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In describing the work of the Special Investigations Committee, I must assume that you already have some understanding of the SEC Practice Section of the American Institute of Certified Public Accountants, its purpose, structure, and self-regulatory program. If that is a false assumption, there will be time for questions during the evening. I warn you, however, that you ask at your own peril. My interest in this remarkable effort is such that you may learn a great deal more than you ever wanted to know about the profession's self-regulatory program.

Initiation of the Special Investigations Committee

When the AICPA's Division for CPA Firms was first created by resolution of Council in 1977 with an SEC Practice Section and a Private Companies Practice Section, the organization of the former Section did not include the Special Investigations Committee. The self-regulatory program relied completely on peer review for the improvement of audit practice, supplemented, of course, by the Section's membership requirements. Peer review was an adaptation of the internal inspection programs utilized within many firms to assist them in maintaining a uniformly high quality of audit work throughout what, in some cases, was a dispersed and decentralized practice.

One of the first matters identified by the Section's Executive Committee for consultation with its Public Oversight Board related to the action to be taken by the Section with respect to an alleged or possible audit failure by a member firm. What investigative activity might or should the Section undertake and what possible disciplinary action should be imposed? To provide you with a basis for appreciating the sensitivity of this issue, let me take a few minutes to discuss litigation from the viewpoint of a CPA firm.

The Litigation Problem

With exceptions so rare as to be nearly nonexistent, no one sets out to do a bad audit. Professional opinions differ as to the amount of audit work required under varying sets of conditions, judgments with respect to the propriety of accounting methods, provisions, and estimates are not always the same, and the work is often performed, unavoidably, under pressures of time, client concern, and plain old uncertainty. Consequently, there is almost no audit that is

completely secure from criticism, no matter how diligent and professional the effort.

Combine these facts with a legal system that permits class action suits proposing damages of staggering amounts, and assessing joint and several liability so that the CPA firm may be charged not only with the share of any loss that its activities may have caused but with the entire loss, whoever was primarily at fault, and accountants' concerns increase. Now recognize that litigation under our present legal system is an extremely complex undertaking with many factors besides professional performance of audit work in compliance with established standards bearing on the outcome, and you can begin to comprehend in some small degree why CPA firms resist every and any action, however otherwise desirable, that they believe will weaken their ability to defend themselves in the face of litigation.

Historically, the AICPA has taken the position that it should keep clear of litigation involving members unless the suit was perceived as a threat to the profession as a whole. The rationale justifying its position is that the legal system is fully equipped to determine the validity of allegations of audit failure, and certainly far better provided with mechanisms and means to protect the rights of all parties to such a contest than could be any organization not possessing equal authority and means. Hence, possible charges of ethical misconduct against members for alleged audit failures are held in abeyance as long as the member is involved in litigation.

One more factor requires consideration. At the time the SEC Practice Section was faced with this problem, litigation against major CPA firms was increasing in number and in financial importance to the point where such actions were considered highly newsworthy. The financial press, which had for many years shown little interest in accounting, was then featuring stories alleging audit failure accompanied by substantial losses to investors and others, and some critics of the profession were crying for stern reprisals.

The POB Recommendation

In brief, these were the realities facing the new SEC Practice Section and the Public Oversight Board when the Section addressed its question to the Board. What should the Section do in the way of self-regulatory measures when charges alleging audit failure were filed either in civil litigation or by a regulatory agency? The POB's response was prompt and to the point. The following words are taken from the POB's annual report for 1979–80.

> After extended study, the Board concluded that protection of users of audited financial statements should be the dominant consideration in any action taken by the Section with respect to a possible audit failure. The Board recommended that a permanent committee be established to monitor, and to determine what action, if any, should be taken with respect to alleged or possible audit failures involving member firms. The principal purposes of the committee and its monitoring efforts would be to determine whether facts relating to any audit failure indicate that auditing standards are inadequate or that the quality controls of the member firm need strengthening. In developing these primary purposes, the Board concluded that disciplinary proceedings directed toward the punishment of a member firm were of less immediate

importance, particularly in view of the fact that the firm and individuals involved in an audit failure would be facing punitive and compensatory actions by governmental and regulatory bodies and by private litigants. Nonetheless, the Board recommended that the Section have the authority to institute formal disciplinary proceedings in those circumstances where such action is deemed appropriate, notwithstanding the pendancy of litigation or governmental action.

