



A SPECIAL REPORT

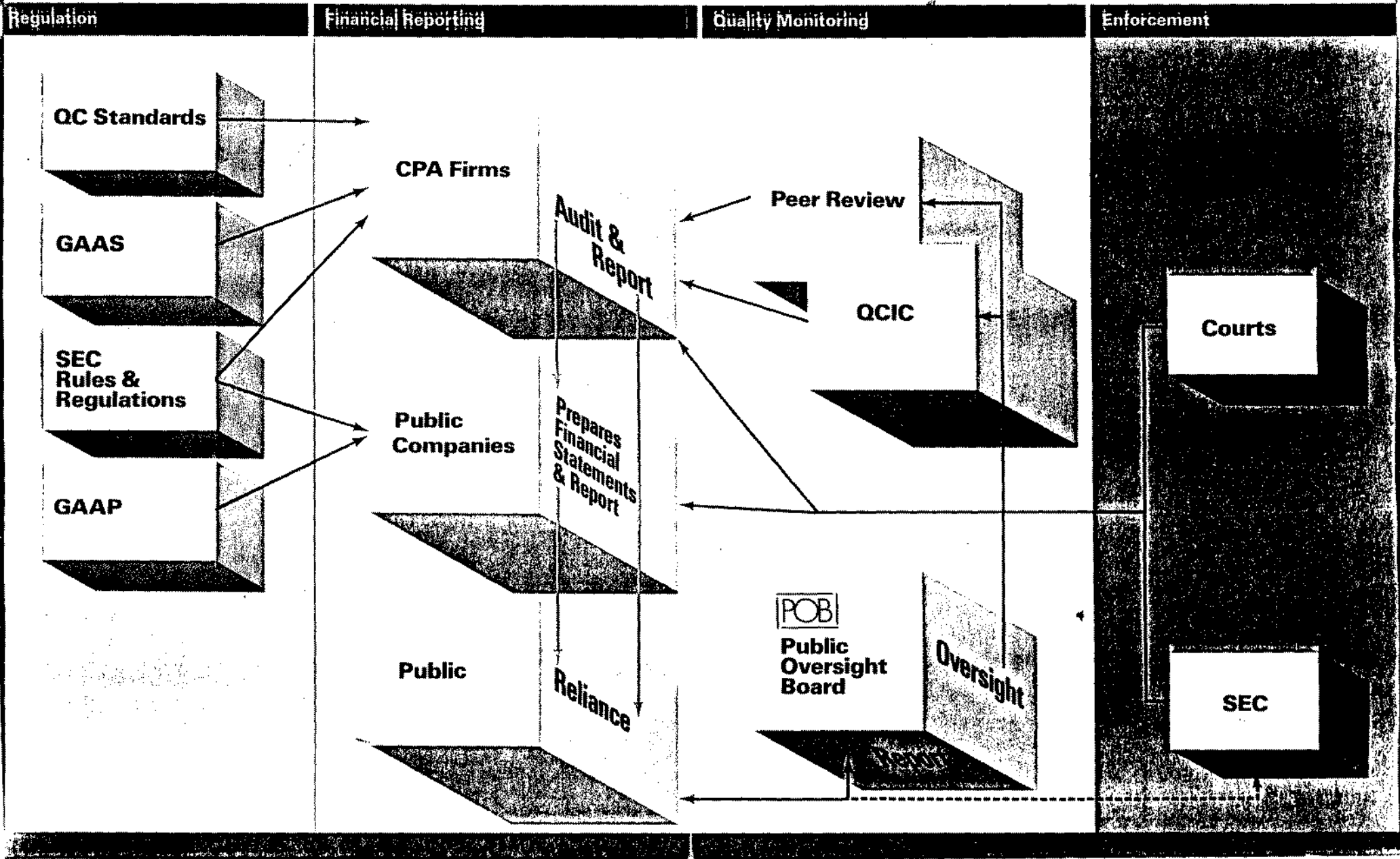
*What is QCIC?*

*What is Peer Review?*

*What is the POB?*

*What is Self-Regulation?*

# The Self-Regulatory Environment of SEC Practice Section Member Firms



**T**he Public Oversight Board is an independent, private sector body that monitors and reports on the self-regulatory programs and activities of the SEC Practice Section of the Division for CPA Firms of the American Institute of Certified Public Accountants.

