



**SECURITIES AND  
EXCHANGE COMMISSION**

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THE ACCOUNTING PROFESSION'S  
SELF-REGULATORY PROGRAM AND  
THE SEC'S OVERSIGHT ROLE

An Address by  
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## Introductory Remarks

It is a great pleasure for me to be here today among such distinguished panelists to participate in this Tenth National Conference on Current SEC Developments. I compliment the AICPA for sponsoring this excellent series of programs designed to promote the exchange of views between the Commission and the accounting profession. I am particularly pleased to have this opportunity to address an area of major importance to us all: the accounting profession's self-regulatory program -- particularly the AICPA's SEC Practice Section -- from the point of view of the Commission.

Historically, as most of you know, the accounting profession has been, for the most part, self-regulated. During the mid-1970's, however, unprecedented public and Congressional attention was focused on the accounting profession and on its role and responsibility in promoting public confidence in the integrity of financial reporting. This was due in large measure to significant unexpected failures by major corporations and disclosures of widespread questionable payments and illegal acts, which raised concerns about the integrity and credibility of the financial reporting and accounting controls of publicly owned corporations. In connection with this scrutiny, a broad examination of the nature and structure of the accounting profession was undertaken, in which public hearings were held by both the Senate and the House, and ultimately, legislation was introduced to create a self-regulatory organization for accountants

to be patterned after the NASD, the self-regulatory body for the over-the-counter portion of the securities industry. While that legislation was not enacted, this intense Congressional scrutiny clearly conveyed a sense of urgency and an expectation that the profession and the Commission must take significant action to improve public confidence in three areas: (1) the independence of accountants; (2) the profession's resolve and ability to develop and maintain a viable system of self-regulation and self-discipline; and (3) the processes by which accounting and auditing standards are promulgated.

In January 1978, with the developments I have just described as prologue, then Chairman Harold Williams addressed the AICPA's Fifth National Conference on Current SEC Developments, and talked about the challenges facing the profession. He concluded his address as follows:

". . . [T]he Commission strongly supports the goal of fostering a strong private accounting profession capable of providing the public with independent assurance and verification of the financial information disseminated by companies. We intend to work actively with the profession and the Congress in that effort. At the same time, however, each of you must bear in mind that there is a timetable running--or a clock ticking--characterize it as you will. What it amounts to is that the profession must, as it has begun to do, assume a much more aggressive role in shaping its own destiny. The profession must accomplish a number of very specific things in a relatively short period of time if, indeed, it is to maintain the initiative to determine its own future."

It has been five years since former Chairman Williams made those remarks. Based on developments which I have observed since that time, a number of which have been reported by the Commission in its periodic reports to Congress on the accounting profession

and the Commission's oversight role, I can confidently report to you that the profession has responded to many of the challenges that he outlined. Indeed, the profession has gone a long way toward proving that it can determine its own destiny.

Perhaps the single most significant development during this period has been the formation of the AICPA's Division for CPA Firms. The Division, which consists of two sections -- the SEC Practice Section and the Private Companies Practice Section -- is intended to serve as the primary vehicle for professional self-regulation. Its formation represents a major commitment on the part of the profession, and we at the Commission continue to support this self-regulatory initiative.

As you know, the major objective of the Division's SEC Practice Section ("Section") is to improve the quality of practice by accounting firms that audit the financial statements of companies that file registration statements and reports with the Commission. Based on discussions with the staff of the Office of the Chief Accountant, which is responsible for monitoring the Section, I believe that the Section is going a long way toward accomplishing this objective in that its peer review and other requirements have contributed to substantial improvements in the quality controls of its member firms. This is not to suggest, however, that the self-regulatory program has fully matured, or that all aspects of the program have been fully tested. It is to say, however, that we are pleased with the course on which it is proceeding.

I would now like to look at certain Section matters in more detail. These include the role of the Public Oversight Board, membership in the Section, the peer review process, and disciplinary procedures.

1. Public Oversight Board--The Public Oversight Board ("POB" or "Board") is an independent body responsible for monitoring and evaluating the activities of the Section. It was set up by the AICPA and is funded by dues paid by the Section's member firms. Its role was -- and still is -- the key to the success of the self-regulatory program. I am impressed with the distinguished members of the Board who have proven that the POB can be effective in an oversight capacity. The role of the POB in evaluating and reporting on the policies and practices of the Section have resulted in substantial benefits to the Commission and the public. In this connection, the Board's periodic reports to members of the Section, the Commission and other interested parties are the vehicle that enables those outside the accounting profession to understand what the Section has accomplished and what remains to be done. Another significant benefit relates to the excellent working relationship between the Commission and the POB. We rely heavily on the POB in fulfilling our own oversight responsibilities, and therefore are able to keep our own costs in this area to a minimum.

