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Plan for Implementation of AICPA Voluntary Program for Reviews of Quality Control Procedures of Mult-Office Firms

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Quality
review

PLAN FOR IMPLEMENTATION OF AICPA VOLUNTARY PROGRAM FOR REVIEWS
OF QUALITY CONTROL PROCEDURES OF MULTI-OFFICE FIRMS



SPECIAL COMMITTEE TO STUDY QUALITY
REVIEW FOR MULTI-OFFICE FIRMS

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

PREFACE

The Plan for Implementation of AICPA Voluntary Program for Reviews of Quality Control Procedures of Multi-Office Firms was presented to the Board of Directors on April 26, 1974 by Thomas L. Holton, Chairman of the special committee to study quality review for multi-office firms.

The Board of Directors accepted the Plan and directed that the Plan's recommendations be implemented.

Wallace E. Olson
President
American Institute of CPAs

PLAN FOR IMPLEMENTATION OF AICPA VOLUNTARY PROGRAM FOR REVIEWS
OF QUALITY CONTROL PROCEDURES OF MULTI-OFFICE FIRMS

By

Special Committee to Study Quality
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American Institute of Certified Public Accountants

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PLAN FOR IMPLEMENTATION OF AICPA VOLUNTARY PROGRAM FOR REVIEWS
OF QUALITY CONTROL PROCEDURES OF MULTI-OFFICE FIRMS

Formation and Role of the AICPA Committee

This program is designed to help improve the quality control procedures of multi-office accounting firms by reviews of those procedures by other members of the profession familiar with the operations of multi-office firms. The program is voluntary, is under the auspices of the Institute, and is limited to offices in the United States.

The Institute should appoint a committee for review of quality control procedures of multi-office firms (supervisory committee) to be responsible for supervision and coordination of the program. The functions of this committee are described below. The Institute should also provide staff to assist the supervisory committee.

The supervisory committee should request nominations of individuals from multi-office accounting firms to serve on a multi-office quality control review panel (panel). The reviews would be conducted by reviewers drawn from the panel.

The supervisory committee should revise the procedures for conduct of the program as necessary. This may be an especially important function at the beginning of the program because the procedures outlined herein are likely to be modified as experience is gained in conducting the reviews.

The supervisory committee should schedule the reviews, select each Review Team Captain, and approve each Review Team Executive Committee (executive committee). (The functions of the Review Team Captain and the executive committee are discussed herein beginning on page 3.) If differences of opinion develop between the Review Team and Reviewed Firm during a review, the supervisory committee or its chairman would be available, at the option of the Reviewed Firm, to consult with representatives of the Review Team and the Reviewed Firm in an effort to resolve differences, but would not arbitrate those differences.

Upon completion of its review, the Review Team should issue a confidential report to the Reviewed Firm. This report would not be given to the supervisory committee.

In order to help the supervisory committee judge the effectiveness of the program and to decide whether changes are needed, the executive committee should submit a report to the supervisory committee summarizing the following:

1. Scope of review, including extent of coverage at national and regional offices, number of practice offices visited, number of engagements reviewed, etc.
2. Any limitations imposed by the Reviewed Firm, such as:
 - a. Not permitting the review of a selected client (but without naming the client) for reasons other than investigation by a governmental authority or litigation.
 - b. Failure to agree to more time and fee than initially proposed if the executive committee concludes that more time should be spent.
3. Description of the Review Team's procedures.
4. Recommendations for improving the program.

Each Reviewed Firm should be encouraged to send the supervisory committee comments on the review and suggestions for improving the program.

Selection of Review Panel and Review Team

The supervisory committee should request multi-office firms to nominate individuals to serve on the panel. At the beginning of the program, only partners should be nominated. Nominations should be requested at the outset from the fifty largest accounting firms based on the number of CPAs in each firm who are members

of the Institute. The firms should be advised that the Institute is seeking experienced audit partners who are presently active in audit practice, and they should be asked to nominate a number of partners equal to 1% of the number of Institute members in their firm, with a minimum of one and a maximum of ten nominees from each firm. Each firm should be asked to submit a profile on each partner nominated, indicating the extent of his audit experience, his SEC experience, his participation in any internal interoffice review programs, his present responsibilities, and his particular industry or other special expertise.

This initial restriction to larger firms is intended to facilitate the administration of the program and to obtain panel members most likely to have the background and experience necessary to make meaningful reviews. It is expected that most multi-office firms requesting reviews under the program will be involved in auditing publicly held companies that file reports with the Securities and Exchange Commission. Since the specific engagements selected for review probably will include many such companies, it is important to have a panel consisting of individuals with considerable experience and expertise in audits of publicly held companies filing with the SEC.

The sequence of events under this program would not be in the same order as mentioned in this plan. The timetable shown in Appendix A illustrates what might be the sequence of events for a review that allows a period of time to implement changes in the Quality Control Document.

When a firm has requested a review, the supervisory committee should acknowledge the request. After the firm's place in the sequence of reviews has been determined, the supervisory committee should designate one member of the panel to act as Review Team Captain, subject to approval by the Reviewed Firm. The Review Team Captain, with the concurrence of the supervisory committee and subject

to approval by the Reviewed Firm, should then select two individuals from the Review Panel to serve with him as the executive committee.

The executive committee should meet with representatives of the Reviewed Firm to discuss the conduct of the review. Together they should estimate the number of reviewers needed, determine whether there is any area of industry specialization within the Reviewed Firm's practice that should be considered in selecting reviewers, and agree upon the approximate timing of the review.

The executive committee should consider the guidelines set forth in the section Conduct of Review by the Review Team in making its initial determination of the number of offices of the Reviewed Firm that the Review Team should visit and the length of time to be spent at each office.

After the executive committee has agreed on the Reviewed Firm's Quality Control Document as described in the next section of this plan and an estimated time for conducting the review has been determined, it will select a Review Team from the panel. The nature and size of the Reviewed Firm's audit practice should be considered so that reviewers with appropriate experience and expertise will be selected. Should the Reviewed Firm have a concentration of clients in specialized industries, individuals with expertise in auditing such industries should be included among the reviewers.

Normally only one partner from a firm should be assigned to a Review Team and in no event should more than two partners from a firm be assigned to the same Review Team.

The Review Team Captain should then submit to the Reviewed Firm for approval the names of the individuals selected to serve on the Review Team. Since the program is voluntary, the Reviewed Firm should be satisfied that the Review Team has sufficient expertise and experience to conduct the review and that there are no

apparent conflicts between any member of the Review Team and the Reviewed Firm. Any subsequent changes in the composition of the Review Team should also be approved by the Reviewed Firm.

The Review Team Captain should then contact those panel members selected and request them to serve on the Review Team. He should obtain commitments that those selected will be available to participate in the review within the scheduled time frame. It is contemplated that all reviews would be conducted during the months of April through October.

It would be preferable for each reviewer, other than individuals serving on the executive committee, to visit more than one practice office of the Reviewed Firm. In addition to their work at the national office, members of the executive committee should probably visit one practice office. Each member of the Review Team, other than members of the executive committee, normally should be asked to spend at least two weeks, but not more than four weeks on the review, exclusive of any time needed for becoming familiar with the Quality Control Document and attending pre-review and post-review meetings of the Review Team. Each member of the executive committee may need to spend as much as three to six weeks in addition to the time spent at a practice office.

The supervisory committee should set a standard per diem fee to be paid to members of the Review Team. The aggregate fee should be paid by the Reviewed Firm to the Institute for disbursement to members of the Review Team. The fee should not be so large that it might become a reviewer's motive for participating in the program, but it should reasonably compensate the reviewers' firms for the services of their partners. Since this program of peer review is considered to be beneficial not only to the accounting firms reviewed but also to the accounting profession as a whole, it is expected that reviewers should receive a fee considerably

less than their standard professional fees for services rendered to clients. It is, therefore, suggested that members of the Review Team, other than the executive committee, be paid a fee based on \$300.00 per day (assuming an eight-hour day) plus out-of-pocket expenses. Because of the longer time commitment and the additional responsibilities assumed by members of the executive committee, it is suggested that they be paid a fee based on \$400 per day plus out-of-pocket expenses. Members of the Review Team should not be paid for travel time.

See Appendix B for an illustrative computation of estimated costs of a review of a fifty-office firm where the national office and ten practice offices of varying size are visited by members of the Review Team.

Reviewed Firm's Quality Control Document

The Reviewed Firm should furnish the executive committee with a written description of its quality control procedures (Quality Control Document). After becoming familiar with the Reviewed Firm's type of practice, the executive committee should determine whether the procedures described in the Quality Control Document appear to be appropriate for providing reasonable assurance that the audit practice of the firm is being conducted in accordance with generally accepted auditing standards. In making this determination, the executive committee should be guided by the elements of quality control suggested in Appendix C. The executive committee should make suggestions for improvement of the Reviewed Firm's quality control procedures if, in its judgement, improvements appear to be desirable. After the Reviewed Firm and executive committee agree on any changes in the described quality control procedures, the Reviewed Firm should incorporate them in its Quality Control Document.

