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Theory and Practice

Practice Monitoring

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Quality control over the practice of public accounting is a major issue for the profession today. Further, it is likely that quality control will undergo change based on the results of two outstanding sets of proposals. One proposal comes from the Anderson Committee, the other from the SEC.

Anderson Committee Proposal

The Anderson Committee Report (AICPA) was released in 1986. This report offers various recommendations, including not only changes in practice monitoring, but also modifications in the Code of Professional Conduct, a restructured Joint Trial Board, a 120-hour continuing professional education requirement (over each three-year period) for members in public practice, a 90-hour continuing professional education requirement (over each three-year period) for members not in public practice and not in retirement, and a post baccalaureate education requirement beginning in the year 2000. Each of the Anderson Committee proposals is being voted on separately by the AICPA membership, and the voting is expected to be completed by the end of the year.

The Anderson Committee Report presents various recommendations for practice monitoring or peer review, to be called quality review. First, all firms in public practice that have personnel who are members of the AICPA must participate in the SEC Practice Section (SECPS), the Private Companies Practice Section (PCPS) or a Quality Review program. Another Anderson Committee recommendation, which was rejected by a vote of the AICPA membership in the spring of 1987, was for all firms that audit one or more SEC registrants to be members of the SECPS. The consequences of a firm's not being a member of the SECPS was to be that the CPAs working for that firm would not qualify for AICPA membership. Shortly after this AICPA membership rejection, the SEC proposed rule changes which require peer review for auditors of SEC registrants. The SEC proposal will be discussed later.

The Quality Review program, still to be considered by the AICPA, would be structured similarly to the peer review programs of the practice sections. It would require triennial reviews. Reviews would be structured and conducted appropriately for the size and type of practice of the CPA firm, taking into consideration the formality of the firm's internal quality control system and the extent of its auditing and accounting practice. Results of the quality review would be monitored. Documents placed in files would be open to the public and would be the same as those filed at the close of a practice section review. Reviewed firms would pay the cost of the review and direct administrative costs.

The quality review must result in an unqualified, a qualified or an adverse report. The report would be examined by a subcommittee of the Quality Review Committee. Then, the entire committee would act on any recommendations of the subcommittee. Actions resulting from an adverse quality review report might include: requiring educational, corrective or remedial measures; referring complaints to the AICPA Professional Ethics Committee or to state CPA societies' ethics committees; and imposing sanctions if deficiencies are not corrected. The recommended structure of the Quality Review program would utilize the state CPA societies, as well as the AICPA, to administer the program.

An AICPA Quality Review Committee would set standards, organize or oversee quality reviews, analyze results, and recommend follow-up action. If the state societies agree to set up state level quality review committees, those committees would also organize or oversee reviews. These state committees would be required to coordinate with the national-level AICPA Quality Review Committee and adhere to its standards.

In the proposed Quality Review program, there are changes in the responsibility for investigating complaints about technical competence. The Quality Review Committee and practice sections peer review committees would investigate complaints against members and firms. The Quality Review Executive Committee would be responsible for action against firms that do not cooperate or that commit serious violations of technical competence. Action by the Executive Committee can result in denial of membership in the Quality Review program. The Quality Review program would establish due process procedures similar to those of the SECPS and PCPS for action against firms.

In summary, the Quality Review program envisioned by the Anderson Committee would be a structure for uniform peer review for those AICPA members in firms choosing not to join the SECPS or PCPS. Its structure and activities largely parallel those of the practice sections, with the exception of working with state CPA societies. One other major difference of the revamped program is that initially it would address only accounting and auditing engagements. Eventually, however, all areas of practice would be encompassed.

SEC Proposal

The SEC voted on April 3, 1987 [SEC, 1987], to propose rules requiring all independent auditors of companies reporting to the SEC to undergo a peer review covering their accounting and auditing practices. The rules, if adopted, will be enforced by changing the SEC definition of "certified" as it relates to financial statements. Financial statements included in SEC filings will be certified

only if the auditor who examines them has met the peer review requirements and has a quality control system which is sufficient to reasonably ensure compliance with generally accepted auditing standards (GAAS).