2. Membership--I would now like to turn to the question of membership in the Section. Although the fact that the Section's approximately 425 member firms audit over 9,600 SEC registrants is indeed impressive when one realizes that we are talking about a voluntary organization, the Commission continues to believe,

as does the POB, that all accounting firms that audit public companies should join the Section. It has been estimated that as many as 700 firms that audit at least one Commission registrant do not participate in the profession's voluntary self-regulatory program. Because I also recognize the importance of bringing these other firms into the program, I compliment the POB for its initiative in writing letters to many of these firms urging their participation. In addition, I also believe that the changes made to membership requirements during the past year will significantly reduce the costs of membership while maintaining an effective self-regulatory program, and should assist the Section in attracting new members.

The principal change in the membership area is the elimination of the requirement for a quality control review panel ("Panel"), which had previously been required for each peer review conducted by another firm or associations of firms (as opposed to reviews conducted by a team selected by the AICPA). The purpose of the Panel was to enhance the credibility of the peer review process, and although Panel members could rely heavily on the work of the peer reviewers, they were required to issue a separate report on the reviewed firm's system of quality control. Member firms were required to pay for the panel, in addition to the fees paid to the primary peer reviewers. The Panel's elimination was recommended by the POB based on its study of the cost effectiveness of the Panel, which made two significant findings. First, it indicated that, in general, Panel participation contributed little that was not already provided by the oversight exercised by the Section's

peer review committee, the AICPA staff and the POB staff. Second, it found that the cost of the Panel is significant, particularly for smaller firms. Based on its study of the peer reviews conducted during the past year, the Commission's staff agrees with the conclusions of the POB's study, and therefore did not object to the Section's determination to eliminate the requirement for a Panel. I would agree with the staff's conclusion, and would support other initiatives designed to facilitate membership in the SEC Practice Section, provided that they do not detract from the credibility of the self-regulatory program.

I also endorse the recent publication by the AICPA of a directory of members of the Division. I hope that this initiative will give well-deserved publicity to those firms that have made the commitment to provide investors and clients with a high degree of assurance that they consistently conduct their accounting and auditing practices in accordance with professional standards, and that it will be useful to those in need of accounting and auditing services.

3. Peer Review--The most important membership requirement for the SEC Practice Section is the agreement to submit to a peer review. While a peer review provides no assurance that any or all audit failures will be identified and corrected, and cannot guarantee that there will be no future audit failures, it should reduce the likelihood of deficient audit procedures. When audit failures occur -- and, unfortunately, there will always be some -- they should be due to isolated breakdowns or "people problems,"

and not due to inherent deficiencies in systems of quality control maintained by firms.

Last year, the Commission's staff reviewed for the first time a sample of certain of the working papers prepared by peer reviewers in support of the results of their review. This was done pursuant to the terms of an "access" arrangement that had been agreed to by the Section and the Commission. As a result of this access arrangement, the Commission's staff now has satisfied itself with respect to the adequacy and application of the Section's peer review standards and believes that the POB is exercising active oversight over the process. Specifically, the staff found substantial evidence that the program entails a rigorous review of a firm's accounting and auditing practices, and that the POB staff is very active and aggressive in ensuring that peer reviews are adequately performed and documented. In sum, the staff believes that the program has resulted in substantial improvements in quality control systems which in turn should benefit the individual accounting firms, their clients, and ultimately investors, creditors and the public in general.

In view of the staff's findings, I believe that the Commission is justified in placing increased reliance on the POB's oversight function in fulfilling its own oversight responsibilities. Nevertheless, I also believe that it is vitally important for the Commission to continue to monitor activities of the Section and the POB -- including the review of certain working papers of the peer reviewers pursuant to the access arrangement -- so that it will continue to be in a position to make an ongoing evaluation

of this important self-regulatory initiative. Such oversight is particularly significant because continuing developments in the peer review process, and changing professional, economic and regulatory conditions, may necessitate further refinements in the peer review program. In addition, both the profession and the Commission must always be ready to respond to any questions regarding the efficacy of the process.

4. Sanctioning Procedures--The true test of any voluntary self-regulatory organization is its willingness and ability to appropriately sanction those of its members that fail to meet its standards. There are two aspects to the Section's disciplinary procedures. First, the Section may impose sanctions as a result of serious quality control deficiencies uncovered during the peer reviews. While the Section has not imposed any "formal" sanctions to date, it has been successful in obtaining voluntary agreements -- such as for follow-up peer reviews -- to provide early assurance that appropriate corrective action is being taken. In its latest annual report, the POB indicated that it believes that this informal process gives the Section the ability to act promptly on matters that do not warrant formal sanctions and to achieve the same result as the imposition of a formal sanction. I agree fully with the objective of assuring that corrective measures are taken promptly. But I also believe that the formal sanction process should be used where appropriate, such as when satisfactory corrective measures are not undertaken promptly, or when a member firm chooses not to cooperate.