The executive committee should be paid a fee of \$400.00 per day plus out-of-pocket expenses for time spent reviewing the Quality Control Document and becoming familiar with the Reviewed Firm's practice.

After the Quality Control Document has been finalized, incorporating any agreed upon changes suggested by the executive committee, the Review Team Captain should submit a written proposal to the Reviewed Firm to conduct a review of that firm's audit practice in the United States. The proposal should describe the scope of the planned review, indicate when the review would be made, specify the period from which audit engagements will be selected for review (e.g., audits completed during the twelve months ending April 30, 1975), and indicate the estimated approximate fee and out-of-pocket expenses.

The Reviewed Firm should accept the proposal in writing. A form of engagement letter is attached as Appendix D. Each engagement letter should be reviewed by Institute legal counsel.

If unanticipated difficulties later result in mutual agreement that more review time should be spent, the fee should be adjusted by negotiation between the Review Team Captain and the Reviewed Firm. If the executive committee concludes that additional review time should be spent and the Reviewed Firm does not concur, this disagreement would constitute a limitation that should be mentioned in the report to the Reviewed Firm and the separate report to the supervisory committee.

Pre-Review Implementation of Procedures Stated
in Quality Control Document

The Reviewed Firm and the executive committee should consider whether a period of time should elapse between finalizing the Quality Control Document and commencement of the review. In some cases, a Reviewed Firm and the executive committee may agree that the review of quality control procedures can be conducted immediately because the Quality Control Document does not appear to need any major changes. In other cases, the Reviewed Firm may need a period of time to implement some of the agreed upon changes in quality control procedures incorporated in the Quality Control Document.

In the latter case, such period of time should be sufficient to enable the Reviewed Firm to communicate the new quality control procedures, as described in the Quality Control Document, to all audit personnel of the firm and to use such procedures in the conduct of its audit engagements. As a result, the start of the review may be delayed several months or possibly a year or more.

The Reviewed Firm would not be precluded from making changes in its quality control procedures subsequent to the time it agreed on the contents of the Quality Control Document with the executive committee. Presumably any changes would improve the Reviewed Firm's procedures. The executive committee, however, should be advised of any changes.

Conduct of Review by the Review Team

There are three general stages to the review:

1. Review of quality control procedures at the Reviewed Firm's national office and, if applicable, at some or all of the regional offices.
2. Review of quality control procedures at selected practice offices.
3. Review of selected audit engagements.

The Review Team Captain should arrange a meeting of the full Review Team to plan, coordinate, and discuss the general approach to the review.

National and Regional Offices. Each accounting firm implements its quality control procedures in a different manner. Therefore, the Review Team should take into consideration the extent to which the Reviewed Firm implements its quality control procedures at national, regional, and practice office levels.

The degree of centralization of the Reviewed Firm's quality control procedures will affect the relative amount of time the Review Team will spend at

national, regional, and practice offices. Documentation should be available at the national office as evidence that certain of the described quality control procedures are in operation. For example, the national office would probably have certain statistics, correspondence, and other data relevant to procedures regarding client acceptance and retention, hiring, training, promotion, independence, and inspection. In addition, the national or regional offices would probably have data useful in judging the effectiveness of the Reviewed Firm's practices at the national or regional office level with respect to supervision and review and consultation (e.g., operation of national or regional accounting and auditing technical departments).

Since it is likely that each accounting firm's quality control procedures will be different, no standard program can be developed for Review Teams to follow. It will be necessary, however, for the executive committee to develop a program to fit each firm's circumstances. The executive committee should develop review procedures and obtain information to the extent practicable that would be of assistance to the Review Team in determining whether the Reviewed Firm's quality control procedures are operating effectively.

To determine whether the Reviewed Firm's internal inspection program is operating effectively, members of the executive committee should read the firm's instructions to inspection teams of the firm and some of the reports on practice offices prepared by those teams. These reports within a firm typically include only adverse comments because their objective is to provide the basis for improvements and favorable comments are of little or no value for this purpose. To avoid the possibility of Review Team members gaining an adverse impression of a practice office before making a review, such reports should be reviewed by the executive committee only and no member of the executive committee should read a report on

an office he is scheduled to visit as a reviewer. In addition to being of value for the purpose of evaluating the firm's inspection program, reading some of these reports may be helpful to the executive committee in selecting aspects of the Reviewed Firm's Quality Control Document to be included on the reminder checklist to be used by reviewers at all offices visited.

Practice Offices. The executive committee should select certain practice offices to be visited to determine whether the procedures described in the Quality Control Document are operating effectively at those offices. The selected offices should be generally representative of the Reviewed Firm's overall practice and accordingly should include large, medium, and small offices.

In deciding upon the number of offices to be visited, the executive committee should consider the following guidelines:

<u>Number of Offices in Reviewed Firm</u>	<u>Approximate Number of Offices to be Selected for Review</u>
1-5	Largest office plus one
6-15	Largest office plus two
over 15	20% of offices (also representing at least 20% of audit personnel)

The executive committee should exercise judgment in selecting the number of practice offices to be visited. The information above is included merely as a guide and should be modified when circumstances warrant.

To assist members of the executive committee in their selection of specific offices to be visited, the Reviewed Firm should furnish them with some overall statistics for each practice office. Such statistics would probably include for each office data such as number of audit partners and managers, number of audit staff, number of audit clients, number of SEC clients, any concentration of practice in a particular industry, how long the operating office has been established, whether

the office includes a practice recently merged with the Reviewed Firm, and other pertinent data that the Reviewed Firm and the executive committee consider useful in selecting offices to be visited.

The length of time to be spent at each office generally should be based on the number of audit personnel in the office. The executive committee should consider the following guidelines:

<u>Number of Audit Personnel in Practice Office</u>	<u>Length of Reviewers' Visit</u>	<u>Man-Days</u>
1 - 25	3 - 5 days (2 Reviewers)	6 - 10
26 - 50	5 - 7 days (2 Reviewers)	10 - 14
51 - 100	7 - 10 days (2 Reviewers)	14 - 20
101 - 200	7 - 10 days (3 Reviewers)	21 - 30
201 - 500	7 - 10 days (4 Reviewers)	28 - 40
over 500	10 - 15 days (4 Reviewers)	40 - 60

The time scheduled to be spent at each office will depend on the executive committee's overall evaluation of the audit practice of the office.

At least two members of the Review Team should participate in the review of each practice office selected. Members of the Review Team visiting a practice office should be from different accounting firms and, preferably, not from the same state where the reviewed office is located. One individual, designated by the executive committee as the Lead Reviewer, would be in charge of the review of each practice office.

Because each firm implements its quality control procedures in a different manner, it is not possible to set forth a standard program for use in determining the extent of compliance at each practice office with the procedures described in the Quality Control Document. As is the case at the national or regional office levels, each practice office under review should furnish the reviewers appropriate documentation useful in judging whether the procedures set forth in the Quality Control Document have been implemented and are operating effectively. The Review

Team members should satisfy themselves by reviewing such documentation and through discussions with personnel in the practice office.

The executive committee should tailor a program to fit the circumstances. For example, with respect to client acceptance and retention, the Reviewed Firm's Quality Control Document may indicate that a prescribed form should be completed for each prospective client to document that an investigation and evaluation of that prospective client was made before it was accepted. In such a case, the Review Team as part of its program may have procedures to determine that the form has been completed appropriately for all new clients accepted during the past year or some other period of time.

Specific Audit Engagements. Members of the Review Team should also review selected audit engagements at practice offices. This review of audit engagements should encompass financial statements, accountants' reports, correspondence, and working papers and should include discussions with personnel of the Reviewed Firm. Clients should not be contacted.

The extent or depth of review of working papers on particular engagements should be left to the judgment of the reviewers, but the review should be directed primarily to selected key areas of each audit in order to make a judgment as to whether in those areas there were well planned and appropriately executed auditing procedures that were documented in accordance with the Reviewed Firm's policies and whether the findings are consistent with the opinion expressed on the financial statements. The review of each engagement also should be directed to determining the extent of compliance with selected aspects of the Reviewed Firm's quality control procedures designated by the executive committee in a reminder checklist tailored to fit the stated policies of the Reviewed Firm. Copies of the reminder checklist should be provided each member of the Review Team.

The Lead Reviewer for each practice office should select the audit engagements to be reviewed. The Reviewed Firm should furnish him with certain statistics and other data concerning the audit engagements of the practice office to be reviewed. Such information would probably include the names of audit clients, types of industries, some indication of client size (e.g., revenues, assets), number of audit hours, names of partner and manager associated with the engagement, and other information the Reviewed Firm and reviewers believe necessary to make an appropriate selection of engagements for review.