The Board has published this pamphlet to clarify the roles and responsibilities of various participants in the self-regulatory process. It is recommended reading for all persons involved in or affected by the financial reporting process.

**T**he accounting profession has a unique responsibility and privilege. Regulators, investors, and the general public rely on CPAs to maintain the integrity and credibility of corporate financial statements. To ensure that independent auditors meet this objective, the American Institute of Certified Public Accountants has developed a multi-level system of self-regulation based on exacting quality control standards.

This self-regulatory effort, operated by the SEC Practice Section of the AICPA Division for CPA Firms, is now in its second decade. From its fledgling status at birth, it has grown into a mature system which has contributed significantly to the quality of auditing in the U.S. It functions smoothly through the partnership and cooperation of thousands of organizations and people across the country.

The Public Oversight Board's role is to monitor and report on this system of self-regulation and, on the basis of its oversight activities, recommend improvement when it observes an opportunity to strengthen the system. The Board recognizes that the self-regulatory system can and should be better understood both by people who perform audits and by those who rely on "auditors' reports." The Board believes that anyone who becomes acquainted with the system structure will share the pride we take in the success of this self-regulatory endeavor, which is unique in the world.

## *Achieving Quality Financial Reporting*

The United States has the most sophisticated and reliable financial reporting process of any country in the world. Audit quality is ensured by a framework of public and private sector initiatives that are continually evaluated and updated.

For example, a 1990 change in the bylaws of the American Institute of CPAs now effectively requires all CPA firms with public company audit clients to participate in the self-regulatory programs of the SEC Practice Section, including mandatory peer reviews every three years.

Yet self-regulation is much more than peer review and the other programs of the SEC Practice Section. The accounting profession is joined by other entities that support quality financial reporting. Together, the framework for achieving quality financial reporting includes:

- 1. Standard-Setting.** The private sector establishes standards for accounting, auditing, ethics, and quality control to govern the conduct of CPAs and CPA firms.
- 2. Firm regulation.** Each firm has policies and procedures to assure that partners and staff adhere to these standards.
- 3. Government regulation.** Auditor conduct is monitored and regulated by state boards of accountancy, the courts, and the SEC. Penalties for misconduct can be imposed by each.

**4. Self-regulation.** Since 1978, the profession has implemented a comprehensive program of self-regulation including peer review, audit failure inquiries, and oversight.

Each of these critical components carries checks and balances designed to detect and correct flaws in audit design and implementation. Responsibility for audit quality is not centered in any single sector, but in the proper functioning of the entire process.

### ***Four Key Elements to Quality Audits***

**Standard Setting.** Standards governing the conduct of auditors are set predominantly in the private sector.

- Accounting Standards are set by the Financial Accounting Standards Board, Governmental Accounting Standards Board, and occasionally the Securities and Exchange Commission.
- Auditing Standards are set by the AICPA's Auditing Standards Board, sometimes with a nudge from the SEC.
- Ethical Standards are set by the AICPA's Professional Ethics Executive Committee, and are then usually adopted by state CPA societies.
- Quality Control Standards for audit practices are established by the AICPA. For firms which audit public companies, adherence to these standards is monitored by the AICPA's SEC Practice Section, which is governed by an executive committee composed of audit practitioners from large and small firms. That committee also

sets policies and membership requirements to help assure quality audits.

***Firm Policies and Procedures.*** CPA firms establish, maintain, and enforce firm-wide quality control policies and procedures. These measures are designed to assure that each firm complies with professional standards, maintains its technical capabilities, applies the appropriate expertise on all audits, and meets SEC Practice Section requirements. Although generally invisible to the public, internal monitoring of audit quality is considered the most pervasive and probably the most productive of all types of regulation. Enlightened self-interest leads alert management to place quality control at the top of its priority list and to discipline professionals who depart from these standards.

***Government Regulation and Enforcement.*** A variety of governmental entities are directly or indirectly concerned with the quality work of CPAs in general and auditors in particular:

- State boards of accountancy license qualified individuals and firms to practice public accounting.
- The SEC's enforcement and review activities affect firms which audit the financial statements of publicly-held companies.
- State and federal courts and regulatory agencies identify and punish violators of laws, regulations, and professional standards. Penalties may take the form of damages to those claiming injury, censure, injunctions, disbarment from practice before the SEC, temporary or

permanent loss of license, and occasionally fines and imprisonment.

