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Russell, Joshua;Armitage, Jack
*Managerial Auditing Journal;* 2006; 21, 1/2; ProQuest Central
pg. 46

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# Peer review effectiveness

## An analysis of potential loopholes within the USA Peer Review Program

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**Abstract**

**Purpose** – To assess peer review effectiveness by identifying potential loopholes that could lead to Type II errors, that is, loopholes that would allow reviewed firms to pass their peer review when they should not pass.

**Design/methodology/approach** – A questionnaire was mailed to a random sample of 500 CPA firms in the USA. A total of 200 responses were received for a 40 percent response rate.

**Findings** – This study found many firms allowed to self-select will select their engagements least likely to contain violations, allowing firms to review engagements selected before submitting them to the reviewer is a problem, 1 percent of respondent firms neglected to fulfill relevant professional standards because the firms felt there was an insignificant chance of the engagements being selected, and 9 percent of respondent firms indicated they had duplicated work papers and may not have actually done required procedures.

**Research limitations/implications** – If improprieties were occurring within respondent firms, those firms could fear some form of backlash from answering the survey truthfully, thus limiting the usefulness of responses received.

**Practical implications** – Many loopholes discussed in this paper are not supported by results showing large percentages of firms violating peer review standards. However, many violations are so significant (e.g. auditor's intentionally violating auditing standards), that even few violations could harm the profession.

**Originality/value** – Prior research has not been extensive in this area and generally surveyed auditors or users of financial statements to obtain their opinion of peer review. This study gathered data on specific problems contained within peer reviews.

**Keywords** Peer review, Auditing, United States of America

**Paper type** Research paper

Managerial Auditing Journal
Vol. 21 No. 1, 2006
pp. 46-62
© Emerald Group Publishing Limited
0268-6902
DOI 10.1108/02686900610634757

The onslaught of recent accounting failures in the United States and other countries has seriously damaged the trust and credibility of the accounting profession in the minds of many. Particularly, the effectiveness of self-regulation within the US assurance industry has once again become a hot topic. Since 1977, the American Institute of Certified Public Accountants (AICPA) has used peer review to monitor assurance quality within the US. The purpose of this study is to assess peer review effectiveness by attempting to identify potential loopholes within peer review that could lead to Type II errors, that is, loopholes that would allow reviewed firms to pass their peer review when they should not pass.

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First, this paper will describe the current US environment of peer review, followed by a review of the prior literature dedicated to assessing peer review effectiveness. Then, the paper will address the research methods employed in the study, the results of the study, and the limitations and conclusions of the study.

## The AICPA Peer Review Program

The American Institute of Certified Public Accountants Peer Review Program has changed significantly since its predecessor, the AICPA Division for CPA Firms, was created in 1977 and created the first peer review standards. This section will discuss the evolution of the AICPA Peer Review Program, the current AICPA Peer Review Program process and some changes recently adopted by the AICPA.

### *Evolution of the AICPA Peer Review Program*

In response to congressional investigations and potential government regulation, the AICPA Division for CPA Firms was created in 1977 to administer quality-enhancing peer reviews (Alam *et al.*, 2000). The Division consisted of two sections, the SEC Practice Section for all firms which audited at least one SEC client and the Private Companies Practice Section for all other firms. Membership in the Division was voluntary, but member firms were required to undergo a peer review every 3 years.

In 1988 and 1989 the AICPA adopted changes to close the gap between those firms which voluntarily enrolled in the Division for CPA firms and those which had not. In response to the AICPA Plan to Restructure Professional Standards, the AICPA membership voted in 1988 to adopt a requirement that all CPA firms not enrolled in the Division for CPA Firms undergo a Quality Review as a condition of the firm's membership in the AICPA. Then in 1989, the AICPA membership voted to adopt a requirement that all AICPA members who participate in the audit of a publicly held company must work for a firm enrolled in the SEC Practice Section.

In 1995, the Quality Review and the Private Companies Practice Section were merged to form the AICPA Peer Review Program. The 1995 changes formed the current structure of the AICPA Peer Review Program. In 2000, the AICPA added a further requirement that all AICPA members in the practice of public accounting in the United States or its territories must be working for a firm enrolled in an approved practice monitoring program or must be individually enrolled in such a program if the firm they work for is not eligible to enroll in such a program.

