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The CPA Gets Audited

Quality Control/Peer Review Gains Acceptance

By Erich Obersteiner and Heidi Hylton Meier

In recent years, the public accounting profession has been exposed to allegations of audit failure and malpractice. Such allegations, even when subsequently shown to be unsubstantiated, often have serious consequences on the credibility of the professional work done by the firms cited. Additionally, the profession itself becomes the target of unfavorable publicity and demands are made for increased federal regulation of the accounting profession and the firms that provide the accounting services.

As a result of these developments, the accounting profession has become much more concerned with questions of quality control and the maintenance of high professional standards for its work. Great efforts have been made to improve self-regulation of members of the profession.

More than ten years have passed since the American Institute of CPAs (AICPA) instituted a program of self-regulation. The AICPA created the Division for CPA Firms and encouraged accounting firms to voluntarily become members of the SEC

Practice Section (SECPS) or the Private Companies Practice Section (PCPS), or both. The objectives of the AICPA are to improve the quality of practice in CPA firms and to establish an effective means of self-regulation. In order to meet these objectives, the division requires that each member firm engage in a triennial peer review as a means of testing the firm's system of quality control.

Peer review has become the major force in the accounting profession's program of self-

regulation. Part of this review includes an evaluation of the adequacy of an accounting firm's system of quality control to determine adherence to the standards outlined in the Statement on Quality Control Standards No. 1, *System of Quality Control for a CPA Firm* [AICPA, 1979]. Peer review has been accepted by the membership of the AICPA and by the SEC as an effective means of ensuring quality practices and of regulating the profession.

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Survey of Local and Regional Accounting Firms

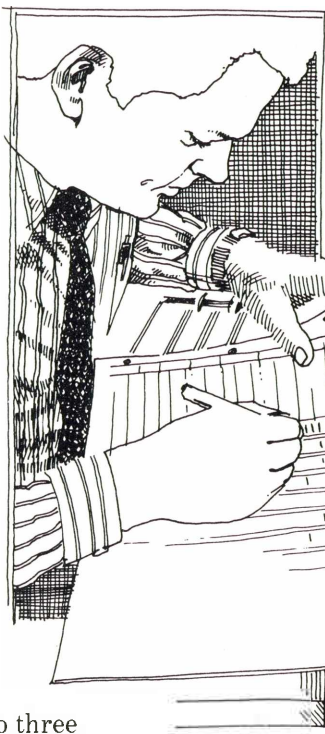
The information presented in this article was derived from a national survey conducted in the spring of 1987 to assess current participation in quality control and peer review programs by local and regional accounting firms. The sample of firms included in this survey was randomly selected from the 1984 edition of the AICPA list of members. Since the purpose of the study was to test local and regional firms' compliance with quality control and peer review

requirements, the Big Eight and other large national firms were not included in the survey. Of the remaining firms on the membership list, every fifth firm was chosen. The sample included 437 firms from all 50 states, the District of Columbia and Puerto Rico. Of the 437 questionnaires mailed, 202, or 46.2%, usable responses were received, and 60, or 13.7%, were returned as undeliverable.

For a more thorough analysis of the responses to the questionnaire, the responding accounting firms were divided into three groups according to size. Small firms were defined as those firms with gross annual revenues up to \$500,000; Medium firms as those having gross annual revenues from \$500,001 to \$1,000,000; and Large firms as those having gross annual revenues over \$1,000,000. The number of firms and the percentage of total respondents for each of these groups are as follows: Small firms — 29 firms or 14.4%; Medium firms — 54 firms or 26.7%; and Large firms — 119 or 58.9%.

Quality Control Programs.

Both the Private Companies and SEC Practice Sections impose a mandatory requirement of a quality control program on their member firms. Table 1 reports the level of compliance with this requirement achieved by local and regional firms. It is interesting to note that nearly all respondents (99.5%) have a quality control



program. Also, it should be noted that non-compliance occurred only in "Medium Sized Firms."