The average time expected to be required for review of one engagement is one day. Using this as a general guideline and taking into account that the Review Team will be performing some limited procedures other than review of engagements at each practice office, the following guidelines should be considered by the Lead Reviewer in selecting the number of engagements to be reviewed:

<u>Number of Audit Personnel at the Office</u>	<u>Number of Man-Days to be Spent Reviewing the Office</u>	<u>Approximate Number of Specific Engagements to be Reviewed</u>
1 - 25	6 - 10	4 - 8
26 - 50	10 - 14	8 - 12
51 - 100	14 - 20	12 - 18
101 - 200	21 - 30	15 - 25
201 - 500	28 - 40	20 - 30
over 500	40 - 60	30 - 40

The size of audit engagements selected will obviously affect the actual number of engagements reviewed. If several large engagements are selected at a practice office, the total number of engagements reviewed is likely to be less than the number suggested above.

The objective in selecting specific engagements should be to obtain a representative sample of the Reviewed Firm's audit practice, including some reasonable distribution among the partners and managers of the office, but it is not contemplated that the engagements selected would be representative in any statistical

sense. The actual number of engagements reviewed usually will be small in relation to the Reviewed Firm's total audit practice. Consideration should be given to selecting specialized industries and some reviews should be made of work performed by the reviewed office on engagements controlled by other offices of the firm.

Only the work performed by the selected office should be reviewed. Therefore, any work performed by other offices of the firm as a part of the selected audit would not be reviewed, except for the reasonableness of instructions from the reviewed office to other offices and appropriateness of the reviewed office's supervision of the work performed by other offices.

If the financial statements of an engagement selected for review are the subject of investigation by a governmental authority or litigation, the Reviewed Firm should furnish the reviewers evidence that there is such investigation or litigation and the reviewer should exclude the engagement from the review. No mention of this need be made in the report to the Reviewed Firm.

The Reviewed Firm may have other legitimate reasons for not permitting a selected engagement to be reviewed. For example, the Reviewed Firm may have been advised by the client that it objects to such a review of the working papers related to the audit of its financial statements. If the Reviewed Firm does not permit the Review Team to review a selected engagement (other than a client whose financial statements are the subject of investigation by a governmental authority or litigation), the Review Team should report this limitation in the report to the Reviewed Firm and the separate report to the supervisory committee. The report to the Reviewed Firm should disclose the office involved, the name of the client, the name of the audit partner, and the reason given for not permitting the engagement to be reviewed.

To facilitate the conduct of the review, the Lead Reviewer should give the practice office, shortly before beginning the review, a list of approximately

one-half of the audit engagements that the Review Team members expect to review. This will give the practice office an opportunity to have the working papers, correspondence, etc., for those engagements available upon arrival of the Review Team. The Lead Reviewer will subsequently select the remaining engagements to be reviewed, taking into consideration any additional information learned about the practice office that may not have been known before the visit.

For audit engagements selected for review, the following should be furnished to the reviewers:

1. All audit working papers for the engagement, including permanent files.
2. All correspondence related to the audit engagement.
3. All reports issued for the year under review, including those accompanying financial statements filed with the Securities and Exchange Commission or other regulatory agencies and other types of reports such as opinions on matters of accounting principle, management letters, and memoranda on internal control sent to the client.

As indicated previously, the Review Team will consist of experienced audit partners who should be able to identify the key areas of the audit examination after reviewing the related financial statements and some discussion with the audit engagement partner. Therefore, the reviewers should exercise judgment in determining the extent of their review of working papers and selection of key areas for review in order to decide whether there were well planned and appropriately executed auditing procedures in those selected key areas that were documented in accordance with the Reviewed Firm's policies and whether the findings are consistent with the opinion expressed on the financial statements. For example, if a company's financial

statements show that sales levels remained constant for the past two years, but receivables increased substantially with no comparable increase in the allowance for bad debts, the reviewer may decide to review the accounts receivable working papers to determine whether there were well planned and appropriately executed auditing procedures in the conduct of the audit of this area of the financial statements and whether the findings are consistent with the opinion expressed on the financial statements. Another example of a key area that may be selected would be the working papers dealing with recognition of profit for a construction company using the percentage of completion method of accounting. Depending on the particular circumstances related to the specific audit engagements selected for review, the selected key areas could be inventories, deferred research and development costs, income taxes, unrecorded liabilities, the method of revenue recognition, contingent liabilities, etc.

After completing the review of a selected audit engagement, the reviewer should draft any comments about the review that he intends to send to the Review Team Captain. These comments generally would consist of constructive criticisms or suggestions for improvements. He should discuss the findings and his draft comments with the partner in charge of the office, the engagement partner, and anyone else they deem appropriate. Any differences of opinion between the reviewer and the office reviewed should be discussed with the Review Team Captain and other appropriate partners of the Reviewed Firm. In the event that differences cannot be resolved, the Reviewed Firm may ask to have the matter referred to the supervisory committee or its chairman. While the committee or its chairman may not be in a position to form an opinion about the unresolved differences, their views and suggestions may be helpful. Any unresolved differences of opinion should be set forth in the Review Team's report to the Reviewed Firm.

The Review Team Captain should furnish each Lead Reviewer instructions on how relevant information pertaining to the review of a practice office should be accumulated in order to facilitate preparation of the overall report to the Reviewed Firm.

The Lead Reviewer should send the Review Team Captain a draft report that would include the reviewers' comments as to whether the procedures set forth in the Quality Control Document are operating effectively at the practice office under review and, with respect to engagements reviewed, the reviewers' comments as to whether the auditing procedures in the selected key areas were well planned, appropriately executed and documented in accordance with the Reviewed Firm's policies, and whether the findings are consistent with the opinion expressed on the financial statements. This report should also include a description of the overall scope of the review of the practice office and any suggestions for improving or modifying the program.

The Lead Reviewer should also identify matters regarding specific clients and firm personnel that he has discussed with the partner in charge of the practice office which he believes the Review Team Captain should discuss with the managing partner of the Reviewed Firm.

If a Review Team member discovers matters that cause him to believe the Reviewed Firm has expressed an improper opinion on financial statements, he should inform the partner in charge of the office under review and also the Review Team Captain, who should immediately notify the managing partner of the Reviewed Firm.

Report to the Reviewed Firm

After receipt of all comments from the Lead Reviewers, the executive committee should draft the report to the Reviewed Firm.

The report should state that the Quality Control Document was reviewed

and should express an opinion as to whether the quality control procedures set forth in the Quality Control Document are appropriately designed to provide the Reviewed Firm with reasonable assurance that its audit practice is being conducted in accordance with generally accepted auditing standards.

The report should also state that the Review Team performed certain procedures to determine whether the Reviewed Firm's quality control procedures appear to be implemented at the national office and the regional and practice offices visited. The scope of this review for each major area of the Reviewed Firm's quality controls should be described and the procedures followed by the Review Team, its findings, observations, and recommendations should be set forth.

The report should also indicate that the Review Team reviewed selected key areas of specific audit engagements to ascertain whether there were well planned and appropriately executed auditing procedures in those key areas, whether the audit work reviewed had been documented in accordance with firm policies, and whether the findings are consistent with the opinion expressed on the financial statements. The scope of this review, as well as the observations and conclusions of the Review Team, should be described.

The report should state specific problems and make recommendations for improvements.

The report should not identify names of clients or names of personnel of the Reviewed Firm except for pertinent information regarding engagements not permitted to be reviewed, as discussed in the previous section.

Copies of the draft report should be sent to all members of the Review Team for their comments and suggestions. A final meeting of the Review Team should then be held to discuss the results of the review and the draft report. The copies of the draft report, as well as all notes, working papers, etc., prepared by Review

Team members during the review should be brought to the final meeting and left with the Review Team Captain. The Review Team Captain should dispose of these and all other materials (correspondence, completed checklists, etc.) connected with the review after the Review Team's final report is acknowledged by the Reviewed Firm.

As mentioned in the preceding section, if a Review Team member discovered matters that caused him to believe the Reviewed Firm had expressed an improper opinion on financial statements, the Reviewed Firm would have been notified immediately. Such circumstances should also be described in the report to the Reviewed Firm, without mentioning the name of the client. In such circumstances, it is the responsibility of the Reviewed Firm to decide what action, if any, the Firm should take, giving consideration to the provisions of section 561 of Statement on Auditing Standards No. 1. Legal responsibilities of reviewers are discussed in Appendix F.

Prior to issuing the report, the Review Team Captain should discuss the final draft with the managing partner of the Reviewed Firm. There should be only one copy of the final report and it should be with the Reviewed Firm.

Neither the supervisory committee nor the Review Team is responsible for subsequent follow up regarding comments or recommendations made in the report; therefore, no copy of the report to the Reviewed Firm should be furnished to the supervisory committee, nor should a copy be kept by any member of the Review Team.

An illustrative report to the Reviewed Firm is attached as Appendix E.

As indicated in the section Formation and Role of the AICPA Committee, the Review Team should furnish the supervisory committee with a report on the scope of the review, description of procedures followed, and recommendations for improving the program. This report should not contain any specific comments about conclusions

reached regarding the Reviewed Firm's practice or the results of reviews of specific engagements.

ILLUSTRATIVE TIMETABLE FOR A REVIEW

The sequence of events under the voluntary program for reviews of quality control procedures of multi-office firms will not always be the same for all reviews made under the plan. The following timetable, however, illustrates what might be the sequence of events for a review that allows a period of time to implement changes in the quality control document.