The AICPA has issued several Questions and Answers documents about its Peer Review Program. Update Number Five (AICPA, 2005a, b) is the current update that outlines the AICPA Peer Review Program.

### *New standards*

In May 2003, the American Institute of Certified Public Accountants issued an Exposure Draft, Proposed Revisions to the AICPA Standards for Performing and Reporting on Peer Reviews (AICPA, 2003). This exposure draft was adopted and became effective January 1, 2005 (AICPA, 2005a, b), with early adoption not allowed. The new standards brought about many changes to the AICPA Peer Review Program.

Previously, reviewed firms were not required to provide the peer reviewer with any representations. The new standards require that all reviewed firms provide a

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representation that the firm has complied with all state regulatory requirements and the firm has submitted a complete list of all engagements subject to peer review.

In addition, the reviewed firm is responsible for submitting any communications received as a result of any investigation within the 3 years proceeding the peer review date. Previously, a reviewed firm may want to exclude certain engagements from the peer review as a result of litigation regarding those engagements, but the new standards indicate that excluding any engagement from the peer review will result in an automatic scope limitation.

The new standards also increase the scope of system reviews. The new system review report now provides an opinion as to whether the reviewed firm has demonstrated the competencies necessary to perform all engagements subject to peer review.

To provide more guidance as to the selection of engagements for peer review, the reviewed firm must provide a list of all engagements subject to review no earlier than 2 weeks before the start of the peer review. Additionally, the peer reviewer is required to select at least one engagement after the review has commenced.

To improve the effectiveness of peer reviews, significant changes to peer review procedures are also required. Peer review procedures now include determining whether the reviewed firm has appropriately identified high-risk areas within engagements and performed and documented the required procedures related to the identified risk areas. Examples of high-risk areas are fraud considerations, use of estimates, and emerging issues.

The latest change in the AICPA Peer Review program is as a result of the Sarbanes Oxley Act of 2002. Section 104 of the Act requires the Public Company Accounting Oversight Board (PCAOB) to conduct inspections of the firms registered with the Board. Because of this, the AICPA established the Center for Public Company Audit Firms Peer Review Program (Center PRP) on January 1, 2004 as the successor to the SEC Practice Section Peer Review Program. The Center PRP is designed to review and evaluate those portions of a firm's accounting and auditing practice that are not inspected by the PCAOB.

The current standards require all AICPA members in the practice of public accounting to either work for a firm enrolled in an approved practice monitoring program or be individually enrolled in such a program. Most AICPA members fulfill this requirement by working for a firm enrolled in the AICPA Peer Review Program or the Center PRP.

*Type of reviews*

All firms enrolled in the AICPA Peer Review Program must undergo one of three types of peer reviews at least once every 3 years. The three different types of peer reviews are system reviews, engagement reviews, and report reviews.

System reviews are the most comprehensive type of peer review. All CPA firms that perform engagements under the Statements on Auditing Standards, the Government Auditing Standards or examinations of prospective financial information under the Statements on Standards for Attestation Engagements must have a system review. In a system review, the peer reviewer will review the CPA firm's quality control policies as well as a cross-section of the firm's accounting and auditing engagements, including work papers. There are no requirements as to the quantity of accounting and auditing

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engagements selected for review, other than that the engagements selected must represent a cross-section of the reviewed firm's accounting and auditing engagements with greater emphasis placed on those engagements with a high peer review risk assessment. When a reviewed firm does not have a formal quality control document or policy, the reviewed firm is required to complete a questionnaire relating to the firm's quality control before the review begins. The completed questionnaire may then serve as the reviewed firm's quality control document.

A system review results in an opinion report for the year under review as to whether the reviewed firm has a system of quality control that is in accordance with the AICPA Statements of Quality Control Standards and whether the reviewed firm is complying with its system of quality control in a way that results in the firm having reasonable assurance that it is complying with all relevant professional standards. Peer reviewers performing system reviews may issue an unmodified, modified or adverse report on the firm's system of quality control. An unmodified report will be issued when the reviewed firm's system of quality control is appropriately designed and being complied with. A modified report will be issued when the reviewed firm's system of quality control is appropriately designed and being complied with "except for" a noted deficiency or deficiencies. An adverse report will be issued when the reviewed firm's system of quality control is not appropriately designed and and/or not being complied with.