The second aspect of the Section's disciplinary procedures relates to the activities of its Special Investigations Committee ("SIC"). Member firms are required to report to the SIC certain litigation, proceedings or investigations relating to alleged deficiencies in the conduct of their audit of a company required to file with the Commission. The SIC then considers whether these allegations indicate the need for corrective measures by such firms, changes in professional standards, or appropriate disciplinary measures. In its latest annual report, the POB states that the SIC has made significant progress during the past year in considering the 34 cases of alleged or suspected audit failure which have been reported by member firms, and in developing internal guidelines to be applied in reviewing such cases. As the POB points out, however, the structure for imposing sanctions has not yet been tested. While the POB believes that the Section will appropriately discipline member firms, the Commission thus far has no basis for reaching any conclusion. I hope that the Section recognizes the compelling need for more visible evidence as to specific SIC activity, in order to demonstrate the effectiveness of this important aspect of the self-regulatory program.

I would emphasize here my belief that this particular aspect of self-regulation is critical to the public's perception of the profession. The concept underlying the SIC is that there should be a mechanism available to respond in a timely fashion to potential problem situations where questions are raised about the performance or professionalism of a member accounting firm --

in other words, to find out if there is a problem with the audit, and, if so, its nature and implications, and to ensure that corrective measures are taken so as to minimize the potential for future harm to the public. None of these initiatives necessarily involves the imposition of formal sanctions. The important point is that the public must have confidence that these actions are being taken. For example, we have all read articles in the press recently with regard to financial fraud, business failures, and financial reporting problems of companies audited by member firms. Some of these involve banks, savings and loan associations or other entities that do not file with the Commission, and therefore are not required to be reported to the SIC, but, nonetheless, do involve circumstances where there is a substantial public interest. Many of these press reports raise questions -- either directly or by implication -- about the role of the auditor, which has already undergone at least one peer review.

In these kinds of situations, where there is a substantial public interest, it is well for the Section not only to take decisive action, but also to assure the public that it has done so. Actions that are shrouded in secrecy can only reinforce an attitude that the profession's own interest is being placed before that of the public. I need not remind you that these kinds of developments were among the factors that led to intense Congressional interest in the profession during the mid-1970's. Of course, as a lawyer, I understand that there are limitations on what the profession can do and say in these situations. Nevertheless, I strongly believe that it is important for

the Section and the POB to demonstrate their responsiveness to the public interest.

Concluding Remarks

Having briefly commented on the accounting profession's self-regulatory initiatives, I want to compliment the AICPA for establishing a recognized and effective organization -- the Division for CPA Firms. Nonetheless, as I have pointed out, there still remain areas where significant challenges exist. I, therefore, strongly encourage you to continue to press forward in these areas in order to retain and enhance your ability to determine the future of the accounting profession.

Above all, accountants must continue to guard against complacency in an era of government deregulation. Some may have a misguided perception that the current Commission is less concerned than prior Commissions about the role of independent accountants with respect to the Federal securities laws, or that the SEC has "gone soft" on accountants because of some of its recent regulatory actions. Any such perception is simply not valid. I, for one, firmly believe that we at the Commission must continue to be vigilant in our oversight of the accounting profession, and to stand ready to respond immediately with strong remedial action when necessary.

The concept of effective regulation that I have been discussing here today is an integral part of our oversight program. Only to the extent such self-regulation is achieved can the Commission reduce its regulatory role. Indeed, the need for the

profession to aggressively pursue its self-regulatory efforts is particularly important in the current economic climate for two reasons. First, a recessionary period can place increased pressure on maintaining audit quality because clients may tend to exert pressure to maintain or, in some instances, to decrease audit fees through audit scope reductions. This, in turn, coupled with the fact that some clients may be reducing their administrative work force in the accounting and internal control areas, creates an atmosphere of increased audit risk. Second, and even more important, severe economic conditions are a natural breeding ground for fraudulent and deceptive practices by companies attempting to mask their financial difficulties. In this regard, the Commission is concerned about the increasing instances of publicized financial problems involving public companies. Our enforcement staff is currently investigating a large number of cases involving alleged financial reporting deficiencies, including cover-ups of financial problems by companies adversely affected by the current recession.

The profession's self-regulatory efforts must stand the test of time. Their effectiveness must and will be judged on the incidence and nature of future audit failures. If significant audit busts occur, the role of the accounting profession and the efficacy of its self-regulatory programs are likely to be called into question. The profession must be able to respond to those challenges. I wish you success.