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Peer Review:

Auditing

MEAs by J. Michael Cook

“In our opinion, the system of quality control that was in effect with respect to your United States audit practice (including coordination of your audit services with those performed outside the United States for your clients) during the year ended March 31, 1977 provided reasonable assurance of conforming with generally accepted auditing standards.”

We take substantial pride in this excerpt from the report of Ernst & Ernst issued at the completion of the toughest test of our quality controls, their application and the people that make them work — a comprehensive review by our peers. Although the opinion confirms our own knowledge and the results of the comprehensive internal practice-review program that we have conducted for many years, we believe that this “audit” provides us, our clients and others who rely on our opinions on financial statements with a meaningful evaluation of the continuing quality of our professional services. This article describes briefly the background and recent developments of the peer-review program of the American Institute of Certified Public Accountants (AICPA) and the review of our audit practice conducted by Ernst & Ernst.

Mike Cook, a partner in Executive Office, is the assistant to the managing partner. Mike was responsible for coordination of our peer review by Ernst & Ernst and has participated in the development of quality control and peer review standards by the American Institute of Certified Public Accountants. He was a member of the peer review committee appointed pursuant to the Securities and Exchange Commission's Accounting Series Release No. 173.

The AICPA Peer Review Program

Various peer review programs have been discussed in the AICPA for almost ten years. The genesis of the current program was the work of the Special Committee to Study Quality Review for Multioffice Firms which was appointed in January 1974. In April 1974 the Voluntary Program for Reviews of Quality Control Procedures of Multioffice Firms was adopted by the AICPA Board of Directors. However, in part because of disagreements concerning publication of the results of such reviews, none were conducted under this program.

In connection with the work of the AICPA Committee on Self-Regulation, there was extensive discussion of the peer review program at the AICPA Council meetings in May and October 1975 and at the 1975-76 Member Forums and Winter Regional Council meetings. In view of the interest in the peer review program expressed by the Securities and Exchange Commission (SEC), firms with SEC practices believed that the voluntary program should be implemented promptly; other firms believed that more time should be devoted to studying the implications of the program. Consequently, a discussion document on a Voluntary Quality Control Review Program for CPA Firms With SEC

Practices was issued for comment in February 1976. The program was approved by the AICPA Council in May 1976. At the same time, the Council instructed the Committee on Self-Regulation to develop a peer review program for firms without SEC clients. The results of these efforts were incorporated into a combined Voluntary Quality Control Program for CPA Firms, which was adopted in October 1976.

Two committees were appointed to implement the program. The Special Committee on Proposed Standards for Quality Control Policies and Procedures was formed to provide guidance on the quality control policies and procedures that would be appropriate for participating firms and to develop guidelines for conducting and reporting on reviews. The Quality Control Review Committee, chaired by DH&S partner Hal Robinson, was charged with developing administrative procedures necessary to implement and operate the program.

While these committees were working diligently on their respective assignments, a major change in the program took place in 1977. At the AICPA Council Meeting in September, the AICPA Division for CPA Firms was established with an SEC Practice Section and a Private Companies Practice Section. One of the requirements for membership in each Section is mandatory peer

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review. Each of the Sections appointed a Peer Review Committee to establish the standards and procedures for conducting and reporting on peer reviews. Simultaneously, Council established the Quality Control Standards Committee as a Senior Committee of the AICPA. Hal Robinson now chairs this committee, which is responsible for establishing quality control standards for CPA firms and for administering the voluntary program for firms that are not members of the Division for CPA Firms.

The peer review program of the SEC Practice Section is one of the most significant elements of the AICPA initiative to demonstrate to the critics of the profession that it has a meaningful self-regulatory program.

DH&S Involvement in Peer Reviews

Early in 1976 it became apparent to us that the AICPA program was viable and meaningful – an idea whose time had come. Mike Chetkovich and Ken Stringer recommended the selection of Ernst & Ernst to conduct a review of our system of quality control. After discussion by the Firm's Policy Committee, the decision to have a review for 1976-77 and the selection of Ernst & Ernst were confirmed.

Our peer review activities for 1976 were by no means limited to preparation for the review of our own system of quality control. We were selected to conduct a review of the system of quality control of Price Waterhouse & Co. and completed that review in 1976. In addition, we were selected to review the system of quality control and to audit the financial statements of Arthur Andersen & Co. for that firm's fiscal year ending August 31, 1977. Substantial preliminary work on these engagements was completed in 1976. We are proud of the recognition of our standing in the profession and our reputation for professional excellence implicit in our selection by two other Big Eight firms to review their systems of quality control – and our selection as the first firm engaged to audit the financial statements of a contemporary.

Our experience with peer reviews has convinced us that the firm-on-firm approach is effective and efficient and is superior to alternative forms of review.