Engagement reviews are the second most comprehensive type of peer review. All CPA firms that are not required to have a system review but do not qualify for a report review are required to have an engagement review. In an engagement review, the peer reviewer will review a cross-section of the CPA firm's relevant engagements, including work papers. With regard to engagements selected for review, the peer reviewer must select at least one (when performed) review of historical financial statements, compilation of historical financial statements with full disclosures, compilation of historical financial statements that omits substantially all required disclosures, and attestation engagement. Additionally, the peer reviewer must select at least one engagement from each partner of the reviewed firm.

An engagement review results in a limited assurance report for the year under review as to whether the reviewed firm's financial statements, related accountant's reports and all other related information conform in all material respects with all relevant professional standards. Peer reviewers performing engagement reviews may issue an unmodified, modified or adverse report expressing limited assurance on the firm's submitted reports' conformity with all relevant professional standards. An unmodified report will be issued when the reviewed firm's conformity with all relevant professional standards is appropriate. A modified report will be issued when the reviewed firm's conformity with all relevant professional standards is appropriate "except for" a noted deficiency or deficiencies. An adverse report will be issued when the reviewed firm has pervasive or significant departures from any relevant professional standards.

Report reviews are the least comprehensive type of peer review. All CPA firms that perform compilations that omit substantially all disclosures as their highest level of service are allowed to have a report review. In a report review, the peer reviewer will review a cross-section of the CPA firm's relevant engagements, including work papers. With regard to engagements selected for review, the peer reviewer must select at least

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one of the compilations of historical financial statements that omit substantially all required disclosures. Additionally, the peer reviewer must select at least one engagement from each partner of the reviewed firm.

A report review results in a report listing comments and recommendations as to whether the reviewed firm's financial statements, related accountant's reports and all other related information appear to conform to all relevant professional standards. Peer reviewers performing report reviews do not express any form of assurance and thus may only issue a report listing comments and recommendations.

*Time period and administration*

Peer reviews in the AICPA Peer Review Program generally cover the 1-year period ending on a date mutually agreed upon by the firm under review and the peer reviewer. This typically results in all relevant engagements having a report issued within the 1-year period preceding the date the peer reviewer begins the review becoming part of the pool of engagements eligible for the peer reviewer to select for review.

The AICPA Peer Review Program is generally administered through the state CPA societies. The administering entities must have a peer review committee that is responsible for administering the AICPA Peer Review Program. Firms undergoing a peer review must communicate the peer review arrangement with the peer review committee, as it is the administering entity that is entrusted with ensuring that the peer review is performed in accordance with the Standards for Performing and Reporting on Peer Reviews. Once a peer review has been completed, the reviewed firm is required to supply the peer review committee with a copy of the report and/or letter of comments. When a letter of comments is issued, the reviewed firm is required to submit to the peer review committee a letter of response outlining any necessary corrective measures. The letter of response must be approved by the peer reviewer before it is submitted to the peer review committee. When deficiencies are reported by the peer reviewer, the peer review committee will require the reviewed firm to take corrective measures and may require the reviewed firm to agree to other actions, such as the submission of a monitoring report or a revisit by the reviewer.

The AICPA Peer Review Program allows CPA firms to self-select their peer reviewer. The three types of available peer reviewers, referred to as peer review teams, are a Firm-On-Firm Review, a Committee-Appointed Review Team (CART) Review or an Association Review. CART Reviews are performed by a review team assembled by the administering entity and Association Reviews are performed by a review team assembled by the association. Most CPA firms, however, select another qualified CPA firm (Firm-On-Firm Review) to perform the peer review. All CPA firms that have been approved through the AICPA Reviewer Database are qualified to perform peer reviews through the AICPA Peer Review Program.

*Qualifications for peer reviewers*

There are four general qualifications for a peer reviewer to be listed on the AICPA Reviewer Database. The first qualification is that the peer reviewer be a licensed CPA that is a member of the AICPA in good standing and practicing for a firm enrolled in the AICPA Peer Review Program or the SEC Practice Section that has received an unmodified report on its system or engagement review. This qualification excludes those who practice for an enrolled firm that receives a report review. The second

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qualification is that the peer reviewer possesses current knowledge of all applicable professional standards. The third qualification is that the peer reviewer has spent, at a minimum, the last 5 years practicing public accounting in the accounting or auditing function. The fourth qualification is that the peer reviewer is practicing as a partner, manager or equivalent supervisory role.

