 - e. Grading practices and provisions for faculty evaluation.
 - f. Nature, extent, cost, and relevance of research activities of faculty members.
 - g. Allocation of committee activities and extent of academic community service.
 - h. Nature and extent of, and rewards for, professional service.
 - i. Nature and extent of faculty consulting, its relationship to department goals, and controls exercised to prevent excessive consulting.

The purpose of the independent review of your department by your peers is to determine whether these policies and practices provide reasonable

* These remarks represent my personal views and are not offered as necessarily representative of any official position of the Public Oversight Board.

assurance of quality performance by your department from the standpoint of the students and others who rely upon it. The review will also determine the extent to which members of your faculty actually comply with those policies and procedures and with any regulations imposed by your college, university, regents, or other authorities.

In performing the review, the review team will visit classes, review syllabi, meet with faculty members and students, examine any policy manuals or handbooks used within your department or university, read examinations and test the grading thereof, read faculty-authored publications, and take such other steps as it considers necessary to form an opinion on the adequacy and effectiveness of your quality control system.

The review team's conclusions will be expressed in a formal opinion supplemented by a letter of comment noting ways in which your system of quality control might be improved. This report and letter of comments will be placed in a public file open to your dean, students, their parents, alumni, and anyone else interested.

You will pay for the review at standard consulting rates and from your own departmental budget. You may or may not have an opportunity to make similar reviews of other departments. No reciprocal reviews are permitted.

This is at least a rough analogy to the peer review program adopted by the AICPA—with what some members thought was excessive haste. The leadership of the profession both believed in what they were imposing upon their own and other firms and also felt that they had no viable alternative. The practitioners who had little or nothing to do with the big decisions but whose lives and pocketbooks were directly affected by those decisions did not welcome the results with great enthusiasm.

The Nature of Professional Regulation

Discussing professional regulation with you involves two difficulties. First, it is still developing so that there is no way to bring you the final word, if there ever will be one. Second, our time is limited and the subject is complex. Hence, I can give you no more than a summary treatment of the subject.

You may find it helpful to think of professional regulation in terms of one goal, two approaches, and three levels.

Stated in simple terms, the goal is to protect the public against audit and accounting failures.

The two approaches are punishment and education. Some believe strongly that the greatest incentive to quality work is the sure knowledge that failure to comply with standards is prompt and appropriate punishment. Almost everyone believes that there are at least some cases in which punishment is appropriate and that punishing the wrongdoer does, indeed, have some deterrent effect on those who otherwise might be tempted to indulge in the same improper practice.

Others believe that education is the best possibility for improvement of professional performance. They hold that as many practitioners as possible should be educated to the existence of standards and how to meet them in the belief that most practitioners, indeed most people, desire to perform well. As you might surmise, a combination of these two approaches provides the best hope of adequate performance.

These two approaches are closely related to the three levels of regulation. Taking a broad view of professional regulation, one finds it applied by three authorities. Public regulation is applied by governmental bodies or agencies, is directed at punishing those who fall below minimum acceptable behavior, and has the full authority and power of the state for enforcement purposes. Most governmental regulation is concerned with conformity with legally established rules and regulations or with alleged breach of contract. In this country and many others, the government provides rules of discovery, subpoena, judicial review, appeal, and other measures intended to assure equitable treatment for both parties to any dispute. Punishment or damages that shift resources from one party to another may result.

Peer regulation is performed through professional organizations which do not have either the power or authority of government. Their primary activity is to establish professional standards—such as generally accepted auditing standards, generally accepted accounting principles, standards of quality control, and rules of ethics—and to encourage members to accept and comply with them. The most that voluntary organizations can do in the way of punishment or enforcement is to censure or expel nonconforming members. Those who do not wish to comply either do not join the organization or drop out in protest against requirements they believe to be improper. Thus, peer regulation is a voluntary matter.

Private regulation occurs within firms, to some extent within every firm, and, therefore, is the most pervasive form of regulation. The motivation is based on professional pride and enlightened self-interest. If a firm is to remain competitive, it cannot tolerate incompetent, careless, or untrustworthy employees. Furthermore, these are the kinds of employees most likely to make the mistakes that lead to litigation, a very undesirable event.

Management of a firm does not have the authority or power of government, but it is far more powerful than a professional organization. The power to terminate employment is a strong one just as is the power to reward excellent performance both financially and with promotions into new opportunities. These options make private regulation extremely important in the overall regulatory process.

Neither of the two approaches and no one of the three levels of regulation is sufficient by itself. If a profession is to be well regulated, public, professional, and private regulation must all be employed, most desirably with some degree of coordination and cooperation. Each of them has the potential for, and usually employs, both punishment and education to some extent, but public regulation tends to stress punishment whereas peer and private regulation emphasize education.