**Self-Regulation.** The profession assures adherence to quality control standards through self-regulation. This involves testing compliance with these standards to provide reasonable assurance that audits are conducted in conformity with generally accepted auditing standards. The nine standards of quality control address a firm's policies and procedures with respect to:

1. Independence.
2. Acceptance and continuance of clients.
3. Hiring procedures.
4. Assigning personnel to engagements.
5. Supervising audit personnel.
6. Consultation.
7. Professional development.
8. Advancement.
9. Inspection.

How an individual firm designs its own quality control system typically depends on its size, the degree of operating autonomy allowed its personnel and practice offices, and the nature of its practice and organization.

### ***How the Profession's Self-Regulatory Program Works***

There are three main elements in the profession's self-regulatory program for CPA firms which audit public companies. The program consists of (1) peer reviews every three years; (2) inquiries to determine whether alleged audit failures indicate breakdowns in a firm's



quality control system; and (3) oversight of the process by the Public Oversight Board.

The SEC Practice Section relies on the skills and talents of volunteer practitioners who serve terms on its Executive, Peer Review, and Quality Control Inquiry Committees. Much of the strength of the process comes from the rigor with which these committees perform their tasks.

### *About Peer Reviews*

SEC Practice Section member firms must have their quality control systems reviewed by independent peers once every three years. These reviews are system oriented, and evaluate whether:

1. A firm's quality control system for its accounting and auditing practice appropriately addresses the nine quality control elements.
2. Quality control policies and procedures are adequately documented and communicated to professional personnel.
3. Personnel are complying with policies and procedures.
4. The firm is complying with the Section's membership requirements.

In a peer review, an independent team of CPAs reviews the firm's stated quality control policies and procedures. Then, by looking at specific audit engagements, the review team tests whether the firm's personnel have consistently applied these policies and procedures. The review team's conclusions are documented in a written report—which may be unqualified, qualified or adverse—and usually a letter of comment.

addressing matters that require or recommend action by the reviewed firm. The reviewed firm then responds in writing, stating what corrective actions it intends to take.

The Section's Peer Review Committee establishes and maintains review standards. At regular meetings, it considers each peer review, evaluates the reviewer's competence and performance, and looks at every report, letter of comment, and accompanying response from the reviewed firm that states its corrective action plan before it is finalized. In its deliberations, it may also question the peer review team, review the team's workpapers, or require the team to revisit the reviewed firm to perform additional procedures. Based on the nature of the peer review results, the committee may require remedial measures beyond those contemplated in the reviewed firm's letter of response and require active monitoring of the firm's follow-up to assure that corrections are made. On some occasions, the committee requires an accelerated follow-up peer review.

Once the committee accepts them, peer review reports, letters of comment, and reviewed firms' responses are maintained in a file available to the public in the AICPA's New York offices.

### ***About Inquiries into Alleged Audit Failures***

Despite the measures the profession takes to assure quality audits, lawsuits are often filed against auditors alleging deficiencies in their work. While many of these suits are unfounded and even frivolous, some do have merit. Mistakes can be made, instructions misun-

derstood, procedures ignored—as has been said, “Even great Homer nods.”

When a lawsuit is filed, it is the Section’s responsibility to determine if allegations in a case suggest:

1. An aberrational error—which no system in the world can totally eliminate.
2. A shortcoming in the charged firm’s quality controls or its compliance with them.
3. A shortcoming in the standards relevant to the matters in the case.

To deal with these problems, the Section established the Quality Control Inquiry Committee (QCIC). Member firms must report to the QCIC all litigation or regulatory proceedings involving audits of public companies or regulated financial institutions within 30 days of receiving a complaint.

The QCIC’s proceedings, conducted in strict confidence, do not determine the merits of a case or the culpability of any party. Rather, their purpose is a review of the firm’s policies and procedures to assure that, when appropriate, the firm takes measures to upgrade its controls and compliance with them.

In conducting its proceedings, the QCIC may interview firm personnel, inspect firm policy and guidance material, and examine selected workpapers to determine the need for corrective action by the firm or by standard-setters. If the committee finds significant doubt about quality controls or compliance, it can require a “special review” designed to evaluate aspects of the firm’s quality control system. The special review may examine engagements conducted by the same personnel, in the same

industry, by the same offices, or with similar transactions or conditions as the audit in question. The QCIC can also request an accelerated peer review.