The SEC uses enhanced audit quality as the primary justification for the proposal for mandatory peer review. Although peer review will not prevent unusual breakdowns of quality control, it may reinforce the accountant's commitment to maintaining good quality control. The SEC's regulations affecting the public accountants who audit registrants are intended to ensure that those accountants accept the high level of responsibility owed to the public and perform their work with the rigorous quality standards expected in SEC practice. The SEC takes the position that peer review helps determine whether an accountant's work conforms to these high professional standards. And assuming that peer review improves audit quality, the SEC believes peer review will increase benefits to the public.

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Two sources for obtaining a peer review are set forth in the proposal. One such source is a person, team or firm, hired by the firm to be reviewed. In this case, the peer review will be overseen by the SEC. The second source for a peer review is one performed under the authority of a peer review organization (PRO). For a PRO to be "qualified," it must meet numerous specifications, and all PROs will be overseen by the SEC. For either approach to a peer review, the SEC has proposed various standards and transition period quidelines.

The activities described by the SEC for a peer review are basically the same as those currently conducted in a SECPS peer review. A review of the quality control system and a substantive examination of engagement files are both required. One issue, on which the SEC directly requested comment, is whether all contested audits, that is, those for which there has been an allegation that GAAS was not followed, should be mandatorily included in the sample of engagement files examined. The reason for including contested audits is that the examination of the files may provide information to the auditor that will help in doing future audits. If contested audits are always included in peer reviews, the risk is that the peer review workpapers, which are normally confidential documents, may become public information through court evidence and testimony.

The proposed reporting procedures are also similar to a SECPS peer review. A peer review report and letter of comments must be issued by the reviewer. The letter of comments will include anything that produces a "more than remote" possibility that GAAS have not or will not be complied with. The reviewed accountant must respond to the comments letter in writing. The report, the letter of comments and the response will be available to the public and will also be filed with the SEC. A major change in the required reporting will be the addition of a new responsibility for the PRO. The PRO must determine whether the reviewed firm's response indicates action, or planned action, that is appropriate for the deficiencies cited by the reviewer. If the firm's response is not appropriate for the cited deficiencies, the PRO must report this conclusion to the SEC. A reviewed firm that responds inadequately to suggestions for improvement could find itself the subject of SEC scrutiny, the result of which may be SEC refusal to accept financial statements audited by that firm.

As in all suggested "improvements" for the accounting profession, the SEC proposal has the potential for creating problems. The first of these is a reduction of competition. A large percentage of the CPA firms currently auditing SEC registrants are already members of the SECPS. For these firms, the adoption of the proposed rules will have little significance. However, opinions vary on the impact the rules may have for audit firms already having SEC practices but not undergoing peer review and for those firms wishing to expand their audit practices to include SEC clients. These firms will have to decide whether or not they are willing to enter into a peer review process. If they elect to accept the peer review requirement, there will be an economic cost,which may affect their competitive positions. If they reject the prospect of undergoing peer review, they will also be rejecting the population of SEC registrants as potential audit clients.

There are several responses to the concern about reducing competition. One is that most firms auditing SEC registrants are already members of the SECPS so the impact will be small. A second is that if a firm is not wiling to undergo a peer review, it should not be accepting SEC clients. This second response is based on the idea that when a firm is auditing SEC registrants, it is in the "big leagues" and must accept the responsibilities that accompany such activity. One of these responsibilities is to confirm that its accounting and auditing practice is governed by an adequate quality control system. To the SEC, the need for quality control and the willingness of an accounting firm to prove that it possesses good quality control seem to outweigh the possibility of limiting competition. There was, however, a request for comments on the possibility of damage to competition. The SEC's current stance mirrors a shift in concern; the Congressional investigations of the 1970s were very concerned about the Big-Eight firms'

dominance of the industry whereas the intense concern now is ensuring quality audits.