In addition to the four general qualifications, there are additional qualifications for peer reviewers performing an engagement review or acting as a team captain for a system review. To qualify as a peer reviewer for an engagement review, the peer reviewer must also complete an applicable AICPA training course. To qualify as a team captain for a system review, the peer reviewer must practice for a firm that has received an unmodified report on it system review. This qualification excludes those who practice for enrolled firm that receives an engagement or report review. Additionally, a team captain for a system review must also complete an applicable AICPA training course.

## Review of literature

Prior research has attempted to determine the effectiveness of peer reviews through various research methods, although it is not an area that has been highly studied. The prior research has generally attempted to gain an overall understanding of the effectiveness of peer reviews, rather than attempting to identify previously unidentified specific problems contained within peer reviews. This section will identify and briefly describe the prior published research relating to peer review effectiveness.

Wallace (1988) surveyed firms that had either chosen not to join the AICPA Division for CPA Firms after making an inquiry or had withdrawn from the Division as of 1983 to analyze the firms' reasoning. The findings of the study indicated that the majority of firms chose not to have membership in the Division because peer reviews were not cost-beneficial, with a variety of specific reasons being cited for a negative cost-benefit ratio.

Evers and Pearson (1989) analyzed the 1986 and 1987 peer review findings for SEC Practice Section members documented in letter of comments available through a Public Oversight Board database. Their research involved analyzing the outcome of peer reviews and identifying the most common deficiency findings. Based on the common deficiency findings identified, the authors identified areas that present opportunities for reviewed firms to improve their peer review outcomes and, ultimately, the quality and effectiveness of their engagements.

Wallace (1991) analyzed the public peer review files of SEC Practice Section members from January 1, 1980 through March 31, 1986. The peer review findings, report types and the attributes of the peer reviewer and reviewed firm were codified to analyze whether the peer review process contained moral hazards relating to the peer reviewer, potential selection biases, timeliness of completing peer reviews and the changing (or lack thereof) substantive nature of peer review findings. The one significant relationship that was found was that large firm (classified as Big 15) peer reviewers and reviewed firms took longer to file their peer review report. No other statistically significant relationship was found between the categories that were identified, suggesting that the peer review process is reliable, specifically with regard to the moral hazards identified previously.

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File *et al.* (1992) examined peer review as a factor influencing the perception of a firm's quality. They surveyed bankers' and auditors' perceptions of the impact of peer review, firm size, and industry expertise on judgments of auditor credibility. Based on discriminant analysis, they concluded it is unlikely that mandatory peer review or other quality control measures could or will eliminate size considerations from substantially affecting perceptions of auditor credibility.

McCabe *et al.* (1993) randomly surveyed Division for CPA Firms members managing partners to analyze the managing partners' perception of peer reviews and the relative cost versus benefits associated with peer reviews. The findings of the study indicated that the costs of peer review are significant, while few membership benefits accrue from having a peer review. Specifically, managing partners did not agree that peer review increased their firm's ability to detect material misstatements, improve profits or increase referrals. Despite these findings, the overall attitude of managing partners was favorable towards peer reviews. Specifically, managing partners felt that peer reviews helped their firms to comply with professional pronouncements, increased confidence in practices and procedures and improved their firm's quality control, morale and prestige. The overall findings of the study suggested that peer reviews are worthwhile but need some changes so that the benefits clearly outweigh the costs.

Elsea and Stewart (1995) randomly surveyed Colorado firms that were members of either the SEC Practice Section, Private Companies Practice Section and/or Quality Review. The findings of the study indicated that the firms found peer review to be beneficial, however, the majority of firms felt that peer review costs outweigh the benefits and that their firms had not significantly improved quality as a result of peer review.