The AICPA's Self-Regulatory Program

Until 1977, the AICPA had been an organization offering personal memberships only. No provision of any kind was made for membership or activity by firms. Under pressure from Congress, in that year the AICPA made a rather remarkable change in its organization. It established a division for firms consisting of two sections, a Private Companies Practice Section and an SEC Practice Section. Any firm could join either or both of these sections.

Each section is governed by an executive committee appointed by the AICPA chairman with the approval of the AICPA Board of Directors. My discussion is concerned only with the SEC Practice Section.

Serving under the executive committee are a peer review committee and a special investigations committee which are responsible for much of the work of the section. A Public Oversight Board (POB) of five members has been established to represent the public interest and to monitor the work of the section. It has no line authority, serving only in an oversight and advisory role. It does have considerable influence.

The original POB was chaired by Mr. John McCloy, a man of very broad experience and great public service. Included in the membership were Arthur Woods and John Harper, retired chief executive officers of Sears and Alcoa, respectively, and Ray Garrett and William Carey, both former SEC chairmen. Both Mr. Garrett and Mr. Carey have since died, and Mr. McCloy resigned very recently. Al Sommers, formerly a member of the SEC, has been added to the Board's membership, and I was added earlier as the first and so far the only accountant on the Board. It has been a very interesting assignment.

The Peer Review Process

Under the supervision of the executive committee, the peer review committee and the special investigations committee direct most of the work of the section. Peer review is the heart of the self-regulatory program. It consists of a quality compliance review of each member firm every three years to be performed by peers; that is, by partners and managers from other firms.

A quality compliance review is based on a set of standards that cover all aspects of a firm's accounting and auditing services. Nine elements of quality control have been identified. These are:

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

The section's *Peer Review Manual* explains the nature and scope of each of these elements. The establishment of this set of quality control standards represents a considerable achievement. A significant part of their development had been accomplished by the Institute's Committee on Auditing Procedure before 1977 and was available for the section to develop further when the need arose. They now provide to member firms an indication of what is expected of them in the way of quality assurance and the standards against which they will be measured during a compliance review.

The compliance (peer) review team may come from another firm (engaged by the firm to be reviewed), or it may be a team selected by the peer review

committee for the purpose. The firm to be reviewed makes that choice. The review team is headed by a team captain who directs the work and writes the final report.

In preparation for a compliance review, a firm prepares a quality control document which describes its policies and procedures for all the nine elements of quality control described previously. This document is supplied to the review team which reviews it for adequacy and compliance with professional standards and, during the course of the review, considers the appropriateness of the described policies and procedures for the firm under review.

In performing the review, the review team reads the firm's policy and procedure manuals, studies its guides and check-lists, examines the technical library for adequacy, selects and examines work papers from audit engagements, and interviews selected people from the professional staff. *The Peer Review Manual* provides guides regarding the number of accounting and audit engagement hours that should be tested by the review team and the number of offices to be visited in a multi-office practice.

At the conclusion of the review, the team captain discusses with his team members the type of report to be issued. It may be unqualified; unqualified with a letter of comments about ways in which the quality control policies and procedures of the firm can be improved; modified and accompanied by a letter of comments; or adverse.

At the conclusion of every compliance review, including compliance reviews of each office covered in a multi-office engagement, the review team captain and possibly his team members meet with the management of the reviewed firm or office to discuss their findings and conclusions, including the nature of the report. When a modified report or even a report with significant recommendations in the letter of comments is planned, the discussion in such an exit conference can become heated indeed. Professional pride on the part of the reviewed firm is such that an adverse report, a modified report, or even strong comments are not well received. At the same time, the reviewers also take some pride in their ability to improve any system they find. Whatever report is finally issued, together with any letter of comments, goes into a public file at the AICPA offices available to anyone interested in seeing it.

The peer review committee will accept unqualified reports without a letter of comments for direct filing in the public file unless it has some reason to question the propriety of the report. Any report accompanied by a letter of comments will receive the committee's attention. Its question is whether the comments suggest the necessity of a modified or adverse report rather than an unqualified or modified report, respectively. In some cases, the peer review committee will detail one or more of its members to discuss with the team captain and any others involved any reservations which it may have. It may even send the review team back for more work, if it feels this is necessary, or schedule an additional or accelerated peer review to assure that recommended quality control improvements are actually implemented. Once the peer review committee is satisfied, a majority vote then accepts the report for public file purposes.

In addition to the review by the peer review committee, the staff of the Public Oversight Board also reviews the quality compliance review work papers, attends the exit conference, or reads the report and letter of

comments. Finally, on a sampling basis and with the identity of the audit engagement work papers masked, representatives of the SEC Office of the Chief Accountant also review the peer review work papers and report.

