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John J. McCloy* Comments on Self-Regulatory Program of Accounting Profession

My six years of service as the first chairman of the Public Oversight Board of the accounting profession's program of self-regulation of accounting firms that audit companies subject to SEC registration have come to a close. This experience has given me a unique opportunity to observe and contribute to the unfolding of what I believe to be a real achievement by the accounting profession, whose audit opinions are relied upon so heavily by businesses, banks, creditors, stockholders and important institutions, including the government itself. That achievement is the establishment of a voluntary program of self-regulation consisting of

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- (1) intra-professional reviews of quality control policies and procedures of member firms (which came to be known as "peer reviews"),
- (2) reviews of litigation alleging audit failure filed against those firms, and
- (3) a requirement for compliance with a number of other conditions of membership.

This program is directed toward improvement of the accounting and auditing work by the public accounting profession. It was developed over several years of experience.

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No single event has attracted media comment. Nevertheless, it has been an important accomplishment, especially today when more emphasis is placed on the desire for reducing government regulation.

A decade ago, the accounting profession was the subject of severe criticism as a result of numerous business failures, improper payments and other reports of misdeeds by corporations. There were insistent demands for some form of government regulation of the accounting profession. It was charged (unfairly in a number of cases) that the accounting profession was not providing the quality audit services that might have prevented, or permitted earlier discovery of, developing failures or corporate malfeasances.

In any event, the American Institute of Certified Public Accountants (AICPA), rather than devoting its principal attention to rebutting such charges, took a direct and unprecedented step. It established, in 1977, a Division for CPA Firms to administer a voluntary program of self-regulation for the primary purpose of improving the quality of audits. I say "unprecedented" because I know of no other profession, including the medical profession and my own legal profession, that has imposed upon itself such a thorough-going, nationwide program of periodic review by peers intended to bring about higher quality performance.

The Division consists of two sections: the SEC Practice Section and the Private Companies Practice Section. The objectives and operations of the two sections are quite similar, except that the SEC Practice Section has an additional objective of improving the practice before the Securities and Exchange Commission.

The AICPA went even further and created an independent Public Oversight Board over the SEC Practice Section. This board consists of knowledgeable and respected persons from outside the public accounting profession, who provide objective review of the structure and operation of the self-regulatory effort. It makes an annual public report of its findings and comments.

This board, on which I served as chairman until recently, was established in 1978 and included two former SEC chairmen, now deceased: Ray Garrett, Jr., and William L. Cary. It also included Arthur M. Wood, former chief executive officer of Sears Roebuck & Co.; John D. Harper, former chief executive officer of ALCOA; Robert K. Mautz, distinguished accounting scholar and educator; and A. A. Sommer, Jr., a prominent lawyer and former member of the SEC. The board has its own staff and conducts extensive review and testing of the section's activities.

Although membership in the program is voluntary,

the participation by accounting firms has been very substantial. Membership in the SEC Practice Section includes firms that audit 85 percent of the country's publicly traded companies, including all but three of those whose stock is listed on the New York Stock Exchange. These companies account for 99 percent of the sales volume of all publicly traded companies.

Each member firm must agree, among other things, to conduct its accounting and auditing practice in accordance with prescribed standards, to make public certain information about the firm, and to subject the quality control policies and procedures for its accounting and auditing practice to peer review every three years.

The centerpiece of the program is peer review. More than 440 firms in the SEC Practice Section have undergone peer review, many for the second time. (More than 900 firms in the Private Companies Practice Section also have undergone peer review.) The purpose of the review is to identify weaknesses in a firm's quality control system and to assure the taking of corrective action.

The review is conducted by another independent accounting firm or a team of practicing public accountants. It involves, among other things, a review of the firm's policies and procedures for conducting audits and includes a review of actual audit workpapers. It is an expensive

and time-consuming process. At the conclusion, a report by the reviewers, a letter containing comments by the reviewers and the response by the reviewed firm are placed in a public file at AICPA headquarters in New York.

Members of the SEC Practice Section also must report all litigation that alleges audit failure where an SEC-registered company is involved. A special committee reviews these allegations and other available information to determine whether the AICPA needs to modify professional standards or whether the accounting firm involved should take some corrective action.

The peer review process identifies matters for correction or improvement in the performance of the reviewed firm. The litigation review process also may disclose areas needing attention. In both cases, the review process recommends procedures for strengthening a firm's quality control system or, in the case of serious deficiencies, requires that corrective action be taken. In some cases, a special review or an accelerated peer review is required.

There is a broad belief within the profession that these procedures have resulted in significant improvements in the quality of audit performance. The Public Oversight Board

is satisfied from its experience that this is the case.

The thrust of the program is to seek improvement of

audit performance within the profession rather than to punish firms for missteps. The SEC and the courts can and do mete out punishment in terms of regulatory sanctions, criminal penalties and monetary damages. But the SEC and the courts cannot perform the function of correcting and improving the audit process in the consistent, efficient and timely manner that the profession's program is designed to achieve. Thus, the profession's program, by complementing the roles of the SEC and the courts, plays a constructive part in the total regulatory scheme.

SEC Chairman John Shad, his predecessor Harold Williams and SEC Chief Accountant Clarence Sampson have given support to the program and have expressed general approval of its progress.

The fact that a program of this magnitude, which depends on voluntary membership, has achieved such broad participation and support in the profession is convincing evidence of the profession's commitment to improving the quality of its audit work. In initiating the program, leaders in the AICPA put aside narrow self-interest and took action which, in my opinion, has enhanced the quality and integrity of financial statements of public companies and their audits.

I have seen the process at work and have observed

that it receives the very serious attention of all who are involved. While no procedure can prevent the occurrence of an audit failure, I believe the likelihood of audit failures in the future has been significantly reduced by this forward step taken by the accounting profession.

I believe the interests of the accounting profession and the public have been well served by the institution of this program, and I am pleased to have been associated with this commendable effort.

John J. McCloy
