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Peer Review: The SECPS Experience, Removing the Shroud of Secrecy

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Peer Review: The SECPS Experience

Removing the Shroud of Secrecy

By Andrew H. Barnett and Russ Alexander

During the late 1970's the accounting profession recognized the need for a self-regulated process for monitoring and checking the quality control (QC) systems of CPA firms. Such a process was needed to assure that firms established effective policies to provide reasonable assurance of conforming with professional standards in performing auditing, accounting, and review services. The peer review (PR) process was initiated to satisfy that need.

The PR program was established in 1977 when the AICPA Division for CPA Firms was organized. The Division is composed of two sections, the SEC Practice Section (SECPS) and the Private Companies Practice Section. Firms that elect to join either section must submit to a PR every three years as a condition of continued membership. Other firms may participate in a voluntary PR program administered by the Quality Control Review Division of the AICPA. Peer reviews are also being utilized by state boards of accountancy as well. This article focuses on the PR program of the SECPS, as it was structured in May 1982.

The Review Hierarchy

The SECPS was established as a vehicle for increased self-regulation in the accounting profession. The section's stated objectives reflect a commitment to quality control through mandatory peer reviews, maintenance of quality control standards and sanctions for substandard performance. The following membership requirements reflect this commitment:

1. Member firms must submit to peer reviews every three years.
2. All professionals must participate in at least 120 hours of professional education over 3 years, but not less than 20 hours in any given year.
3. Before issuance of an audit report for an SEC client, the audit report must be reviewed by a partner other than the audit partner. (concurring review)
4. Report any litigation against the firm or its personnel that involves clients or former clients that are SEC registrants and that allege deficiencies in the conduct of an audit.

Organization

The activities of the section are governed by an Executive Committee composed of representatives of at least 21 member firms. The Peer Review program is administered by the Peer Review Committee (PRC) of 15 individuals selected by the Executive Committee from member firms. Figure 1 depicts the organizational framework of the Public Oversight Board (POB).

A Special Investigations Committee (SIC) was established in November 1979 to undertake investigations in connection with alleged or possible audit failures involving member firms. The SIC receives the reports from member firms which list any litigation against the firm and monitors those cases to determine whether an investigation is necessary. Interestingly, from November 1979 to March 1981, only 14 cases were reported to the SIC; none of them were deemed to require a special SIC investigation.

A POB of five prominent individuals (primarily non-CPAs) maintains and evaluates the regulatory and sanction activities of the three committees to assure their effectiveness. The POB is deeply involved in the whole peer review process. Three types of monitoring are used by the POB to assess peer reviewer's adherence to standards:

1. the visitation-observation program, consisting of a review of workpapers and reports issued as well as visits to offices of the reviewed firm during the performance of the review;
2. the workpaper review program consisting of a review of workpapers and reports; and
3. the report review program consisting of a review of the reports issued and summary review memorandum.

In 1980 the five Board members visited over 60 offices in connection with peer reviews, averaging 12 visits per member.

If a peer review provides evidence to show that a member firm is not satisfying the membership requirements, sanctions can be imposed by the Executive Committee. Such sanctions range from requiring corrective measures to expulsion from membership.

