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QUALITY REVIEW -- A NECESSITY

A PAPER PRESENTED TO AICPA COUNCIL ON OCTOBER 9, 1971

by David M. Culp, 1971-72 Chairman
Advisory Committee on Quality Review

First I want to state that Jim Ould of Virginia has been our chairman for the past year. His driving leadership has resulted in the accomplishments of our Committee. Illness prevents his giving this report.

Improvement of the quality of auditing is much like the weather. We do a lot of talking about it but very little is done about it. It is usually high on the agenda for next month's projects or when "we get caught up." Yet the lack of quality auditing or reporting has found our members losing their certificates and thus ending their careers and being fined major amounts of money.

Integrity, quality reporting, and quality auditing procedures are the raw materials which produce quality auditing services for the public. If these are safeguards for the public, they are also safeguards to the independent accountant, his firm, and his profession. The recent surge of activity in the courts only underscores what we have always known: the public relies on our services and expects them to be of the finest quality. As individual accountants and as a profession we have not tried to change this image nor indeed should we.

Let's briefly consider the auditing education of our members. Typically they have had two semesters of auditing -- a subject which becomes the foundation of their lifetime career. These courses include almost no laboratory work or working paper preparation. Such courses were taken in a business school or university only casually interested in public accounting. Typically these courses are taught by instructors with little or no auditing experience.

The major advancement in auditing education in recent years has been the development of training courses by individual firms and by the professional development division of the American Institute. Some of our members have taken these courses. Although auditing is a combination of art and science, the education-scientific aspect has only received minimal attention.

A few years ago the Planning Committee of the Institute became concerned that there was very little collective effort to guarantee the profession was indeed performing quality auditing services. Their study concluded: "The quality of the audit depends on the competence of each practice unit . . . Each practice unit has a direct responsibility to the profession as a whole and the profession as a whole has a direct responsibility to every practice unit." The Planning Committee concluded the Institute should take the leadership in offering quality review of independent audits to member practice units.

A Quality Review Advisory Committee was appointed in August, 1970. This Committee set about to establish a volunteer program and to conduct it for one year on a pilot basis. Pertinent details of the program developed are as follows.

The general process involved closely parallels the general process used by schools in their cross reviews to become accredited.

- 1) The program is to be educational and confidential. All information developed remained in the office and became the property of the reviewee. The results of the review were not used for accreditation or for any punitive action. Again, I restate that the purpose of the review was and is educational.
- 2) The Institute and its Committee coordinated the activities of the program. The review consisted of supplying two CPAs as reviewers for two days at the reviewee's office. We recommended that typical audits, working papers and some unaudited statements be supplied from the work of as many partners as possible. Each reviewer was carefully screened for his competence. In addition, the reviewers for a particular engagement were selected on the basis of being several hundred miles away from the reviewee, being from another state and having no potential competitive

factors. Reviewers who are not part of the program were paid \$100 a day plus expenses. To reap the full benefits of the program, most reviewees will also participate as a reviewer during a subsequent practice review of another firm. The Committee firmly believes as much can be learned by being a reviewer as by being reviewed.

- 3) A standard agreement is executed between the reviewer and reviewee creating an agent relationship and of course spelling out the confidential nature of the work to be performed. At this time a fee was paid (\$375 to be charged in the future).
- 4) Before commencing the review certain initial data was compiled by the reviewee and was supplied to the reviewers so that they could better understand the make-up of the firm.
- 5) The review was conducted by the use of a 50-page written quality review program checklist covering the various requirements of good reporting and of good working papers. The questions were so worded that a "no" answer constituted an unsatisfactory condition. Such unsatisfactory conditions were discussed with the reviewee partners on the final

afternoon of the review. Such discussions are offered in a constructive manner. Because of the nature of the reviewers selected, such comments come from independent professionals not prejudiced by the reviewee's firm policies, personal relations, career ambitions or competitive factors. Truly such advice is difficult to obtain and priceless in nature. The quality review program checklist resulted from a study of interoffice review programs used by regional associations and by national firms. The program was field tested by the Committee members who cross reviewed each others practices. Subsequent reviewers were and will be encouraged to give constructive comments to constantly update the program. Various steps in the program are cross referenced to APB and other pronouncements. The reviewers are supplied sample footnotes covering the over two dozen footnotes which are now required in certain circumstances. The program developed is restricted to profit-seeking companies.

- 6) The program was tested on approximately 12 firms in various parts of the country. The evaluation by reviewers and by reviewees indicated an enthusiastic acceptance of the program. The written quality review checklist is now sufficiently tested that the Committee believes further tests are not needed. The mechanics of the pilot program have been completed and the Committee has designed a workable program.

As with the CPA exam, no perfect scores were observed.