The Work of the Special Investigations Committee

As mentioned, the peer review process works on a triennial rotation basis and on a sampling basis for each firm. Thus, there is no way a compliance review can assure freedom from error. In addition, compliance review is concerned with the reviewed firm's system of quality control policies and procedures. When litigation against a member firm concerning the propriety of its accounting or auditing findings is initiated, there immediately exists an implication that the quality control system is not adequate. Of course, allegations in litigation proceedings are no more than allegations until actually tested by the legal process. Nevertheless, the possibility that they might be found valid raises questions about the system of quality control.

The special investigations committee was established to inquire into such possibilities. Each member firm must report all litigation involving audits of SEC clients within 30 days. The special investigations committee then can call for whatever information it considers necessary to discover whether the firm's quality control situation is adequate or not. It typically begins by reading the allegations and reviewing the financial statements to which they relate. It may also obtain the latest peer review report and letter of comments, consult with members of the review team and reviewed firm, and take whatever other steps are necessary to determine whether the allegations indicate a significant weakness in the firm's quality control.

Allegations charged in litigation may be:

- Frivolous.
- Made in error relative to the role and responsibility of the independent accountant.
- Valid but the result of personnel failure rather than failure of the quality control system.
- Valid and the result of a weakness in the quality control system:
 - Which the firm has already corrected.
 - Which still needs to be strengthened.

In almost half the cases that are reported, the committee finds the charges to be frivolous or based on error. These cases are promptly closed. When it finds what appear to be valid allegations with the likelihood that personnel failure is at fault, the committee leaves the matter to public regulation which is much better equipped to determine responsibility and fix punishment, if any is called for. If the allegations appear valid and imply a significant system weakness, the committee will call for a special review under its direct control.

Such a review may be directed at specific offices of the firm, at the work of specific individuals, or at the services performed by the firm in a given industry or industries as seems necessary. The approach followed is one of seeking to find weaknesses that may exist so they can be remedied and the public protected.

If the firm management has already looked into the possibilities and taken the necessary action, the committee desires assurance that this has really

happened and then will take no further action other than to add a report to that effect to the public file. If nothing has been done, it will insist that the member firm take appropriate action.

When notification of litigation is first received, a staff summary is prepared and supplied to all (nine) members of the committee. The chairman will appoint one or more members as a task force to direct the staff in obtaining whatever additional information is needed. Until the task force members are themselves satisfied that the case should be closed and can influence the rest of the committee to agree, the case will remain open. The committee's desire, of course, is to reach the most effective conclusion as soon as possible, an effective conclusion being one that provides adequate protection to the public without undue cost to the member firm.

The Executive Committee

The executive committee supervises the peer review committee and the special investigations committee, providing general guidance as necessary. It also has final authority for the imposition of sanctions. These are provided for in general terms within the rules and membership requirements of the section which are necessarily limited in scope and authority. The self-regulatory program in no way replaces or substitutes for either public or private regulation. Firms or individuals found guilty of breaking the law or of breach of contract will be punished by our public regulatory process. Those found guilty of negligence, irresponsibility, or other inadequacies are likely to be dealt with by their employers in a manner that seems appropriate to them in the circumstances. Sanctions most likely to be imposed by the executive committee would be for failure to comply with membership requirements, including refusal to cooperate with either the peer review or the special investigations committee. The executive committee also has the authority to determine whether sanctions should be publicized.

Sanctions mentioned in the *Peer Review Manual* include:

- Corrective measures by the firm, including consideration by the firm of appropriate actions with respect to individual firm personnel.
- Additional requirements for continuing professional education.
- Accelerated or special peer reviews.
- Monetary fines.

Role of the Public Oversight Board

In its guardianship of the public interest, the POB serves in an oversight capacity only. It has no line authority. Members of the staff and of the Board attend meetings of other components of the self-regulatory process, always have the privilege of entering into the discussion, sometimes meet with specific components or their leadership for discussion purposes, and do not hesitate to comment either critically or constructively as necessary. Responsiveness to Board comments has been gratifying.

Conclusion

This paper provides no more than a quick introduction to the AICPA's program, but there are three thoughts I hope you will take with you. First, over time self-regulation should have a significant effect on the quality of audit service provided by independent accounting firms. It is a remarkably effective educational device. Second, self-regulation replaces nothing; it is an addition, not a substitution. Public and private regulation are still in place and effective. All three aspects of regulation are necessary to get the job done well. Third, as devised and as functioning, the present program is a remarkable addition to the regulatory mechanism previously in existence, so far as we can determine, unmatched in any other profession.