



*Accountants
Self Regulation*

MEMORANDUM

June 3, 1978

TO: Commissioner Loomis
Commissioner Evans
Commissioner Pollack
~~Com~~missioner Karmel

FROM: Dan Goelzer *DL*

RE: Chairman Williams's letter of June 2
to John J. McCloy

Attached is a copy of a letter, drafted jointly by the Chairman's Office and the Office of the Chief Accountant, which Chairman Williams sent late on Friday to John McCloy, Chairman of the SEC Practice Section's Public Oversight Board. Because the Section's Executive Committee is meeting early Monday morning to consider the peer review program, it seemed essential that the letter go out on Friday -- indeed copies were hand-delivered to AICPA officials here in Washington early this morning so that the thoughts in the letter could be adequately considered before the Executive Committee meeting.

Attachments

- (1) Chairman Williams's letter of June 2
- (2) John McCloy's letters of April 4 and 19

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OFFICE OF
THE CHAIRMAN

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

June 2, 1978

John J. McCloy, Esquire
Milbank, Tweed, Hadley & McCloy
1 Chase Manhattan Plaza
New York, New York 10005

Dear Mr. McCloy:

I was glad to have the opportunity to meet with you and your colleagues on May 17 to discuss the work of the Public Oversight Board. As I have stated on several occasions, the Commission believes that the Board is the key to the success of the AICPA's evolving program of self-regulation. Accordingly, regular and frank communication between the Commission and the members of the Board is vital.

I indicated during our meeting that I would be responding in writing to certain points raised in your letter of April 19, 1978. The areas you have identified for the Board's early attention are essential to the credibility and functioning of the SEC Practice Section, and I urge the Board to act promptly in addressing them. In that connection, I think it important for the Board to recognize that it cannot be effective if it views itself simply as a sort of appellate body chartered to pass upon the reasonableness of the profession's own determinations of how to balance the accountants' interests against the public's. On the contrary, the Board must involve itself directly in the formulation and implementation of Section policy. With that thought in mind, I want to comment on specific points which you raised in your letter.

Structure and Administration of the SEC Practice Section

As you know, the Commission continues to believe that the most effective and viable structure for the SEC Practice Section would include granting "line" authority to the POB. The self-regulatory program, however, may yet fulfill the expectations of Congress and the Commission if the Board's members are independent in fact and committed to their responsibilities. The changes in the organization document which will give the Board increased control over its own composition, and which authorize the Board to prepare an annual report, evidence an encouraging degree of responsiveness on the part

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of the profession and a willingness to equip the Board with the power necessary for it to function effectively. Whether these changes, however, when coupled with the Board's willingness to monitor and review the activities of the section and to make recommendations, publicly when appropriate, will serve as an adequate substitute for more formal authority remains to be seen. ;

Peer Review Program

The bulk of my comments deal with the SEC Practice Section's evolving peer review program and the most recent, and troublesome, recommendations of the Peer Review Committee with respect to the administration of the program. The unresolved questions in the Peer Review Program, coupled with those recommendations, call into question the profession's effort to engage in meaningful self-regulation. From the beginning, we have urged that an effective peer review program required rigorous standards of quality control and a process characterized by independence both in appearance and fact. Unfortunately, over the past several weeks, we have seen an increasing rigidity in the Institute's approach to these important objectives. A peer review program conceived to provide effective Board and Commission oversight, to empower an independent panel to approve the scope of the undertaking, and to produce results available to public scrutiny now stands perilously close to being reduced to a self-serving effort conducted behind closed doors.

As I am sure you recognize, effective Board oversight will have to include an adequate opportunity for the Board to observe the peer review process itself in the field, as well as to review overall programs and specific findings. Similarly, we continue to believe that procedures will have to be implemented which will enable the Commission to fulfill its own oversight responsibilities. While the Commission can rely on the Board's supervision of the peer review process to a great degree, it will be necessary for our staff to have sufficient access to the process to permit us to make an objective evaluation of the adequacy of the reviews undertaken. Regrettably, the position which the Peer Review Committee recently adopted fails to provide for any Commission access to documents developed as part of the review process and would, if ultimately adopted by the Executive Committee, severely impair the Commission's

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ability to perform its important oversight responsibilities. I recognize, of course, that the question of Commission access to the peer review process raises complex and difficult issues; the Board must, however, seek a solution which reconciles the profession's specific concerns with the Commission's needs.

Your letter indicates that the Board will soon be considering whether the peer review process should incorporate firm-on-firm review. As you know, the Peer Review Committee has recommended firm-on-firm reviews, possibly leaving to the discretion of the firm under review the selection of the reviewing firm. As I understand the Committee's current proposal, the Performance Review Panel's involvement in the process would be limited to reporting on whether the reviewing firm met established standards in conducting the review, rather than the quality of the reviewed firm's practice.