The SIC—Composition and Operation

The Section accepted the recommendation of the Public Oversight Board and appointed a nine-member committee composed of active and retired partners, all with extensive audit experience. By the rules of the Section, member firms are required to report litigation charging deficient audit performance to the Section within 30 days of receiving notice of such litigation. Accompanying this notice is a copy of the official complaint. Staff members assigned to the Special Investigations Committee forward copies of the complaint to the members of the committee and proceed to prepare a summary of the case including the staff's recommendations for action by the Committee.

Though few in number, some cases are so without merit that no investigation is required. Rather the case is closed on staff recommendation plus a reading of the allegations and financial statements by committee members.

For most cases, the chairman of the SIC at the next meeting assigns the case to a one or two-person task force to work with the staff in formulating a recommendation to the committee. Working with the staff, task force members read the complaint, the relevant financial statements and any press notices and, in case of an investigation by a regulatory body, any available releases. They may also and frequently do meet with representatives of the firm to learn how the firm has responded to the charges, read the most recent peer review report on the firm's quality controls, and may meet with members of the peer review team to obtain additional information. The task force does not have the right under normal conditions to see the working papers or interview the staff members involved in the audit in question. In a few instances, firms have made personnel who participated in audits that are the subject of litigation available to a task force, but this is the exception rather than the rule. At the date of this presentation, SIC members have no authority to "investigate" the case in litigation. Their concern is with the subject firm's quality control system only.

The Confidentiality Requirement

Two points deserve attention here. When the SIC was first established, the profession's concern for litigation resulted in a requirement for complete confidentiality for SIC activities. Members of the committee are not to discuss matters under investigation with anyone other than committee members and members of the staff who serve the committee. No one attends committee meetings but its members' staff and representatives of the POB. Within a meeting, discussions are free and open. The POB staff keeps itself and the POB members fully informed on developments as SIC inquiries proceed. Once the SIC has completed its work on a "case," all working papers and notes are destroyed.

Recall that the purpose of the SIC investigation is not to try the case; that is left to the judicial system. Its purpose is to determine, first, whether the professional literature is lacking in instructional material to aid professionals in responding to similar circumstances; second, to discover whether weaknesses exist in the design of or compliance with the quality control system of the firm involved. Neither of these purposes, at this time, is considered to require access to the audit work papers of the case under litigation or to the personnel involved in that audit.

Confidentiality and SEC Oversight

The Securities and Exchange Commission is charged by the Congress with responsibility for oversight of the CPA profession. In meeting that responsibility, the SEC staff has access on a stratified random sample basis to selected peer review working papers and to the working papers of the POB staff resulting from its peer review oversight activities. The SEC does not have access to SIC working papers nor to the working papers of the POB staff in the performance of its oversight with respect to the activities of the SIC. The SEC staff takes the position that without some access to SIC activities, it is foreclosed from formulating any valid conclusion as to the effectiveness of that committee. The SEC staff has refused to accept unsupported statements from the POB that the SIC is functioning effectively and well. Time after time we have been told that if the SIC is ever to be accepted as an effective part of the self-regulatory program, some way must be found to provide the SEC with more access than it now has. That would constitute a breach of confidentiality that the member firms have not as yet been willing to accept. Negotiations are still in process. It seems inevitable that a solution to this impasse be found if the self-regulatory program is to be fully accepted.

SIC Courses of Action

In the original organization document for the Special Investigations Committee, provision was made for an initial investigation of the implications of the case that could be followed by (a) a continuing monitoring of the case for subsequent developments, (b) an investigation of the firm, or (c) an investigation of the case. Monitoring was utilized when it appeared that the investigations of a regulatory body of some kind might produce information relevant to the committee's final decision and not otherwise available to the SIC. When the information available to the committee was such that there appeared a strong likelihood that the firm's quality control system had not been effective, the committee could call for a special investigation of the firm's quality controls. This might run to a review of the firm's quality controls with respect to a given industry, a given office or offices, or the work of specific professional personnel. Just what an "investigation of a case" might entail was not clear.

Not long after it began operation, the committee found it necessary to undertake a limited number of investigations of firms (which soon came to be referred to as "special reviews"). A number of these have now occurred. Needless to say, no firm desired to be the first one investigated by the SIC and to this day, no firm seems to welcome a special review. They do occur, however, and I will describe their results in a moment.