The E&E Review

The objective of a peer review is to express an opinion on whether a firm's system of quality control provides the firm with reasonable assurance of conforming with

Photograph not included in Web version

generally accepted auditing standards. "Reasonable assurance" in this context is comparable to "presents fairly" as used in auditors' opinions on financial statements. The objective is accomplished by a review of the firm's organizational structure and of its policies and procedures, with tests to determine the degree of compliance with these policies and procedures. Although Statement on Auditing Standards No. 4, "Quality Control Considerations for a Firm of Independent Auditors" (SAS No. 4), provides the elements of a system of quality control, E&E was encouraged to consider any aspect of our practice that they believed could be significant for the control of our audit practice. The elements of quality control set forth in SAS No. 4 are independence, assigning personnel to engagements, consultation, supervision, hiring, professional development, advancement, acceptance and continuance of clients, and inspection.

The E&E review was supervised by Robert D. Neary, National Partner in Charge of E&E's Accounting and Auditing Department, assisted by Harry F. Reiss, Jr. and Donald L. Neebes (accounting and auditing) and Wayne J. Albers (personnel). Team captains supervising the practice office visits generally were E&E's district accounting and auditing partners.

Review at Executive Office

The initial phase of the E&E review consisted of a study of our organizational structure and documented quality control policies and procedures. This study was made in late 1976 and early 1977 by reviewing our Audit Practice Manual, pertinent sections of our Administrative and College Interview Manuals and other documentation and by interviewing the Executive Office partners responsible for quality control functions. This phase of the review was conducted mainly by partners responsible for parallel functions in E&E.

After the initial phase of the review was completed, E&E tested compliance with our policies and procedures in Executive Office — for example, the monitoring of recruiting activities and personnel policies; the preparation of continuing education materials; the activities of the practice-office support function, including documentation of consultation and supervisory review by the Research and SEC Departments; and the conduct of our practice-review (inspection) program. In addition, compliance with prescribed policies and procedures by the practice offices was tested to the extent that such compliance was determinable

from Executive Office records — for example, the acceptance of new clients and compliance with independence requirements.

At the completion of this phase of the review, we met informally with E&E representatives to discuss their preliminary observations and findings and their plans for tests of compliance in visits to selected practice offices.

Practice Office Visits

The second phase of the review comprehended tests of compliance with prescribed policies and procedures by the review of practice-office functions and working papers and reports for selected audit and unaudited engagements. The emphasis in this phase of the review was on the ultimate purpose of our quality controls — the proper execution of engagements.

In the review of engagements, consideration was given to planning, supervision and review of the audit work, including the timely involvement of management personnel; documentation of work performed; the composition of the audit team, including the use of industry, computer and mathematical applications specialists; compliance with prescribed policies and procedures, including the appropriate use of forms, checklists and questionnaires; and conformity of the financial statements and accountants' report with applicable reporting standards.

Office functions tested included personnel evaluation and counseling, assignment of personnel to audit engagements and procedures for intraoffice consultation.

Practice offices were selected by E&E to provide a representative cross section of our practice — geographically, by size of office and by type of client. The primary selections were main offices; certain affiliated offices were visited in conjunction with the visits to main offices. Certain engagements were selected in advance to provide a cross section of our practice by size of engagement, specialized industries and supervising partners. The preliminary selection of engagements was supplemented with an additional number selected on the basis of information obtained at the practice offices. Other criteria considered in the choice of engagements for review included new clients; participation by other U.S. offices, offices outside the United States and other auditors; and reviews of interim financial statements and SEC filings. The selection of engagements to be reviewed emphasized audits of publicly held companies, in recognition of the public interest in such engagements.

The scope of the E&E review met or

exceeded AICPA guidelines with respect to the number of offices, audit personnel and audit hours to be reviewed. The review took approximately 9,500 hours; about 70 E&E partners and managers participated in the review.

Cincinnati (and Lexington) was selected to be the pilot office for field tests of E&E's practice office function and engagement review programs. Credit goes to PICs Chris Christensen and Frank Kromer, Accounting and Auditing Coordinator Jerry DeBrunner and the partners, managers and staff of these offices for their cheerful cooperation in this necessary, but sometimes difficult, aspect of the review. Other offices (and affiliated offices) visited were Charlotte (Columbia), Houston (San Antonio), Los Angeles (Newport Beach), Miami, Milwaukee, New York (Bergen County), Portland, Salt Lake City (Nampa) and Tulsa. At the completion of each office visit, the E&E findings were reviewed with the partner in charge of the office, the office's Accounting and Auditing Coordinator and an Executive Office partner (Charlie Walworth or me) who participated to provide continuity. E&E team captains were unanimous in their expression of appreciation to the personnel of our offices for their friendly and willing cooperation. Each person involved is to be commended. This cooperation was a significant factor in the efficient conduct of the review.

Wrap-up of the Review

After completion of the practice-office visits and accumulation of the results, we met with E&E representatives responsible for the engagement to review their short-form report and letter of recommendations. The letter is comparable to the constructive-service letter that we issue to our clients at the completion of an audit engagement. E&E provided us with candid observations, and their recommendations are constructive input to our continuing development of quality control policies and procedures for our practice. Each recommendation has received careful consideration, and most have already been implemented.

Conclusion

The rapid acceptance of the peer review program by the profession has been a somewhat surprising development. The sharing of the "trade secrets" of CPA firms with their competitors is a practice virtually unheard of elsewhere in the business community — a fact that should not be overlooked by those who are critical of the accounting profession. □