Among deficiencies noted were:

- 1) Failure to include proper footnotes in financial statements.
- 2) Improper wording in accountants' letters resulting in inadvertent non-compliance with SAP 33 and 38.
- 3) Inconsistency between the quality of workmanship under one partner versus another.
- 4) Lack of consistent policy on staff training.
- 5) Insufficient information in working papers although in many cases it was apparent that the work had been done.
- 6) Insufficient quality of work performed by staff personnel even though work performed by partners was excellent. This condition puts

undue importance on the work of the reviewer and/or partner and may lead to oversights in reporting.

- 7) Lack of use of the firm's prescribed audit work program, internal control questionnaires and standard financial statement formats.
- 8) Lack of proper organization of working papers.

The committee discussed the possibility of transferring the program's administration to state societies. Concerning this possibility the following conclusions were reached.

- a) Before a transfer to state societies could be effected, a finished program complete with instructions for its supervision plus all questions of ethics and liability must be answered to the satisfaction of all. (If the program were offered to the states, the Institute should probably continue to offer the program to Institute members of those states which do not take on the program.)
- b) If the program were taken over by the state societies, the Institute should continue to develop review programs for specialized types of audits and to revise the existing review program when appropriate.
- c) The Institute's staffing for the program's administration will need to be expanded.

The chief advantage of transferring the program to the state societies would be that in their administration of it, competent agent-advisors selected from within the state or from a neighboring state, would allow travel costs associated with the program to be reduced thereby reducing the cost of the program's services to principal-participants.

The advantages of maintaining the program with the Institute is that a voluntary program might be more widely accepted if agent-advisors were from other states. If the program is multi-state, the Institute may yet be the more efficient coordinator of the program.

The Institute's Committee on Relations with the Department of Agriculture has asked if the Department of Agriculture could refer individual practitioners doing substandard work on behalf of clients reporting to the Department of Agriculture, to our committee for educational benefits. This request appeared to be within the aims of the Quality Review Program.

Other parties such as the Ethics and the Practice Review Committees of the Institute and the various state societies may also choose to suggest that firms guilty of substandard reporting or auditing procedures engage in this educational activity.

Confidentiality Problem -- The major problem for the program's operation from the point of view of the organized profession deals with the profession's ethics rule concerned with confidentiality.

Initially, the committee agreed that it be suggested that the principal-participant go to the client whose files were to be reviewed and get his permission prior to the commencement of the review. Further committee discussion on this suggestion led to the unanimous conclusion that the requirement to advise clients of the review would probably doom the program because these same clients might be adversaries in future litigation. Another solution considered by the committee was that the principal-participant obtain such permission via an engagement letter; however, many participants do not follow the practice of getting engagement letters.

The committee believes that no participants in the pilot program obtained the client's permission for reviews conducted.

The committee in deliberating this topic was not able to distinguish as to confidentiality propriety in the examination of work papers in pre-merger talks between CPA firms, use of service bureaus in preparation of tax returns and in write-up engagements where names are left on material sent to the service bureau, cooperating groups of independent CPAs having interoffice reviews, etc. from the activity of the Quality Review Program.

We have brought this matter to the attention of the Ethics Division and have been informed that permissive language will be included in the Code revision to make the program operational. There still may be some difficulty however with certain state statutes. After consultation with legal counsel

it is considered prudent to advise CPAs using the Quality Review Program to have local attorneys give an opinion as to state law and the risks involved, where this issue may be a problem. This might be done collectively by state societies.

Conclusion and Recommendation -- As was previously mentioned, publicity efforts undertaken on behalf of the project have generated considerable interest in the service being offered. Based on the limited number of reviews performed; verbal praise of the procedures, methods and objectives of the program indicate that the Quality Review service is definitely beneficial and should be continued.

Institute Board of Directors approved the continuation of the Quality Review Program for one year. Activities of the Quality Review (Advisory) Committee in addition to coordinating reviews will include: requesting Committee on Auditing Procedure to consider the merits of post audit review and make its conclusions known, refining the administration of the program, obtaining principal-participants and agent-advisors, preparing public relations brochures, obtaining an article for The Journal of Accountancy, making general policy for the conduct of an ongoing project and developing audit review programs for specialized organizations.

As with even the best of machines, an occasional tune-up is needed; so it is obvious that even the best accounting firms can profit from periodic independent reviews.

We're offering the opportunity of a confidential in-house review by independent qualified professionals. Firms will now have the opportunity of making certain that their auditing policies for quality are executed and coordinated and are in compliance with current practice. When we consider the evolution of firms, both large and small, the educational process of auditing the turnover of staff and the rapid advancement and requirement of auditing procedures and financial reporting, the quality review becomes part of the new generation and becomes a necessity.