The Institute has indicated to us that about 35 percent of the firms participating in the program will elect the firm-on-firm approach. Since nearly all of the large firms are likely to be in this group, this type of review will apparently encompass the great majority of engagements involving Commission registrants. Unfortunately, however, I do not believe that the firm-on-firm review approach, as presently structured, is the appropriate way to provide the appearance and assurance of independence that both the Commission and the profession are seeking. If peer reviews conducted by one firm of another are to be credible, it would be preferable to have the Performance Review Panel select the reviewing firm and issue its final report without expressing reliance on any report prepared by those engaged to staff the review. Stated differently, the Performance Review Panel report should ideally be based on its own independent evaluation of the materials developed in the peer review process.

Before the Commission can evaluate whether the more restricted approach recommended by the Peer Review Committee can meet the objectives of the peer review program it will be necessary for us to understand more clearly the obstacles

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which the profession sees to the Performance Review Panel's reporting on the quality of the reviewed firm's work; the specific procedures by which the Panel would evaluate the reviewing firm's performance of its engagement; and the nature of the report which the Panel would issue. While the issues involved are difficult, I am hopeful that, once the POB has had an opportunity to address these it will be possible to find common ground which will serve the profession's concerns and the Commission's oversight responsibilities.

Another important element of the peer review program which you indicate that the Board will be considering in the near future is the question of what peer review documents will be available to the public. The proposed peer reviews will apparently result in the issuance of several different reports. Two of these -- a brief opinion, comparable to an audit report, and a longer, more detailed list of recommendations -- will reflect the results of the examination of the reviewed firm's system of quality control. Only one of these reports -- the conclusory opinion -- is to be public; the report containing the reviewers' recommendations and suggestions for improvement in the reviewed firm's system is to be confidential, as is the firm's response to these recommendations. The Commission's initial reaction to this concept is that the process cannot attain the necessary degree of credibility if these critical documents are not available to the public. Accordingly, we urge the Public Oversight Board to weigh carefully the costs and benefits, and to consider the possible trade-offs, in analyzing the question of public availability of peer review documents.

The Commission is also concerned about certain possible limitations on the scope of peer reviews. The Peer Review Committee has recommended that the firm under review, or its clients, may exclude from the process the details of any specific audit engagement. We also understand that the scope of review may be further limited if an aspect of the underlying engagement is in litigation. While valid reasons may exist for certain limitations, we are not persuaded that the reviewed firm or its clients should be the parties making those decisions. Any decision to exclude certain

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engagements should rest with the reviewers, under Board oversight, and should depend on whether they are satisfied that the reviewed firm's personnel and the procedures utilized in those engagements can be examined in other ways. As we discussed at our May 17 meeting, the Board will be looking specifically at these troublesome issues.

Another important question bearing on the scope of peer reviews is the extent to which work performed outside of the United States should be encompassed. Where American investors are asked to rely on an audit report based upon work performed overseas, they are entitled to expect, and should receive, the same level of professionalism and judgment in both the foreign and the domestic phases of the audit. Accordingly, I urge the Board to recognize the need to satisfy itself as to the quality of engagements performed outside the United States. Again, however, I also recognize that there may be legal and other difficulties unique to peer reviews performed outside of this country. In the Commission's judgment, the Public Oversight Board is the body best suited, as an initial matter, to address these problems and to attempt to strike the proper balance.

In my view, credible peer review procedures are an essential element in the AICPA's self-regulatory effort, and I expect that much of the Board's energies over the next few months will have to be devoted to that subject. Both the Board and the Executive Committee must realize that a self-regulatory effort which fails to incorporate a meaningful system of peer review will compel the Commission to withdraw its support for the profession's program. I am deeply concerned that the status of the Peer Review Committee's recommendations as of May 25 make that possibility a very real one.

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Management Advisory Services

Your letter implies that the Board intends to defer to a later date the question of the proper scope of management advisory services. As you know, there is considerable public and Congressional interest and concern surrounding that question, and both the Commission and the profession

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have been attempting to articulate reasonable limits on non-audit services. The Board's views on this issue would be a valuable addition to the debate, and the Commission feels that the Board would be well-advised to readjust its priorities in order to reflect the urgency of its consideration of the question of the auditor's performance of management advisory services.

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As I stated at the outset, the Public Oversight Board is the most important link in the AICPA's program of self-regulation. And, in turn, the central ingredients necessary to the Board's effectiveness are, I believe, the resolve, commitment, and ability of the Board's members. Accordingly, while I expect, of course, that the Board will give serious consideration to the Commission's suggestions, in the last analysis, the success or failure of the program depends -- not on the uncritical acceptance of all of the Commission's suggestions -- but on the exercise of the sound discretion of the Board's members as to whether the specific objectives of the program are being met. In that spirit, I look forward to working with the Board, and urge that you not hesitate to call on me whenever the Commission can be of assistance or counsel.

Sincerely,


Harold W. Williams
Chairman