Firm requests review	May 15, 1974
Supervisory committee acknowledges request	May 20, 1974
Supervisory committee selects Review Team Captain	June 14, 1974
Reviewed Firm approves Review Team Captain	July 1, 1974
Review Team Captain selects other members of executive committee	July 10, 1974
Reviewed Firm approves other members of executive committee	July 15, 1974
Executive committee reviews quality control document and Reviewed Firm's type of practice	August 5-16, 1974
Executive committee and Reviewed Firm agree on any changes to quality control document	September 2, 1974
Reviewed Firm implements the agreed upon changes in quality control procedures	September 2, 1974 to April 30, 1975
Executive committee plans review and submits proposal (engagement letter) to Reviewed Firm	September 9-11, 1974
Reviewed Firm accepts proposal	September 20, 1974
Executive committee selects Review Team and obtains Reviewed Firm's approval of Review Team	February 1975
Executive committee reviews procedures at national office and prepares instructions for Lead Reviewers and reminder checklist of selected aspects of Reviewed Firm's quality control procedures	April 1975
Review Team has pre-review meeting to plan review	April 30, 1975
Reviews made	May 1 to July 31, 1975
Executive committee drafts report	August 11, 1975
Review Team has post-review meeting	August 25, 1975
Review Team Captain discusses draft report with managing partner of Reviewed Firm	September 1, 1975
Report issued to Reviewed Firm	September 15, 1975
Report issued to supervisory committee	September 20, 1975
Reviewed Firm reports program suggestions to supervisory committee	October 15, 1975

ILLUSTRATIVE COMPUTATION OF ESTIMATED COST OF A REVIEW

The cost of a review under the voluntary program will depend on various factors, including the number and size of a firm's offices and the manner in which a firm implements its quality control procedures. The following computation, however, illustrates what might be the range of cost for reviewing a fifty-office firm where the national office and ten practice offices of varying size are visited by members of the review team.

<u>Number of Audit Personnel In Practice Office</u>	<u>Number of Offices Visited</u>	<u>Length of Visit (Days)</u>	<u>Number of Reviewers At Each Office</u>	<u>Range of Man-Days</u>
1 - 25	2	3 - 5	2	12 - 20
26 - 50	2	5 - 7	2	20 - 28
51 - 100	2	7 - 10	2	28 - 40
101 - 200	2	7 - 10	3	42 - 60
201 - 500	2	7 - 10	4	56 - 80
over 500	-	-	-	-
				<u>158 - 228</u>
Time of reviewers other than executive committee to familiarize themselves with quality control document (14 reviewers)				14 - 21
Pre-review and post-review meetings (1 day each)				<u>28 - 28</u>
Total man-days for review of practice offices				200 - 277
Executive committee time other than for practice office reviews				<u>45 - 90</u>
Total man-days				<u>245 - 367</u>
				<u>Range of Costs</u>
Range of fee at \$300 per day for review of practice offices and related activities (200-277 man-days)				\$ 60,000 - \$ 83,100
Fee rate differential for participation by executive committee members in practice office reviews (20-30 man-days at \$100)				2,000 - 3,000
Range of fee at \$400 per day for executive committee functions (45-90 man-days)				<u>18,000 - 36,000</u>
Range of total fee				80,000 - 122,100
Estimated out-of-pocket expenses at \$100 per man-day (245-367 man-days)				<u>24,500 - 36,700</u>
Range of total fees and expenses				<u>\$104,500 - \$158,800</u>

ELEMENTS OF QUALITY CONTROL

Rule 202 of the Code of Professional Ethics of the AICPA requires a member, when his name is associated with financial statements, to comply with the applicable generally accepted auditing standards.

Generally accepted auditing standards, which are set forth in Section 150 of Statement on Auditing Standards No. 1, direct themselves to defining the qualifications of the auditor, the performance of his field work, and his reporting. Authoritative quality control standards for accounting firms have not been promulgated by the AICPA, but the following nine elements of quality control are recommended for consideration by the Review Team:

- Client Acceptance and Retention
- Hiring
- Training
- Promotion
- Independence
- Conduct of an Engagement
- Supervision and Review
- Consultation
- Inspection

These elements are not standards, but are only suggested as areas to be considered by the executive committee in deciding whether the procedures in the Quality Control Document would provide reasonable assurance that the audit practice of the Reviewed Firm is being conducted in accordance with generally accepted auditing standards.

The procedures listed for each element are examples of those followed by some accounting firms. The specific procedures of a particular firm are based

on that firm's overall system of quality control and would not necessarily include all of the procedures listed in this appendix as examples. Also, such procedures are not all inclusive and are not meant to be proposed standards, but have been provided to assist the executive committee in evaluating a firm's quality control document. It is contemplated that evidence of compliance with the quality control procedures of a firm would be documented where appropriate.

The auditing standards executive committee of the AICPA is presently considering a proposed Statement on Auditing Standards entitled "Considerations of a CPA Firm in Maintaining the Quality of its Auditing Practice." Should a statement on this subject be issued, the elements of quality control identified herein may need to be changed to conform to the Statement on Auditing Standards. In the meantime, the following elements should be considered by the executive committee.

Client Acceptance and Retention

The financial statements on which an accounting firm reports are representations of the issuer's management. If the client's representations in the financial statements and related information and explanations are of doubtful validity, the CPA's risk of lending credibility to misleading financial statements may be increased.

Accordingly, a quality control system should include procedures for client acceptance and retention so as to minimize the likelihood that an accounting firm might accept or retain an undesirable client.

Some accounting firms have in effect procedures such as the following to obtain reasonable assurance that only appropriate clients are accepted and retained:

1. Potential new clients are investigated and their acceptability determined by partners to whom such authority is given.

2. Previous auditors are consulted prior to acceptance of new clients.
3. Prior year's financial statements are reviewed prior to acceptance of new clients.
4. Existing clients are reevaluated when there is a significant change in management or ownership or some other event suggests that a reevaluation would be appropriate.
5. The accounting firm evaluates its own qualifications and availability of qualified professional staff before accepting new engagements.

Hiring

The quality of an accounting firm's work depends ultimately on the integrity, competence, and motivation of the persons who perform and supervise the work.

Accordingly, a quality control system should include procedures for hiring professional employees so as to minimize the likelihood that an accounting firm might employ unqualified staff members.

Some accounting firms have in effect procedures such as the following to obtain reasonable assurance that qualified employees are hired:

1. Beginning accountants are recruited at the college level.
2. The firm suggests general guidelines for grade levels and class rankings for beginning accountants, taking into consideration the college or university attended by prospective employees.
3. The background of new employees is appropriately investigated to avoid hiring persons with less than acceptable qualifications.

4. Applicants for higher level positions are interviewed and approved by partners in addition to the personnel department.
5. The overall recruiting results are evaluated at the end of the recruiting season to determine whether the firm is maintaining its hiring standards.
6. Persons involved in recruiting are given adequate instructions so that they have a clear understanding of the firm's recruiting objectives.

Training

The nature and extent of training required by an accounting firm's staff depend on the types and extent of training they have had previously and on their responsibilities. Training may be provided in many ways, such as through instruction on the job, through meetings or programs conducted by the accounting firm, through meetings or programs conducted by the AICPA or a state society of CPAs, or through courses presented by colleges or universities. For more experienced people, training may concentrate on updating for developments in the technical phases of accounting and auditing.

Accordingly, a quality control system should include procedures for training professional personnel so as to minimize the likelihood of an inadequately trained staff.

Some accounting firms have in effect procedures such as the following to obtain reasonable assurance that their professional personnel are adequately trained:

1. All new employees must attend a professional orientation program.

2. All audit personnel are furnished and required to be familiar with technical accounting and auditing materials issued by the firm.
3. The firm has a formal continuing education program that coordinates training activities at national, regional, and practice office levels. Minimum annual attendance requirements are set for staff members and partners and are appropriately monitored.
4. The firm has programs for the development of specialists, such as industry specialists or computer audit specialists.
5. Periodically the firm reviews its continuing education programs to determine whether they are adequately meeting the firm's needs.
6. Appropriate emphasis is given to on-the-job training of professional personnel.

Promotion

An accounting firm's practices in advancing its professional personnel through organizational levels at which they bear increasingly heavy responsibilities have important implications for quality control. The practices in supervision and review may both influence and be influenced by the practices in promotion.

Accordingly, a quality control system should include procedures for promotion so as to minimize the likelihood that an accounting firm might advance employees to responsibilities beyond their capabilities.

Some accounting firms have in effect procedures such as the following to obtain reasonable assurance that the people selected for promotion will have the personal and professional qualifications for satisfactorily discharging the responsibilities they will be called upon to assume:

1. Guidelines exist for promotions to various organizational levels, including partner, and are designed to avoid promotions that might lead to assignment of responsibilities greater than the individuals' capabilities.
2. A formal program utilizing personnel evaluation forms exists for the evaluation of personnel.
3. Personnel are advised of their evaluations promptly upon completion of assignments and their overall progress, strengths, and weaknesses are discussed with them on a regular basis.
4. Passing the CPA examination is encouraged by financial assistance and allowing the necessary time to sit for examinations.