The Peer Review Team

Peer reviews are conducted by a peer review team (PRT), which is

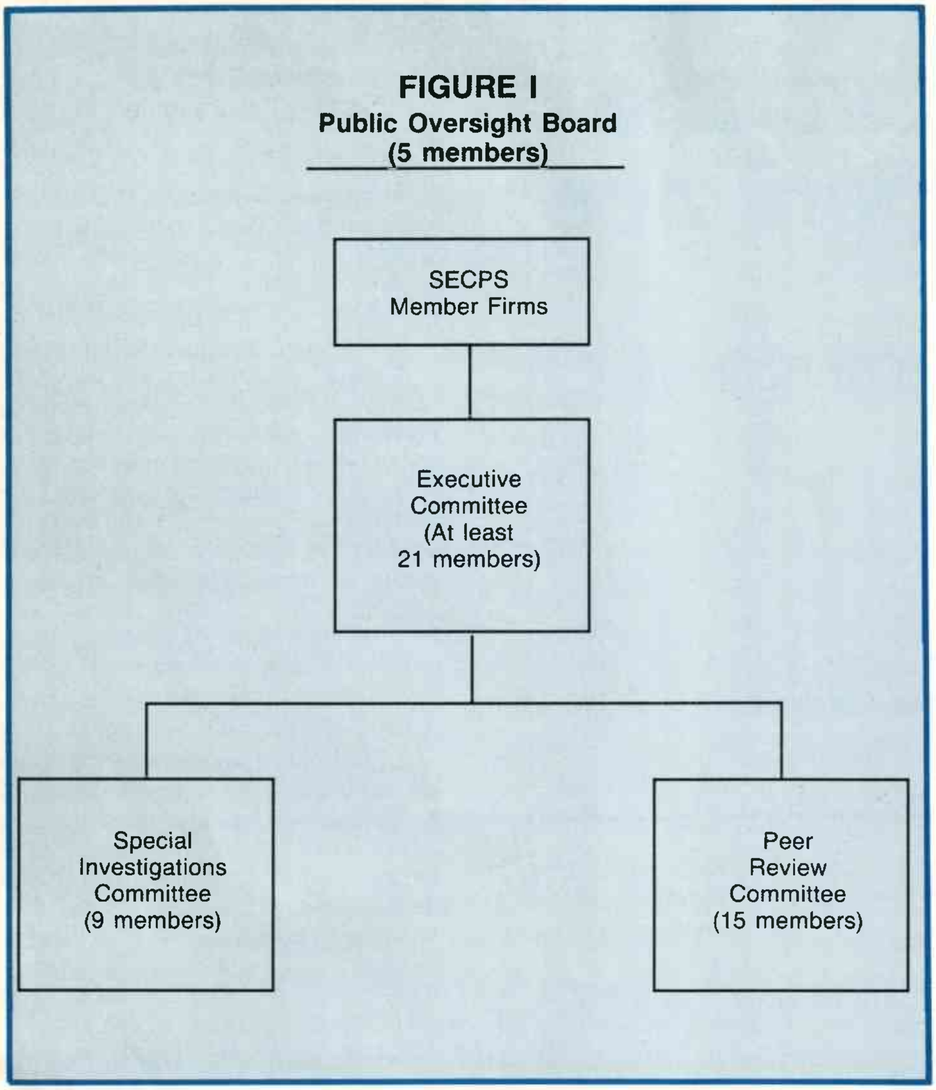


FIGURE I

established in one of three ways:

1. appointed or authorized by the PRC (committee-appointed review); or
2. formed by the firm engaged by the firm under review (firm-on-firm review); or
3. appointed by an association of CPA firms (association review).

Committee-appointed review teams are selected from a list of nominees of member firms. Member firms that want to be reviewed request that the committee appoint such a team, which then conducts the review. A fee estimate is prepared by the PRC. Standard rates are charged per hour of the reviewer's time. The hourly fee is based on the number of professionals in the *reviewed* firm. Fees for 1979 were:

Size of Firm	Partner	Manager
500	$90	$70
50-499	65	50

Rates are established annually by the PRC.

The PRC maintains a list of member firms who are available to conduct firm-on-firm reviews. Member firms who want to be reviewed engage one of those firms, and advise the PRC that a firm-on-firm review will be conducted. The reviewing and reviewed firm make their own fee arrangements. One PRC member estimates the fee for a firm-on-firm review of a large national firm ranges from $800,000 to $1,500,000. Reciprocal reviews are not permitted.

General criteria for the choice of a reviewer are sufficient size, capability, and resources to do the review. In one national firm partner's view, the large national firms are limited to perhaps 14 firms that could serve as reviewers. After narrowing the field by eliminating firms who do work for the reviewed firm (such that independence would be impaired) only a handful may remain. Due to the high start-up costs involved in the peer review process, reviewed firms usually retain their reviewer for subsequent reviews.

While the fee range stated previously may be substantial, it only represents out-of-pocket costs of the reviewing firm. Internal costs, such as the opportunity cost involved in having partners and managers involved in reviews when they could be supervising audit engagements, are not recovered. For this reason, the peer review process does not appear to be generally regarded as an attractive source of revenues for firms.

Each review team is headed by a team captain, who must be an audit partner in a member firm. Other reviewers can be either partners or managers, and must be CPAs (unless a non-CPA specialist is needed to serve as a consultant).

Generalizations about the number of reviewers on a review team are difficult because the number is dependent upon the number of offices visited. The same group of reviewers do not visit all the practice offices to be reviewed. Typically, however, a visit to one practice office may involve 3 partners and 2 managers. If 10 practice offices are visited, at least 50 people could be involved, while large reviews could involve more than 100 people.