Table 2 provides information on the types of quality control programs that firms have established.

Audited and unaudited workpaper reviews and report reviews seem to be the most popular forms of quality control used by the firms in the sample. Firm policy review, practiced by more than 75% of the firms surveyed, appears to indicate that firms are genuinely concerned with the quality of work done.

Table 3 shows the methods respondent firms use to implement their quality control programs. Most of the firms participating in this survey reported extensive "in-house" reviews of their work. In addition, about two-thirds of the firms also report AICPA or outside reviews as part of their quality control program. Only about 6% of the firms surveyed report reviews by members of the association to which the firm belongs. It should also be noted that differences between the implementation of the programs among the Small,

Medium, and Large firms were found to be insignificant.

Participation in Peer Review and the Division for CPA Firms.

Table 4 shows that an overwhelming number of the respondents reported a peer review with in the last three years. This is true for all sizes of firms and approaches 100% for the Large firms. The high degree of compliance with quality control requirements and the level of participation in peer reviews indicate that the local and regional firms

surveyed share the goals of the accounting profession to provide quality services in a self-regulated environment. This goal congruence is more clearly demonstrated by the levels of participation in the AICPA's Division for CPA Firms. Table 5 shows the participation rates of respondent firms according to the section(s) to which they belong.

Almost 95% of the firms responding to the survey reported membership in the PCPS, the SECPS, or both. The participation rate for small firms is a very substantial 86.2%.

Results of the Previous Study

In 1979, a study similar to the current one was conducted as a means of determining early compliance of local and regional CPA firms to the then recently established requirements of the

More than ten years have passed since the American Institute of CPAs (AICPA) instituted a program of self-regulation.

Division for CPA Firms [Obersteiner, 1982]. The earlier study was limited to a survey of CPA firms registered in the state of Ohio, and therefore differs from the current study in scope and comprehensiveness but is comparable in focus and content.

The previous study revealed that only 34.1% of the surveyed firms had a quality control program in 1979. Of those firms that had a quality control program, the majority of the firms would have been categorized as Large firms (gross annual revenues over \$1,000,000). Work paper review for audits, report reviews, and tax return reviews were the most common forms of quality control programs reported, and these patterns held for all firms, regardless of their size. With respect to program implementation, 94.4% of the firms reported that the quality review was performed "in house," while only 15.7% reported that the review was performed by an outside firm, and 6.1% indicated review by the AICPA.

Only 7.7% of the firms responding to the 1979 survey reported having a peer review within the previous three years. Of those firms, large firms made up 60% while no small firms had undertaken reviews.

One explanation for the low participation rates in 1979 can be inferred from the low percentage of

TABLE 1
Existence of a Quality Control Program
by Size of Firm
(Percent of Firms Responding)

	All Firms	Small Firms	Medium Firms	Large Firms
Firm has a Quality Control Program	99.5%	100.0%	98.1%	100.0%
Firm Lacks a Quality Control Program	0.5	0.0	1.9	0.0

Small Firms: Gross Annual Revenues up to \$500,000
 Medium Firms: Gross Annual Revenues between \$500,001 and \$1,000,000
 Large Firms: Gross Annual Revenue over \$1,000,000

TABLE 2
Types of Quality Control Programs
(Percent of Firms Responding)

	All Firms	Small Firms	Medium Firms	Large Firms
Workpaper Review — Audits	96.5%	89.7%	94.4%	99.2%
Workpaper Review — Unaudited Reports	92.1	86.2	85.2	96.6
Report Review	94.6	93.1	92.6	95.8
Firm Policy Review	78.7	72.4	68.5	84.9
Tax Return Review	56.9	62.1	53.7	57.1
Other Means of Quality Control (Hiring, Promotion, Professional Development)	13.9	10.3	13.0	15.1

Small Firms: Gross Annual Revenues up to \$500,000
 Medium Firms: Gross Annual Revenues between \$500,001 and \$1,000,000
 Large Firms: Gross Annual Revenue over \$1,000,000

the respondents that were members of the Division for CPA Firms. Over 70% of the total firms in the sample stated that they did not hold membership in either the PCPS or SECPS. As would be expected, fewer small- and medium-sized firms were members of the Division. Even among the large firms, however, more than one-fifth did not belong to either of the sections. In addition, when the 1979 survey was conducted, the Division for CPA Firms had been in existence for only two years, and many of the firms that were members were still preparing to meet the mandatory requirements.