Independence

Compliance checks as to matters relating to independence, such as stock ownership, tend to receive at least adequate attention since they are obvious. Independence of mental attitude is equally important, but less discernible by observation.

Accordingly, a quality control system should include procedures for assuring independence so as to minimize the likelihood that an accounting firm might lack independence in its relationships with clients.

Some accounting firms have in effect procedures such as the following to obtain reasonable assurance that persons at all organizational levels are in compliance with applicable independence requirements as set forth by the profession, regulatory authorities, and the firm:

1. The firm has procedures to obtain assurance that partners

and employees are complying with its rules concerning avoidance of ownership of clients' securities and other prohibited financial relationships. Examples of these procedures would be furnishing to partners and employees lists of clients and other companies as to which independence must be maintained and obtaining their written assurances that there are no prohibited security holdings or financial relationships or, conversely, partners and employees providing lists of their security holdings and financial relationships which are checked by responsible persons at the national office.

2. The firm has a written policy prohibiting partners and employees from accepting personal benefits from clients, such as special discounts on purchases or gifts.
3. The firm has a written policy regarding collection of unpaid fees for prior engagements, before beginning a current audit.
4. Independence of mental attitude is emphasized in training programs and in supervision and review of work.

Conduct of an Engagement

The conduct of engagements is the single most important factor that determines the quality of a firm's practice.

Accordingly, a quality control system should include procedures for the proper conduct of audit engagements.

Some accounting firms have in effect procedures such as the following to obtain reasonable assurance that its audit engagements are conducted properly:

1. Internal control questionnaires are used as an aid in studying and evaluating internal control.

2. A written audit program, responsive to the needs of the engagement, is developed in the light of the strengths and weaknesses of internal control.
3. Sufficient competent evidential matter is required to be included in the working papers.
4. Consideration is given to the training and proficiency of staff members when making assignments to engagements and specialists, such as computer audit specialists or industry specialists, are assigned as needed.
5. There is evidence that staff members are adequately supervised and their work is properly reviewed.

Supervision and Review

The extent of supervision and review appropriate in a given instance depends on a number of factors, including the complexity of the subject matter, the qualifications of the persons performing the work, and the extent of consultation available and availed of.

Accordingly, a quality control system should include procedures for supervision and review so as to minimize the likelihood that an accounting firm might complete an engagement without proper supervision of staff or review of the work performed.

Some accounting firms have in effect procedures such as the following to obtain reasonable assurance that all work of professional staff members is properly supervised and reviewed:

1. Supervisory personnel participate in advance planning of engagements.
2. Firm policy gives guidance regarding the extent of review needed at various levels of responsibility.

3. The working papers bear evidence of appropriate levels of review.
4. A field review checklist is utilized to assist in determining that certain aspects of firm policy have been followed on each engagement.
5. Pre-issuance reviews by partners not otherwise associated with the audit engagement are required on certain types of engagements.
6. Firm policy stresses the importance of engagement reviews being made in clients' offices.
7. Clients are advised that the firm must review, before publication, all financial statements associated with the firm's report.
8. Memoranda and working papers explain the basis for resolution of difficult accounting and auditing problems.
9. The federal income tax provision and liability are reviewed by tax specialists.

Consultation

The nature of arrangements made for consultation depends on a number of factors, including the size of the accounting firm and the levels of knowledge, competence, and judgment possessed by the persons performing the work.

Accordingly, a quality control system should include procedures for consultation so as to maximize the likelihood that persons in the firm will seek assistance on technical accounting and auditing questions to the extent needed.

Some accounting firms have in effect procedures such as the following to obtain reasonable assurance that persons having appropriate levels of knowledge, competence, and judgment are consulted on technical accounting or auditing problems when assistance is needed:

1. Accounting and auditing technical departments are available at national and regional offices and are consulted as needed.
2. Partners expert in certain areas, such as economic stabilization controls, renegotiation, and taxes, are available for consultation and are consulted as needed.
3. When a specialized industry problem arises, experts in the industry are consulted.

Inspection

In an accounting firm with more than one office, there is a need for periodic inspections for the purpose of seeing that there is adherence to firm policies and professional standards and that there is an appropriate degree of uniformity among practice offices.

Accordingly, a quality control system should include procedures for periodic inspection of practice offices so as to determine that they are complying with firm policies and professional standards.

Some accounting firms have in effect procedures such as the following to obtain reasonable assurance that quality control procedures are being effectively applied in practice offices:

1. Reports are submitted to a national or regional office for post-issuance review.
2. A formal program exists which requires inspection teams to visit practice offices and review a representative sample of audit engagements.
3. The results of the inspections are reviewed with the partners of the practice offices and submitted in a written report to the national office.

4. Appropriate follow-up actions are taken to remedy any deficiencies noted in the inspection of practice offices.
5. Based on findings of the inspections, the quality control program is continuously evaluated for its effectiveness.

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FORM OF ENGAGEMENT LETTER FOR REVIEW OF
QUALITY CONTROL PROCEDURES OF MULTI-OFFICE FIRM

Your firm (the "Firm") has submitted to the AICPA Committee for Review of Quality Control Procedures of Multi-Office Firms (the "Committee") a request that a review be made of the Firm's quality control procedures in accordance with the AICPA Voluntary Program for Reviews of Quality Control Procedures of Multi-Office Firms (the "Program"). This is to advise that such a review will be undertaken by Review Team No. _____, of which I have been appointed Captain, subject to the terms and conditions set forth below.

The review will be of the scope described in the Plan for Implementation of the Program and will be conducted in accordance with the procedures set out therein. Its purpose will be to furnish to the Firm, for the Firm's own internal use exclusively, a professional evaluation of the Firm's quality control procedures and of the extent to which they are being implemented in the offices visited by the Review Team. Neither the review nor the report resulting therefrom is intended for use by any other party.

It is understood that the Firm will not rely upon the review or seek to hold or cause to assist to hold jointly or singly, the AICPA, the Committee, any member of the Review Team, or the firm of any such member liable for damages for any error or omission in the review or in respect of any deficiency in any professional work which the Firm has performed or may in the future perform; that the Firm will not disclose the identity of the members of the Review Team or the content of their report to any person outside the Firm other than regulatory authorities having jurisdiction over the Firm; that the Firm will not subpoena or cause or assist in causing to be subpoenaed or otherwise called upon to testify in respect of the review, the AICPA or its staff, the Committee, any member of the

Review Team, or the firm of any such member; and that the Firm will not make any representation to any person whatever that the AICPA, the Committee, any member of the Review Team, or the firm of any such member have in any way vouched for or undertaken any responsibility for the quality of any professional engagement performed or to be performed by the Firm. In addition to the foregoing, the Firm's disclosure of its participation in the program will be governed by the applicable rules of professional conduct.

The review will be conducted with due regard to any applicable provisions, including requirements of confidentiality, of the rules of professional ethics of the AICPA and State Societies and Boards of Accountancy, and no confidential information with regard to the Firm or any client of the Firm will be imparted by the Review Team members to anyone except other members of the Review Team, their clerical assistants, and the Firm unless they are advised by counsel that they are under a legal obligation to disclose such confidential information. It will be the Firm's responsibility to take such measures, if any, as may be necessary to discharge its obligations with regard to client confidences. The Review Team's report will be supplied only to the Firm and no written notes in respect of any information secured during the review will be retained by the Review Team. The Review Team may, however, submit to the Committee the separate report that is contemplated by the program.

The engagement may be terminated at any time by the Firm or the Review Team without giving reason therefor and without recourse, except that in the event of any such termination the Firm will pay the fees and expenses of the Review Team theretofore accrued.

As compensation for the services to be rendered, the Firm agrees to pay to members of the Review Team fees at the rate of \$400 per day for members of the

Executive Committee and \$300 per day for other members of the Review Team (assuming an eight-hour day) plus actual out-of-pocket expenses, to be billed by and promptly paid to the AICPA for distribution to the members of the Review Team. The Executive Committee expects visits to be made to the national office and ten practice offices and estimates that the total fees and out-of-pocket expenses for this engagement will range between \$_____ and \$_____. The Firm will be notified if it appears that the total is likely to exceed the higher amount.

If the Firm accepts the terms and conditions for the engagement contained in this letter, please so indicate by signing the enclosed copy in the place provided and returning it to the undersigned.

AICPA Multi-Office Quality Control
Review Team No. _____

By _____, Review Team Captain

We agree to the terms and conditions
above set forth.

Reviewed Firm

By _____
Name and Title

Date

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ILLUSTRATIVE REPORT TO REVIEWED FIRM

(Intended only to suggest the approach to a report. Not to be used as a standard report for any review.)

CONFIDENTIAL

Mr. John J. Jones
Managing Partner
ABC&Co.
Anywhere, U.S.A.