The Quality Control Review Panel

For firm-on-firm reviews or association reviews, the peer review committee (PRC) will appoint a Quality Control Review Panel. The primary function of the panel is to oversee the performance of the review team. The panel members are selected from those individuals available to serve on committee-appointed review teams. A fee estimate is prepared by the PRC for the reviewed firm based on the rates previously shown.

The size of the panel depends primarily on the size of the reviewed firm. For large, multi-office firms, a panel will normally consist of three members. For smaller firms, the panel may consist of only one member.

Functions of the QCRP include:

1. determining before the review team begins its review that the team is qualified to perform the review.

2. obtaining a general familiarity with the reviewed firm's quality control policies and procedures.
3. concurring in the nature and scope of the review procedures to be performed by the review team.
4. visiting selected practice offices of the reviewed firm during review.
5. reviewing the team's findings.
6. observing the team's final discussion of its overall findings with the reviewed firm.
7. reading the review team report.
8. issuing a report of its own.

The POB questions whether the QCRP is really necessary to the PR process, and is conducting an investigation to determine cost/benefit data to serve as a basis for evaluation of the continued need or desirability of QCRP involvement in the PR process.

The objectives of the peer review are to determine whether:

1. the reviewed firm's system of quality control for its accounting and auditing practice is appropriately comprehensive and suitably designed for that firm.
2. its quality control policies and procedures are adequately documented and communicated to professional personnel.
3. those policies and procedures are being complied with to provide the firm with reasonable assurance of conforming with professional standards.
4. the reviewed firm is complying with the membership requirements of the section.

Procedures to Achieve the Objectives

Several procedures are involved in the review of the firm's quality control system. First, the review team studies and evaluates the firm's QC system. This procedure is performed at the executive office, and provides evidence about the firm's quality control system and documentation. The amount of time spent at the executive office is largely dependent on how centralized the firm is. One estimate is that on the average, 20-30 percent of the time involved in a PR is spent at the executive office of the reviewed firm. The more decentralized the firm, the greater the proportion of time spent in the practice offices.

At no time during a review will review team members have contact with any client of a reviewed firm in connection with the review.

Based on this first step, the review team tests compliance with the quality control policies. This would include an evaluation of the nature and extent of tests to apply at the executive office, and the identification of the practice offices to be reviewed. The number and location of practice offices to be visited are not subject to definite criteria; such decisions require the exercise of judgment by the review team. Visits to the practice offices are never made on a surprise basis.

Compliance tests may include:

1. review of selected administrative and personnel files.
2. interviews with firm professional personnel at various levels.
3. evaluation of the firm's inspection function.
4. review of selected engagement working paper files and report.
5. review of other evidential matter.

The third step is to develop and execute a program to review selected engagements. The engagements are selected so as to provide a reasonable cross-section of the reviewed firm's accounting and auditing practices. Greater weight is given to selecting engagements for publicly-held clients and engagements that are large or complex. The number of engagements to be reviewed is left to the judgment of the review team.

After all compliance tests have been performed but prior to issuing its report, the review team communicates its conclusions to the reviewed firm. The formal report is then prepared and submitted to the reviewed firm and to the PRC.

At no time during a review will review team members have contact with any client of a reviewed firm in connection with a review. Hence, the review team, in the absence of evidence to the contrary, would presume that the reviewed firm's representations concerning items contained in the working papers are correct. The review team is testing the reviewed firm's working papers for compliance with the reviewed firm's prescribed system of quality control and is not able to test whether the firm did in fact comply with GAAS in the engagement being tested. Rather, it appears that the logic of the PR process is that if the firm's QC system is appropriately comprehensive and suitably designed, it is fair to conclude that audit and accounting services are in fact performed in accordance with GAAS.

For example, the first general standard says that "the examination is to be performed by a person or persons having adequate technical training and proficiency as an audtior." If the firm has appropriately comprehensive and suitably designed policies and procedures for assigning personnel to engagements, supervision, hiring, professional development, and advancement then a priori the firm should be complying with the first general standard.

The review team is required to prepare and retain working papers to document the work performed, its findings, and conclusions. The SEC and the POB reached an agreement in 1980 that provides for SEC staff access to selected portions of PR team work papers for reviewed firms that audit one or more SEC clients. The name of the reviewed firm will not be disclosed in those work papers. The SEC also has access to the POB's work papers.

Reporting on a Peer Review

The review team is required to prepare a report addressed to the partners of the reviewed firm which expresses either an unqualified or modified opinion on whether the firm's system of QC is appropriately comprehensive and suitably designed, whether the firm is complying with the QC system, and whether it is complying with the SECPS membership requirements.