Another anticipated complaint about the SEC proposal is the economic burden that mandatory peer review will bring. As can be expected, the main issue is the cost it will impose on smaller firms. Various estimates of average peer review costs are presented in the proposal, but at this point, the impact of the costs is unknown. Costs clearly relate to the competition issue. They also relate to the competency issue because the more quality control problems an audit firm has, the higher its peer review costs are likely to be. At the core of the concern is the belief that small firms may be faced with what they perceive to be excessive new costs, from not only the actual peer review fee, but also the preparation required for the peer review.

The SEC does not contest that there will be new costs incurred when firms that have not been peer reviewed in the past enter into such a program. Its position, though, is that the actual peer review fee should be the only new cost. Statement on Auditing Standards (SAS) No. 25 requires that appropriate quality control standards be in place to reasonably ensure that GAAS is followed. The SEC suggests that a CPA firm cannot meet the requirements of SAS No. 25 without having documentation of its quality control standards and an internal system for monitoring compliance with those standards. In other words, if a firm is already complying with GAAS, the only new requirement and cost imposed by mandatory peer review is the review itself. The implication is that if a firm is not already meeting the requirements of SAS No. 25 by formally assessing quality control issues, it should not be auditing SEC registrants. The opposing position is that a firm can meet the requirements of SAS No. 25 without having a written description of its quality control procedures or a formal internal monitoring system and that the development of these prior to undergoing an initial peer review can be very expensive. Although it appears clear that the SEC does not believe the proposed requirement will be excessively costly, direct comments on cost were requested.

Credibility is added to the greater concern for quality than for reduced competition and increased cost by the result of staff studies the SEC performed. The SEC's staff analyzed enforcement actions brought by the SEC between 1981 and 1986. A majority of these actions were brought against accounting firms which had not had a peer review at the time the problem audit arose. The actions brought against firms which *had* undergone peer review most frequently resulted from the handling of very complex transactions, rather than the general ways in which the audits were conducted. This might suggest that firms that are peer reviewed conduct higher quality audits. However, there is evidence to suggest that large firms undergo peer review more often than do small firms. Thus, an alternative conclusion is that larger firms may be able to conduct higher quality audits on SEC registrants as a result of being more experienced in auditing SEC clients. The SEC asked for comments on the two possible conclusions. A mandatory peer review requirement might lead to better quality control for smaller firms, thus leading to better quality audits. Alternatively, if size and experience are the real causes for fewer enforcement actions, then requiring peer review of smaller firms will not improve the situation at all. Further, in the latter case, if a peer review requirement makes the smaller firms less able to compete, then peer review may reduce small firms' ability to get experience and to grow, and thus to improve their audit quality.

A final major controversy on this proposed peer review requirement deals with CPA firms and clients which "grow up" together. Small CPA firms often comment on the inequity of a system which causes their best audit clients to change auditors as they plan a public offering because the clients believe Big-Eight audits carry greater credibility. It may be that the SEC proposal will exacerbate this situation. Assuming a CPA firm has not previously been peer reviewed, it must deal with beginning the process. And although entering the program might prove costly, the CPA firm must maintain a pricing structure that will encourage the client not to change auditors. Clients themselves may be burdened if they wish to stay with their current auditor but are forced to change because the firm refuses to be peer reviewed.

Aside from the question of whether mandatory peer review will have good or bad results, there is also the question of whether such a requirement is really necessary. A suggestion was previously considered, and then dropped, of requiring disclosure in SEC filing documents of whether a company's auditor has undergone peer review. The logic behind this suggestion is that if peer review is beneficial, clients will consider it as a major criterion in selecting auditors. The market, if informed, may determine the desirability of peer review. Ω

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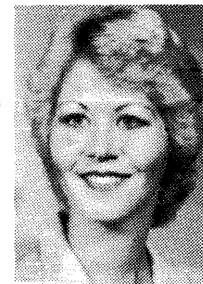

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