Dear Mr. Jones:

As a participant in the American Institute of Certified Public Accountants' voluntary program for reviews of quality control procedures of multi-office firms, I have served as Captain of the Review Team assigned to review the quality control procedures of ABC&Co. (the Firm). The Review Team Executive Committee (executive committee) consisted of J. T. Brown, T. J. Smith, and me.

In addition to the executive committee, the other individuals listed at the end of this report participated in the review of selected practice offices. All members of the Review Team submitted comments on their findings. The executive committee prepared a first draft of a report that was then reviewed by all members of the Review Team and their suggestions were obtained. This final report was approved by the executive committee.

Review of Quality Control Document

During the first week of August 1974, we made a preliminary review of the quality control procedures of the Firm described in the Quality Control Document dated June 30, 1974 for the purpose of considering whether the procedures described in the document appeared to be appropriate in the circumstances.

Our review included the related manuals and publications of the Firm

which communicate to partners and professional employees the policies of the Firm regarding its audit practice. Certain changes were then made to the Quality Control Document as of September 30, 1974.

Tests to Determine Whether Quality Control Procedures Were in Operation

Between May 1 and July 31, 1975, we made a review on a test basis to determine whether the procedures set forth in the Quality Control Document were operating effectively. We reviewed the procedures followed at the national office of your Firm and then conducted reviews at ten practice offices.

Our procedures and observations with respect to the elements of quality control described in the Quality Control Document are set forth below.

Client Acceptance and Retention

We have read in the Quality Control Document your Firm's procedures regarding client acceptance and retention and have seen that such policy is included in a manual furnished to all members of the management group of the firm. We also made inquiries of individuals responsible for administering this policy at your national office and discussed the policy with the partners in charge of the ten practice offices visited. In addition, in each of the ten practice offices visited we identified selected new clients and examined for each of these new clients the prescribed form that is required to be completed in connection with evaluating new clients.

The required form was generally completed for these new clients. In one instance, however, the client acceptance process was not followed because, according to the engagement partner, he had known the chief executive officer of the client very well for over twenty years. In three other cases, the required client acceptance form had not been completed, but our discussions with the engagement partners indicated that the evaluation process had been followed.

Based on our discussions with individuals in the national office and the ten practice offices visited, it is our opinion that the client acceptance and retention procedures described in the Quality Control Document were being followed at those offices. We believe, however, that the Firm could improve the documentation of such procedures.

Hiring

We reviewed the Firm's hiring policies described in the Quality Control Document and the Firm's personnel and recruiting manuals.

In order to determine whether the policies set forth in the Quality Control Document were being followed, we made inquiries at the national office of the partner in charge of personnel and the partner in charge of recruiting. We were furnished with various reports and other data summarizing the Firm's recruiting activities for the year ended December 31, 1974. The reports indicate that the Firm is complying on a nationwide basis with its stated recruiting policies. We did not verify the accuracy of these reports.

We had discussions with the individuals responsible for recruiting at each of the ten practice offices to determine whether they had been furnished with the personnel and recruiting manuals and whether they were knowledgeable about the Firm's hiring policies. We also reviewed (but did not verify the accuracy of) certain reports prepared at the ten practice offices summarizing the recruiting activities for the past year. Based on our review of these reports and our discussions with individuals responsible for recruiting in the reviewed offices, it is our opinion that the practice offices are aware of the Firm's recruiting policies and have adhered to the policies in most cases. We did observe, however, that at three practice offices certain individuals hired during the past year did not meet the academic standards set forth in the Firm's Quality Control Document. In

each case, the individual responsible for recruiting advised us that there were extenuating circumstances, that the individuals employed had other qualifications to offset their academic record and that they were in fact qualified individuals. These facts were not documented in the personnel files of those three individuals.

Training

We reviewed the description of training policies in the Firm's Quality Control Document, reviewed the training materials available at the national training center, and reviewed (but did not verify the accuracy of) various reports for the past year summarizing the number of training programs of each type held, number of persons attending, description of courses, and other aspects of the Firm's formal training programs. In addition, we read the "Continuing Professional Education" policies described in the Firm's Accounting and Auditing Manual which is incorporated by reference in the Quality Control Document.

We had discussions with the partner in charge of education at the national office to determine his familiarity with the procedures set forth in the Quality Control Document and to determine to what extent he believes such procedures are being followed. We also made inquiries of certain partners and staff who have served as instructors at the national training center to determine their familiarity with the Firm's educational program and the extent to which their experience as instructors conformed to the policies of the Firm as set forth in the Quality Control Document.

We also reviewed:

1. Selected national and regional training program materials.
2. Selected program evaluations submitted by instructors and attendees.

3. Changes in training programs during the past three years.

We also had discussions with the individuals in charge of training at the ten practice offices visited to determine in each case whether he was knowledgeable about the policies set forth in the Firm's Quality Control Document. We reviewed (but did not verify the accuracy of) reports for the past year summarizing the participation in formal training programs by the professional staff of each practice office visited and reviewed the material pertaining to local office training programs conducted by each of those offices.

Based on the above discussions and our review of training materials and statistics, it is our opinion that the training policies in the Firm's Quality Control Document are generally being followed at the national office and the ten practice offices reviewed. We did note, however, that at each of the offices visited certain professional employees had not attended required training courses because they were committed to work on audit engagements that conflicted with the timing of the particular programs. The individuals in charge of training at each of the offices visited stated that they would make a concerted effort to avoid this happening in the future and also see that those individuals take the required courses at a later date.

Promotion

We reviewed the policies pertaining to the promotion of professional personnel set forth in the Firm's Quality Control Document and discussed these policies with the partner in charge of personnel at the national office and the partners in charge of each of the ten practice offices visited to determine their understanding of the promotion policies described in the Firm's Quality Control Document and their satisfaction that these policies were being followed.

At the national office, we read various reports, mostly statistical,

summarizing promotions during the past year at all levels of the Firm. They tended to support the fact that the Firm does monitor its promotion policies.

At the ten practice offices visited, we determined, on a test basis, that the personnel files of professional employees and partners contain periodic evaluation reports as required by the Firm's promotion policies and that such reports supported the promotions made. We noted in seven cases that these evaluation reports did not indicate that the persons preparing them had discussed them with the evaluated personnel and in three cases the reports were not approved by appropriate supervisory personnel.

Based on our discussions and our reading of the indicated material, it is our opinion that the promotion policies of the Firm are generally being followed at the national office and at the ten practice offices visited.

Independence

We reviewed the independence policies set forth in the Quality Control Document and determined that they were included in technical manuals furnished to professional employees and partners.

We had discussions at the national office with the individual responsible for maintaining the Firm's list of companies in which investments should not be made and the list of partners' investments. We reviewed and tested the controls employed by the Firm to assure that the list of prohibited investments is complete and that appropriate responses have been received from partners with respect to their investments. We also reviewed correspondence instructing practice offices about how to monitor the independence of its professional staff.

We interviewed the Firm's Independence Committee to determine their knowledge of the Firm's stated independence policies and their evaluation of the implementation of such policies. We had similar discussion with the partners in charge of the ten practice offices visited.

Based on these discussions and our review of the material indicated, it is our opinion that the Firm's independence policies are being adhered to at the national office and at the ten practice offices visited. However, in order to facilitate the monitoring of the independence of its professional staff, the Firm should adopt a policy requiring all such employees to submit a list of their personal investments or, alternatively, professional employees in each office should be provided a list of companies in which they may not invest.

Supervision and Review

After reviewing the supervision and review policies in the Firm's Quality Control Document, we had discussions in the National Accounting and Auditing Technical Department with the individuals responsible for the Firm's audit practice. The discussions were aimed at determining their knowledge of the Firm's stated supervision and review policies and how those policies were being implemented. At the ten practice offices visited, we discussed the supervision and review policies with the partners in charge and certain audit engagement partners and managers to determine their familiarity with the stated policies.

In the ten practice offices visited, we found general compliance with all of the supervision and review policies set forth in the Quality Control Document. However, we found the following instances where the prescribed procedures had not been adhered to:

1. In three engagements, several significant questions on the audit review checklist had not been completed.
 - a. In one instance, question number b-6 was not answered to indicate the reviewer's conclusions as to whether receivables from affiliated companies had been investigated adequately and the answer could not readily be discerned from the working papers.

b. In two instances, involving two different offices, client representation letters were not obtained. In one case, a request for such a letter had been overlooked and we were informed that an appropriate letter would be obtained. In the other case, the working papers stated that the engagement partner had determined that requesting such a letter was deemed to be unnecessary because of the absence of similar letters from that particular client in previous years.

According to the Quality Control Document, client representation letters are to be obtained for all audit engagements. If exceptions are to be permitted, consideration should be given to modifying the Document so as to define the permissible circumstances.

2. In four engagements performed by one practice office, the working papers show no indication of the extent of audit planning. However, each of the audit partners involved stated that, although not specifically documented, effective planning had been an integral part of the development of the respective audit programs.
3. In one engagement, there was no second partner review. The partner in charge of the office explained that a last minute change in the deadline of the client had precluded the second partner review.