Circumstances that would require a modified report are:

1. a limitation on the scope of the review
2. review discloses significant deficiencies in the prescribed QC policies and procedures, and/or a significant

lack of compliance with those prescribed procedures.

3. review discloses significant lack of compliance with the SECPS membership requirements.

It is not clear from either the *Peer Review Manual* or the POB Annual Report under what circumstances an adverse report must be issued.

During the course of their review, the review team may note items that, while not significant enough to result in a modified report, are of sufficient weight to warrant bringing those items to the attention of the firm's partners. These items might, if corrected, result in an improvement to the QC system of the reviewed firm. Such items are communicated in a "Letter of Comments" that is meant to be a part of, but not to change, the opinion expressed in the report itself. While the letter is issued at the option of the review team, over 90 percent of unqualified reports also have a Letter of Comments.

The reviewed firm is required to respond to the Letter of Comments and must either describe the action that will be taken in response to the suggested improvement, or present reasons for disagreement with the suggestion as justification for not implementing them. There is no standardized form or language for the response.

In firm-on-firm and association reviews, the QCRP will also issue a report. The unqualified opinion paragraph of the QCRP is essentially the same as the opinion paragraph of the review team report.

The review team report, Letter of Comments, Response to the Letter of Comments, and the QCRP report are all submitted to the PRC for approval, and then placed in the public file at the AICPA.

An Analysis of Selected Peer Reviews

To develop insight into the outcome of peer reviews at the national firm level, we examined the peer review reports on eight large national firms. Included in our examinations were the review team reports, comment letters, responses to comment letters, and the quality control review panel reports for each firm. In every case, unqualified opinions were issued by both the reviewing firm and the review panel. Table 1 presents a concise abstract of the nature of the recommendations presented in the comment letters.[1]

TABLE 1

Letters of Comments — Areas Mentioned as Needing Improvement

Reviewed/ Reviewing Firms	Report Year Ended	# of Areas Mentioned	Documentation	Within-Firm Consultation	CPE	Planning & Program Preparation	Special Audit Techniques
AA/DH & S	8-31-80	3	x	x	x		
AY/PW	6-30-78	2	x	x			
C&L/AY	6-30-79	6	x		x		
DH&S/E&W	3-31-77	17	x	x	x	x	x
E&W/PMM	3-31-80	3	x			x	x
PMM/AY	3-31-78	5			x		
PW/E&W	6-30-78	6	x	x			
TR/PW	3-31-79	5	x	x			
TOTALS		47	7	5	4	2	2

The peer review of Deloitte Haskins & Sells (DH&S) by Ernst & Whinney (E&W) occurred prior to both the organization of the SECPS in September 1977 and well before the *Peer Review Manual* was published in August 1978. This review arose because of certain proceedings before the SEC (per ASR 241) involving alleged deficiencies in the conduct of audits of four companies by DH&S. A special committee was appointed by both DH&S and the SEC to examine and render a report concerning the manner in which DH&S conducted its audit practice. While DH&S had engaged E&W to perform their review prior to the formation of this committee, the committee was permitted to utilize the work of E&W in formulating their opinion. The report of the committee, which contained an unqualified opinion, was issued on December 15, 1978. That opinion, which was unqualified, is remarkably similar to the sample standard report contained in the *Peer Review Manual*.

The committee was satisfied that the changes initiated by DH&S as a result of E&W's suggestions were sufficient to correct the deficiencies. Despite being performed before the formal PR program was established, the E&W review and the reports arising from ASR 241 were accepted and placed in the public files in mid-1979.

Items of Interest

All of the firms opted for a firm-on-firm review rather than a committee appointed review. Three firms, Arthur Young & Co., Price Waterhouse, and E&W, each served as reviewers for two different firms. Arthur Andersen & Co., Coopers & Lybrand, and Touche Ross did not serve as reviewers for the other firms.

All of the firms received an unqualified opinion from both the review team and the QCRP. All of the reports were in the standard language prescribed by the *Peer Review Manual* except for the QCRP report for Peat Marwick Mitchell & Co. (PMM). The Panel inadvertently omitted a key phrase from their opinion paragraph. PMM brought the omission to the attention of the QCRP which corrected the omission by issuing a new report.

Each review team submitted a Letter of Comments along with its report. As required, the reviewed firm prepared a point-by-point response to that letter. Although in general most of the reviewed firms agreed that the points outlined in their reviewer's Letter of Comments were justified and in need of attention, two firms, PMM and Price Waterhouse & Co., disagreed with several points raised in the Letter of Comments, (both rather pointedly, in fact). As the *Manual* directs, the reasons for their disagreement were stated in their responses.