Progress in Quality Control

Comparison of the results of these two studies show that great strides have been made by local and regional accounting firms in establishing quality control programs and actively participating in the review of these programs. For example, in the intervening eight-year period, the percentage of surveyed local and regional accounting firms with quality control programs has increased from about one-third to nearly 95%. Although the types of programs that these firms have established are very similar to those reported in the earlier study, there does seem to be less emphasis on tax workpaper review. The results would also indicate a shift from almost exclusive "in house" reviews to a greater use of reviews conducted by AICPA review teams and outside firms.

Conclusion

Over the past decade, the accounting profession has made great efforts to establish a program of self-regulation that would be accepted by the profession as well as the general public. The results of

TABLE 3
Methods of Implementation
(Percent of Firms Responding)

	All Firms	Small Firms	Medium Firms	Large Firms
Quality Review Performed:				
Within the Office	73.1%	79.3%	64.8%	72.3%
In the Office Within the Firm or an Associated Firm	9.4	13.4	3.7	10.9
By the AICPA	20.8	20.7	31.5	16.0
By an Outside Firm	45.0	41.4	40.7	47.9
Other (Primarily by Associations to which the firm belongs)	5.9	6.9	3.7	6.7
Small Firms:	Gross Annual Revenues up to \$500,000			
Medium Firms:	Gross Annual Revenues between \$500,001 and \$1,000,000			
Large Firms:	Gross Annual Revenue over \$1,000,000			

TABLE 4
Peer Review Within the Last Three Years
(Percent of Firms Responding)

	All Firms	Small Firms	Medium Firms	Large Firms
Yes	94.5%	86.2%	90.7%	98.3%
No	1.5	3.4	3.7	0.0
No Response	4.0	10.4	5.6	1.7
Small Firms:	Gross Annual Revenues up to \$500,000			
Medium Firms:	Gross Annual Revenues between \$500,001 and \$1,000,000			
Large Firms:	Gross Annual Revenue over \$1,000,000			

this survey in comparison with those of an earlier study provide evidence that many local and regional accounting firms have accepted the concept of quality control, peer review, and self-regulation.

One of the most dramatic changes over the last ten years is the level of participation in peer reviews and in the AICPA Divisions for SEC Practice and Private Companies Practice. The percentage of firms that have had a peer review has increased nearly twelve times, while membership in the PCPS and/or SECPS has more than tripled.

It would appear that the profession has accepted wholeheartedly the concept of self-regulation, quality control, and peer review. Larger firms, as would be expected, are in the forefront of this trend. The evidence suggests, however, that small- and medium-sized firms deem compliance with AICPA guidelines to be important. Furthermore, it is expected that this trend will continue, and even accelerate, when the new quality control requirements of the AICPA become effective later this year.

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Classifieds

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TABLE 5
Membership in AICPA Sections
(Percent of Firms Responding)

	All Firms	Small Firms	Medium Firms	Large Firms
Private Companies Practice Section	62.9%	75.9%	68.5%	57.2%
SEC Practice Section	1.0	3.4	0.0	0.8
Both Sections	30.2	6.9	20.4	40.3
Total Participation	94.1	86.2	88.9	98.3
None of the Sections	5.9	13.8	11.1	1.7
Total	100.0	100.0	100.0	100.0
Small Firms:	Gross Annual Revenues up to \$500,000			
Medium Firms:	Gross Annual Revenues between \$500,001 and \$1,000,000			
Large Firms:	Gross Annual Revenue over \$1,000,000			

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