The required second partner review of this engagement should be undertaken promptly. Also, assurances should be obtained from the partner in charge of the office that further departures from the policy requiring second partner review will not be permitted.

4. We noted three exceptions to the policy requiring the engagement partner to prepare a memorandum summarizing his review of the critical areas of the audit.

Based on our discussions and the review described above, it is our opinion that professional personnel at the national office and the ten practice offices visited are generally aware of the Firm's policies regarding supervision and review. As indicated by the exceptions noted above, however, we believe the Firm could improve considerably the documentation of such supervision and review procedures and should take appropriate steps to attain adherence to its policies in all offices.

Consultation

After reviewing the procedures on consultation in the Quality Control Document, we had discussions with the individuals in the National Accounting and Auditing Technical Department responsible for consultation with practice offices, the individual in charge of the SEC group at the national office, and the regional technical coordinators. These discussions and a limited review of memoranda in the files were aimed at determining the extent to which these people were involved in consulting on difficult accounting and auditing technical problems.

We also questioned ten of the designated industry experts within the Firm to determine the extent to which they were consulted on audit engagements.

We made inquiries of the partners in charge and engagement partners at

the ten practice offices visited to determine the extent to which they consult with other partners on difficult accounting and auditing matters. We also reviewed correspondence files and memoranda in connection with the specific engagements reviewed.

Based on these discussions and our review of engagements, it is our opinion that the Firm's policies regarding consultation are generally known and adhered to at the national office level and at the ten practice offices visited. However, we noted seven cases in the specific engagements reviewed where the audit engagement partner stated he had consulted on an accounting problem, but no documentation of such consultation could be found.

We recommend that the Firm make an effort to improve its documentation of the consultation actually being done.

Inspection

We reviewed the policies regarding inspection in the Quality Control Document, made inquiries of the individuals at the national office responsible for the various inspection programs of the Firm, and reviewed methods of selection and assignment of inspection teams. We reviewed some inspection reports submitted to national office by the individuals who conducted such inspections and also reviewed various data summarizing the results of these inspections. We also reviewed correspondence and memoranda evidencing the fact that practice offices are required to utilize the findings of inspection teams to improve their performance. Four of the practice offices visited by the Review Team had been visited by the Firm's own inspection teams during the previous year. We discussed the operation and effectiveness of the inspection programs with the partners in charge of the practice offices visited.

Based on these discussions and our review of the information mentioned

above, it is our opinion that the Firm's inspection programs are operating as described in the Quality Control Document.

Conduct of an Engagement

We reviewed the procedures and controls described in the Quality Control Document for the conduct of audit examinations and then reviewed selected audit examinations in the ten practice offices visited. These engagements are summarized by industry as follows:

	<u>Number</u>
Commercial	
Bank	
Institution	
Insurance	
Other	_____
	=====

Of the engagements selected, _____ were companies subject to regulation by the Securities and Exchange Commission. Our reviews encompassed financial statements, accountants' reports, correspondence, and working papers and included discussions with personnel of the practice office assigned to each of the engagements.

The review of working papers on the engagements selected was directed primarily toward selected key areas of each audit to ascertain whether in those areas there were well planned and appropriately executed auditing procedures that were documented in accordance with Firm policies and whether the findings were consistent with the opinion expressed on the financial statements. In addition, the review of each engagement was directed to determining the extent of compliance with selected aspects of the Firm's overall procedures set forth in the Quality Control Document.

Our review of selected audit engagements disclosed that, with one major

exception, the quality control procedures described in the Quality Control Document were generally being followed on the engagements reviewed.

The major exception was a failure by an audit engagement partner to document his decision on a significant sensitive audit area for one client. His decision was highly judgmental and could easily be questioned by a third party. In fact, the reviewer of this particular audit engagement had serious reservations about the decision. When judged in the light of subsequent events described to us, the engagement partner's decision appears to have been appropriate. However, there was no documentation supporting the decision as of the audit date and the partner did not consult with the regional technical department as required by firm policy. Such documentation is clearly called for in the Firm's Quality Control Document.

Several of the other exceptions to the Firm's quality control procedures are noted below:

1. No reason was given for not utilizing a computer audit specialist on an audit engagement that appeared to have significant computer applications.
2. The audit review memorandum was not signed by the audit partner on two of the engagements reviewed.
3. There was no audit planning memorandum prepared for four of the engagements reviewed.

Conclusion

Based on the findings of the above described review, it is our opinion that the quality control procedures of ABC&Co. set forth in the Quality Control Document are appropriately designed to provide reasonable assurance that the audit practice of the Firm is being conducted in accordance with generally accepted auditing standards and that those procedures are generally being implemented at the

national office and the ten practice offices visited.

Yours very truly,

AICPA Multi-Office Quality Control
Review Team No. 17

S. R. Jackson, Review Team Captain

Executive Committee:

S. R. Jackson, Review Team Captain
J. T. Brown, Executive Committee
T. J. Smith, Executive Committee

Other Review Team members:

(List of other members)

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April 5, 1974

MEMORANDUM OF COUNSEL

AICPA VOLUNTARY PROGRAM FOR CONDUCTING REVIEWS
OF QUALITY CONTROL PROCEDURES OF MULTI-OFFICE FIRMS

This memorandum sets out our comments on certain legal considerations bearing on the above-referenced Program. The points to be discussed are these: (1) the legal responsibility of the Institute, the reviewers and the reviewers' firms; (2) confidentiality of the work product of the review teams; (3) confidentiality of client communications to the reviewed firm; and (4) the question whether the reviewers would have a "whistle blowing" obligation.

(1) Legal Responsibility of the Institute, the
Committee, the Reviewers and the Reviewers' Firms.

The possible point of concern under this head would be that the Institute or its proposed Committee for Review of Multi-Office Firms' Quality Control Procedures, or the reviewers, or the firms of the reviewers, might run some risk of civil liability to the

reviewed firm, to the reviewed firm's clients, or to users of the client's financial statements. These risks, which appear to us in any event to be remote, would be dealt with under the Program by several relatively simple measures.

As regards possible liability to the reviewed firm, the solution is a waiver of claims against the reviewers, the Committee, and the Institute, contained in the engagement letter, which will be executed by the reviewed firm before the review is undertaken. The possibility of liability to clients or third parties would rest upon representations made to such persons, with the consent (express or implied) of those against whom liability was to be asserted, to the effect that some responsibility had been assumed. The solution to this possible problem envisioned by the Program is, accordingly, an undertaking by the reviewed firm, again in the engagement letter, not to represent to any party that the reviewers, the Committee or the Institute had assumed any responsibility for the quality of the reviewed firm's professional work.

In addition to the foregoing measures, the reviewers would be included in the coverage of the Institute's general liability insurance policy. This coverage would make clear where the obligation and expense of defending a lawsuit, if one were to be brought, would lie.

There is a possibility that if suit were brought attempting to assert liability against the members of the review team who had

participated in a particular review, their firms would also be named as defendants. In light of this, we recommend that each firm which nominates candidates for the review panel have its own counsel review its insurance coverage to make sure that it would apply to such a lawsuit.*

(2) Confidentiality of the Work of the Review Team.

It would naturally be important both to the reviewed firm and, to a lesser degree, to the reviewers that the work of the reviewers be surrounded by a reasonable degree of confidentiality: absent some assurance of privacy, the free communication necessary for the performance of this or any other professional engagement would not be possible. Mutual contractual undertakings to this effect, on the part of both the reviewed firm and the reviewers, are accordingly included in the engagement letter. These undertakings should suffice as a practical matter to prevent the persons immediately involved from publicizing the results of the review.

The more important aspect of confidentiality with respect to a quality review program relates to the discoverability and potential use of the reviewer's work in civil litigation or enforcement proceedings in which the reviewed firm is a defendant. The possibility of such litigative discovery and use seems likely to constitute the major potential legal problem presented by any program of this sort.

*See Supplementary Memorandum of Counsel, dated April 30, 1974, attached.

There appears to be no way to bar completely litigative discovery and use of the reviewers' work: all that can be done is to put reasonable limits on the number of documentary targets that would be available for such discovery and use, and to limit the period for which they are available. The Program would offer such limitations on discoverability by providing that the reviewers' notes and workpapers would be disposed of once the team's report had been submitted, and that the report would be submitted only to the reviewed firm -- which could dispose of the report as it saw fit. There would of course remain the recollections of the reviewers, which would be largely unprotected from discovery -- but their value to interested litigants would be much less than the documentary work product. The protection offered by these provisions appears to us to be as much as can be expected; and, presumably, as much as or more than any firm now has with respect to its own internal quality reviews.

Another feature of the Program which bears on this subject is the provision that audits which are the subject of litigation or governmental investigation will not be reviewed. This seems to us a clearly desirable provision, from the point of view of prospective reviewed firms, since any information gathered by the reviewers, and particularly any judgments made by them, with respect to an audit which was the subject of litigation (or any subsequent audit for the same client) would be a very high priority target indeed for pretrial discovery.