Letters of Comments

Table 1 presents a summary of the number of points mentioned in the Letter of Comments for each firm, and the specific points mentioned most frequently. The specific points do not represent areas of failure of the QC system of the reviewed firm; rather they are areas where infrequent instances of noncompliance were discovered, or where minimum levels of compliance were encountered. Specific points mentioned in the Letters are meant to point out areas that require attention because a change would result in *substantial* improvement (in the opinion of the reviewing firm) in the reviewed firm's system of QC.

Discussion and Conclusion

The primary objective of the SECPS is to improve the quality of accounting practice before the SEC. The question that must be asked is: "Is this objective being achieved?"

Statistics on the number of unqualified, modified, and adverse reports accepted by the PRC for the SECPS as of February 1982 are:

	1978	1979	1980	1981
Unqualified	10	30	114	88
Modified	1	8	23	4
Adverse	0	2	3	1
Total	11	40	140	93

The percentage of unqualified opinions went from 57% in 1975 to 95% in 1981, while the percentages of modified and adverse opinions both declined. Since the reviews are only required every 3 years, the statistics reflect many first-time reviews. It is reasonable to expect such a trend, for over time firms will come to know what is expected of them and will implement policies and procedures to assure that they will satisfy the criteria for unqualified opinions.

The POB said:

> *"Based upon its monitoring of reviews conducted to date under Section requirements, the Board believes that the peer review process is constructive and is achieving its objectives. The improvements being implemented by firms as a result of peer review demonstrate the real value of the process." (POB, 1981, p. 12)*

If an unqualified opinion is in fact a reliable indicator of an appropriate QC program, and; if the reviews are conducted in an independent and objective manner, such a conclusion seems warranted.

As previously stated, all of the selected firms received unqualified opinions. Although a naive observer might conclude: "Ah-hah — because the Big 8 all got clean opinions, the process is not working," such a conclusion is unwarranted.

In the first place, these firms have their own internal QC inspection programs, which have substantial budgets to provide continuing assurance that the firm is providing high-quality service to clients, consistent with professional and firm standards. Hence, it may be true that the process is not substantially improving the quality of their practices because they were and are committed to maintaining quality, independent of any outside review. However, the process is useful to any firm because it: 1) gives them a challenge to make sure that they do well in the inspection so that they receive an unqualified opinion; and 2) provide the firm with an opportunity to share advice about QC programs so that both the reviewing and reviewed firm can mutually benefit from each other's experience and expertise.

According to one national firm partner, the PR is like a check-up by the family doctor which individuals undergo periodically. The doctor examines the healthy patient to see if any corrective actions are needed to assure future good health. Likewise, the PR serves to assure that any trends reflecting possible future QC problems are corrected before they jeopardize the quality of the firm's service to clients.

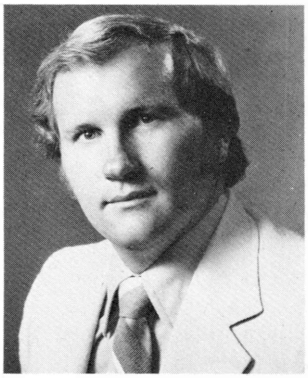
Second and most importantly, the conclusion that the PR program is not working is unwarranted because while the practices of those firms which have extensive QC programs may only be marginally improved, the PR program should result in substantial improvements to the practices of firms with inadequate QC systems.

One criticism that can be made of the process is that it seems rather shrouded in secrecy. Considering that the objective is to improve practice of CPA firms, it would be appropriate to let users of financial information know of the results of the profession's self-regulation, to help improve the public image of the profession. Initial efforts at increasing dissemination of information are being made. The POB is considering publishing the names of the reviewed firms that have received favorable reports in the 1981-82 Annual Report. In addition, the AICPA is considering publishing a directory indicating which firms are members of the Division of CPA Firms. The POB endorses this idea. Interested users who know that membership in the Division means that member firms must undergo mandatory peer reviews would therefore also know that those firms who do not belong are not to be subject to such, unless they participate in the voluntary peer review program. By more open reporting, the profession will maximize the benefits of the PR program.

The PR program of the AICPA was born at a time when the profession was under attack from outside groups. It is certainly an extensive, well-organized process. The exceedingly difficult question of whether the benefits exceed the costs remains to be answered. Ω

NOTE

[1]While Exhibit 1 indicates that recommendations were made in 47 areas, not all of them are classifiable in the four areas presented.



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