QCIC "cases" are not closed until the committee is satisfied that a firm has properly addressed any weaknesses discovered in its quality control system and that matters that require consideration by the accounting or auditing standard-setting bodies have been reported for their consideration.

### ***About the Public Oversight Board***

The self-regulatory process answers to legislators, regulators, and the general public. Oversight of the process—by the Public Oversight Board and the SEC—makes the Section's self-regulatory system both more effective and more credible.

The five-member Board, assisted by experienced accounting professionals and legal counsel, closely monitors the work of the SEC Practice Section. The Board is autonomous; its members represent a broad spectrum of business, professional, regulatory, and legislative experience. To ensure its independence and objectivity, the Board appoints its own members, chairman, and staff, and establishes its own compensation and operating procedures. The Board meets about eight times a year, and at least one Board member attends every Section committee meeting.

***Peer Review Oversight.*** The Board's carefully selected staff directly oversees each peer review by evaluating the review teams' qualifications and experience, and by

reading the peer review report, letter of comment, and the reviewed firm's response letter. As a result of Board recommendations, the Section may change the peer review team's composition, its scope, the report or letter of comment to be issued, and corrective measures the reviewed firm should take.

The Board's staff also directly observes the peer reviews of many firms, particularly firms with five or more SEC clients. For all reviews, the staff looks at review workpapers, reports, and letters of comment. They also attend Peer Review Committee meetings at which findings and reports are presented for acceptance.

***Oversight of Quality Control Inquiries.*** The Board oversees all QCIC inquiries into alleged audit failures. Its staff reviews both the plaintiff's allegations and the QCIC staff's analysis of them. Board members and/or its staff attend meetings between firms reporting litigation and QCIC task force members, and participate in discussions about committee recommendations. The Board observes all "special reviews," inspects their workpapers, discusses their results, and monitors the implementation of any corrective actions.

### ***The Role of the SEC***

The Securities and Exchange Commission plays an important role in linking self-regulation with government regulation. The SEC performs its own independent evaluation of the effectiveness of the peer review process, QCIC activity, and Board oversight. To do this, the SEC inspects a sample of peer review workpapers with the corresponding Board oversight workpapers. All workpapers are masked to protect client identities. The SEC

also reviews summaries of closed QCIC cases.

Based upon its inspection of the peer review process, the SEC has said that "the peer review process contributes significantly to improving the quality control systems of member firms and, therefore, should enhance the consistency and quality of practice before the Commission."

### *A Unique and Effective System*

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

The Board believes the activities of the accounting profession—combined with efforts of those charged to oversee these activities—provide a sound, comprehensive, and effective system of audit quality assurance. Its success shows clearly that carefully trained peers are best equipped to develop and administer quality control programs with the acumen and rigor necessary for broad-based compliance.

Moreover, the accounting profession's commitment to quality assurance, as demonstrated by the breadth and effectiveness of its self-regulatory programs, is unique—and the most well-developed of any profession. The Public Oversight Board will maintain keen vigilance over the process, now and in the future, consistent with its commitment to the public interest.

## ***SECPS Membership Requirements***

***AICPA Individual Member***—A certified public accountant engaged in the practice of public accounting with a firm auditing one or more SEC clients may retain membership in the AICPA only if the firm in which he or she practices is a member of the SEC Practice Section.

***Firm Member***—An accounting firm that is a member of the SEC Practice Section must meet membership requirements. Compliance with them is tested in the peer review process. A member firm must:

- Adhere to quality control standards established by the AICPA.
- Have a peer review every three years, the results of which are available to the public.
- Require all professionals in the firm—not just CPAs—to take part in 120 hours of continuing professional education every three years.
- Periodically rotate the partner in charge of each SEC audit engagement.
- Conduct a concurring, or second partner, preissuance review on each SEC audit engagement.
- Report annually to the audit committee or board of directors of each SEC audit client on the fees received from the client for management advisory services during the year under audit and on the types of services rendered.
- Report to the Quality Control Inquiry Committee any litigation against the firm or its personnel that alleges deficiencies in an audit of an SEC client and regulated financial institutions.
- Report directly to the SEC the termination of any client-auditor relationship with an SEC registrant within five business days.
- Report annually, for the Section's public files, the number of firm personnel, the number of SEC clients, data about MAS fees and other information.

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