One other point, also related to the question of litigation, is that the form of engagement letter contains an undertaking by the reviewed firm not to try to make use of the reviewers in litigation. This, of course, would provide some additional protection to the reviewers in avoiding involvement in litigation.

(3) Confidentiality of Client Communications.

Another matter requiring consideration is that of client confidences of the reviewed firm: specifically, whether allowing the reviewers access to the reviewed firm's workpapers could constitute a breach of the firm's obligation of confidence. There are two possible sources for such an obligation: statutes and ethical rules.

If there were problems on this score, they would in our judgment be most likely to arise from the statutory provisions, in some states, establishing an obligation of confidence, or a testimonial privilege, or both, with respect to accountant-client communications. There appear to be 16 states with such laws,^{*/} at least some of which could be read to prohibit the reviewed firm from giving the reviewers access to its workpapers in the absence of consent by the client to which the workpapers pertained. If any such statute were indeed read by the courts to impose such an obligation of confidence on the reviewed firm, only consent of the client would suffice to eliminate the obligation.

*/ A review of the CCH Accountancy Law Reporter indicates that the following states have such laws: Arizona, Colorado, Florida, Georgia, Illinois, Indiana, Iowa, Kentucky, Louisiana, Maryland, Michigan, Missouri, Montana, New Mexico, Pennsylvania and Tennessee.

It appears to us unlikely, however, that even in the states with such a statutory provision, the reviewed firm's furnishing access to its workpapers without the client's consent would be treated as in derogation of the reviewed firm's legal obligations; and since the reviewers would be bound not to disclose any confidential client information except to the reviewed firm, additionally unlikely that the review would give rise to any liability for the reviewed firm even if there were a technical breach. Certainly no such statute would be read to prohibit an accounting firm from allowing its partners and employees to have access to any of its workpapers, even if this were not for the purpose of performing the engagement to which the workpapers pertain: thus, for example, there could be no serious contention that allowing a partner from the national office, or from an out-of-state office of a firm, to examine workpapers in connection with an in-house quality review would constitute a breach of any statutory obligation of confidence. If this is so, then there would be no good reason, from the point of view of the public policy sought to be served by the statute, why the statute should be construed to reach a different result when the reviewed firm engages professionals not otherwise connected with the firm to perform such a review.

As regards ethical requirements with respect to client confidences, there would certainly be no problem under the prime source of such requirements, which is the Institute's Code of Professional Ethics. Rule 301 of that Code specifically contemplates an exception

to the obligation of confidence for "review of a member's professional practices as part of a voluntary quality review under Institute authorization". The ethical rules promulgated by the State Boards of Accountancy^{*/} present a somewhat more complicated picture. The Boards in 12 states have adopted the Institute's new Code,^{**/} including Rule 301, and in an additional three states^{***/} the code of ethics makes explicit provision, similar to that of Rule 301, for voluntary reviews. In 19 states the confidentiality requirement is in the bare bones form of the Institute's prior Code, providing simply that the accountant "shall not violate the confidential relationship between himself and his client."^{****/} It seems highly improbable that such language, borrowed from the Institute's old Code, would be held to prohibit conduct which the new Code explicitly permits. There are, however, 13 states where the confidentiality provisions are somewhat more explicit, and where in consequence they might, like the statutory provisions discussed above, be literally read as prohibiting the disclosure

^{*/} All but four of the State Boards appear to have promulgated Codes of Ethics: the exceptions are the District of Columbia, Louisiana, Maryland and New York.

^{**/} These states are Alaska, Arizona, Arkansas, Hawaii, Idaho, Indiana, Montana, New Hampshire, New Mexico, North Dakota, Vermont and Wyoming.

^{***/} These states are Kansas, Oregon and South Carolina.

^{****/} These states are Alabama, Colorado, Delaware, Florida, Illinois, Kentucky, Massachusetts, Michigan, Minnesota, Mississippi, Nevada, Oklahoma, Pennsylvania, Tennessee, Texas, Utah, Virginia, West Virginia and Wisconsin.

necessarily involved in the review program.^{*/} To the extent that this is so, however, the public policy considerations suggested above as bearing on the construction of statutory provisions (see page 6) should be even more compelling.

It should also be observed that as a practical matter, the probability of a client of the reviewed firm making a claim with respect to a supposed breach of the firm's obligation of confidence in connection with a voluntary program seems likely to be slight. The reason for this is that the reports of the review team would not go to anyone except the reviewed firm itself. Moreover, clients' names would not be mentioned in the report. There would, therefore, be no reason for the reviewed firm's client to anticipate harm befalling it by reason of the disclosure of confidential information.

Thus it would appear that neither as a technical legal matter nor from a practical point of view should the question of confidentiality of client communications prove to be an insuperable obstacle to the Program. However, each reviewed firm will necessarily have to secure advice on this subject from its own counsel. The engagement letter makes clear that it is the reviewed firm's responsibility to deal with legal problems, if any there are, relating to such obligations of confidence.

^{*/} The states are California, Connecticut, Georgia, Iowa, Maine, Missouri, Nebraska, New Jersey, North Carolina, Ohio, Rhode Island, South Dakota and Washington.

(4) Problems that May Arise in the Course of the Review: Whistle Blowing.

The final problem requiring consideration relates to "whistle blowing", in the situation where the reviewers have come across a matter which they believe the reviewed firm has an obligation to report to the public or to the SEC; have brought the problem to the attention of the reviewed firm; and have learned that the reviewed firm has not so reported it. The question will then arise whether the reviewers themselves have an obligation to make such a report. In our opinion, in the current state of the law, the answer to this question is that the reviewers would not have any such obligation.

The reviewers under the Program would not have any contractual obligation to report anything to the public or the SEC: on the contrary, their contractual obligation would be to keep what they learned in confidence. Nor would they have such an obligation as a matter of general law. The argument might be made that if they were aware of continuing criminal action by the reviewed firm or its client -- and a willful failure to correct financial statements currently in circulation which are known to be materially misleading would be a crime under the federal securities laws -- that the reviewers having knowledge of the continuing commission of the crime would be guilty of misprision of a felony if they did not report their knowledge of the crime. It is, however, clearly the law, as to the federal misprision statute, 18 U.S.C. § 4, that something

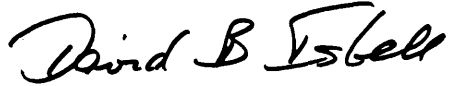
more than mere inaction in the face of knowledge of someone else's crime is necessary in order to constitute misprision: there must be "some affirmative act of concealment." United States v. Daddano, 432 F.2d 1119 (7th Cir. 1970), cert. denied, 402 U.S. 905 (1971).

It might also be argued that the reviewers would have liability as aiders and abettors of violations of the securities laws by the reviewed firm or its client; but so far, at least, aider and abetter liability has not been imposed by the courts for mere inaction by a person not having any original responsibility for or interest in the violation. Cf. Brennan v. Midwestern United Life Ins. Co., 450 F.2d 991 (7th Cir. 1971).

Finally, as is well known, the SEC has lately given indications that it is of the view that in certain circumstances accountants have, or should have, an obligation to report to the SEC certain kinds of matters for which they do not have direct responsibility.^{*/} However, the SEC has not, so far as we are aware, expressed the view that an accountant or other professional person in circumstances like those of the reviewers here under discussion has an obligation to make any report to the SEC; and certainly it has not promulgated any such view in a legally enforceable form. We therefore conclude that, as of this writing, there is no such obligation.

*/ See Complaint in SEC v. National Student Marketing Corp., Civ. No. 225-72 (U.S.D.C. D.C., filed Feb. 3, 1972); Address by Commissioner Sommer, Jan. 8, 1974, CCH Fed. Sec. L. Rep. ¶ 79,620 (suggesting concept of "auditor of record").

It must of course be recognized that this is the consumer age, and various kinds of public responsibilities are being expanded apace. Although in the preceding paragraphs we have in our judgment accurately described the present state of the law, in the nature of things we cannot state with confidence that this will remain the law. Accordingly, it is our recommendation that the reviewers keep in mind that in the event they run into the problem under discussion, they should touch base with counsel before before deciding whether or not to bring the problem to the attention of a third party.

A handwritten signature in black ink that reads "David B. Isbell". The signature is written in a cursive, slightly slanted style.

David B. Isbell

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SUPPLEMENTARY MEMORANDUM OF COUNSEL

AICPA VOLUNTARY PROGRAM FOR CONDUCTING REVIEWS
OF QUALITY CONTROL PROCEDURES OF MULTI-OFFICE FIRMS

Our memorandum of April 5, 1974 on the above subject mentions, in the paragraph starting at the bottom of page 2 and continuing over to page 3, the possibility that if the reviewers were named as defendants in a suit relating to their review, their firms might also be so named, and suggests that each firm nominating candidates for the review panel should have its own counsel review the firm's insurance coverage in this light. It will be helpful for counsel in such review to be aware that the Institute's errors and omissions insurance policy has been amended to extend coverage to --

"the firms of which such [reviewers] are partners or employees, but only in respect of claims arising out of conduct of such reviews."


David B. Isbell

DBI/fms