No investigation of a case took place, however, and none has to date. As the committee acquired experience with these matters and as the philosophy of self-regulation developed, the members of the SIC became convinced that they could perform their function satisfactorily without ever undertaking an investigation of a case. That is, their purposes, as stated above, could be met with special reviews directed at the firm's activities in a given industry, or at the functioning of specific offices or personnel, without going directly to a case in litigation. That is where the matter stands at this time.

Effect of a Special Review

What results from a special review? First, consider the obvious fact that the self-interest of any firm is best served by bringing damage control to bear on a problem as rapidly as possible. Contrary to the apparent expectations of some critics, this does not consist solely of employing the best legal talent available, although that may be necessary. If there is a weakness in a firm's quality control, it must be repaired immediately or additional damage may occur. If that weakness is one of personnel rather than system, repairs are still necessary. This may involve transfers of personnel, other changes of assignment, remedial training, improved supervision, or, in some cases, termination of employment.

In most cases, by the time an SIC review of a firm has been mounted, the firm has already taken measures to shore up its system of quality control. Where this has not yet occurred, recommendations by the SIC are unequivocal and are followed up to assure that whatever the deficiency in quality control was, it no longer constitutes a threat to the public that relies on the firm's audit opinions.

Professional Acceptance of the SIC

How has the work of the Special Investigations Committee been accepted by the members of the SEC Practice Section? At the beginning, it met with very mixed enthusiasm. There was general recognition among the member firms that something of the sort was needed. The attention being given to allegedly unsatisfactory audits demanded that the profession have a mechanism for dealing with them, and there was more than a suspicion within the profession that strengthened audit procedures were both possible and needed. But when your own firm is the one threatened with the need for and the cost of a special review, then the "dedication" of the SIC bordered on "over-zealousness." With time, however, and the necessity of responding in writing to the findings and recommendations of a special review, there has come a reluctant but general recognition that the SIC is a necessary and useful part of the self-regulatory program.

SIC Procedures

What happens at a meeting of that committee? After some preliminaries by the chairman and the senior staff member present, generally designed to bring the committee members up to date on developments within the Institute and the Section that bear on the work of the Committee, the chairman leads into an

organized discussion of the cases on the committee's agenda. Each member assigned to serve as or on a task force reports on activities concerning that case since the last meeting. That activity may have been a discussion with firm representatives, with the leader of the team for the most recent peer review, or, in the case of a special review, a visit to an office to supervise the review of quality controls and audit work papers. The intent in reporting is to convey to the rest of the committee the understanding acquired by the committee member so that when he offers a motion either to close the case, to monitor it, or to initiate a special review, the rest of the committee will be in agreement.

Some cases are closed rather quickly because the allegations are so general as to have no real meaning and the review of the financial statements in question shows no deficiencies related in any way to the allegations. Others remain open for some time while a variety of inquiries take place and the committee member assigned satisfies himself that he has learned everything necessary to make a reasonable and supportable recommendation to the committee.

Quality of SIC Activity

How satisfactory is the work of the committee as an essential part of the self-regulatory program? Overall, I regard it as an essential feature of that program. SIC work is generally of very high quality. The astuteness and dedication of the chairman, the quality of the staff, and the support of the section's membership are all important. Ultimately, however, the work is done and the recommendations are made by the members of the committee. Any committee of nine members selected from different firms and possessing different backgrounds of experience and authority will experience some unevenness in its work as those members undertake their assignments. The chairman and the staff can do much to overcome shortfalls in diligence and pursuit, but not all.

The committee has been blessed with high quality members and with some whose concern for the profession is genuine and apparently limitless. I continue to be impressed at what people who love and respect their profession and have high standards can accomplish in making others aware of the necessity and the opportunity to bring about change.

A Personal Evaluation

I attend almost all SIC meetings and occasionally participate in task force meetings with firm representatives. I think of SIC members as secret heroes. Questioning fellow practitioners from other firms about the quality of their work is seldom pleasant and can be very difficult. Refusing to accept ready answers, penetrating to the heart of possible failures, hanging on to a line of questioning until satisfactory answers are received are far from easy. And all this must be done with the utmost confidentiality. There is no discussing one's work with one's partners. SIC members received few plaudits; there is no fan club. But those who have served a term on that committee and have performed to the best of their ability have made an important contribution to the well being and to the environment of the profession, and they have strengthened the self-regulatory progam immeasurably.