Ehlen and Welker (1996a) randomly surveyed firms that were members of the Private Companies Practice Section as well as firms that were members of the SEC Practice Section to analyze the correlation between the firms' perception of the decision-making procedures used by the AICPA to establish peer review and firms' perception of the AICPA and their peer reviewer. The findings of the study indicated a positive correlation between the firms' perception of the fairness of the AICPA decision-making procedures for establishing peer review and the firms' perception and commitment to the AICPA. The findings also indicated a positive correlation between the firms' perception of the fairness of the AICPA decision-making procedures for establishing peer review and the firms' perception and trust in their peer reviewer. The overall findings of the study suggested that the AICPA should give firms affected by new peer review policy decisions a greater voice in the formulation and adoption of those procedures to increase the probability that firms will view the AICPA and their peer reviewer in a positive light, which should increase the effectiveness of peer review.

Ehlen and Welker (1996b) randomly surveyed peer-reviewed firms that were members of the AICPA to analyze members' cost concerns, acceptance of the peer review process, perception of the fairness of peer reviews and acceptance of the timing of the peer review cycle. The findings of the study indicated that the majority of peer-reviewed firms found peer reviews to not be cost-beneficial, with even more agreement among smaller firms that peer reviews were not cost-beneficial. Additionally, the majority of the surveyed firms felt that peer reviews were fair and would not consider resigning from the AICPA to escape peer reviews. However, only

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small firms felt that the 3-year peer review cycle was too short, while large firms felt that the cycle was appropriate.

Alam *et al.* (2000) randomly surveyed four different SEC Practice Section user constituencies to analyze the users' perceptions of peer review. The four constituencies surveyed were SEC Practice Section member firms, audit clients, bankers and financial analysts. The authors identified six primary goals of peer review and asked the respondents to rank the goals' importance on a seven-point Likert scale followed by a ranking of the constituents' perception of the effectiveness of the most important goal identified. The majority of constituents identified either the improvement of audit practices or self-regulation as the primary goal of peer review and perceived that peer review was effective with regard to these two goals. However, the other four goals, reducing audit failures, detecting audit fraud in financial statements, enhancing the public image and reducing government criticism of the profession were not perceived by a majority of all four constituent groups to be effective. Additionally, a majority of the constituent groups' perceived peer review to not be fully understood by most stakeholders.

**Research methods**

A questionnaire was mailed to a random sample of peer-reviewed firms in October 2003 and second requests were mailed approximately 3 months later. To ensure that a representative cross-section of all peer-reviewed firms was obtained, a random sample of 500 CPA firms with AICPA membership was generated. Because all AICPA member firms must participate in either the SEC Practice Section or the AICPA Peer Review Program, a sample from the population of AICPA member firms would be the most representative sample of peer-reviewed firms available. The random sample was obtained from the AICPA.

The questionnaire contained seven yes-no research questions that identified actions that could be constituted as peer review loopholes and requested a response as to whether any person in the respondent firm had or had not participated in such action at any time. The questionnaire is included in the Appendix to this paper. The questions were developed from personal experience and consultation with practicing CPAs that conduct peer reviews. Although the questionnaire was designed to identify actions taken or not taken by all employees and representatives of the respondent firm, it was expected that only one individual would complete the questionnaire. Accordingly, the questionnaire was addressed to the managing partner of the respondent firm but requested that the questionnaire be directed to and completed by someone in the respondent firm who was actively involved with the firm's most recent peer review.

The first two research questions identified actions that would allow a reviewed firm to submit a list of engagements eligible for peer review that was incomplete. The first survey question asked the respondent firm whether the firm had, at any time, deliberately omitted one or more engagements eligible for peer review from the list of engagements submitted to the peer reviewer. The second question asked the respondent firm whether the firm had, at any time, inadvertently omitted one or more engagements eligible for peer review from the list of engagements submitted to the peer reviewer.

The third and fourth questions identified actions that would allow a reviewed firm to omit engagements eligible for peer review from the engagements selected for review

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by the peer reviewer. The third question asked the respondent firm whether the firm's peer reviewer had, at any time, allowed the firm to self-select engagements to be reviewed. The fourth question asked the respondent firm whether the firm had, at any time, self-selected the engagements least likely to receive negative peer review comments when the firm was allowed to self-select engagements to be reviewed.

The fifth question identified actions that would allow a reviewed firm to make changes to engagements selected for peer review by the peer reviewer. The question asked the respondent firm whether the firm had, at any time, reviewed any of the engagements selected for peer review before submitting the engagements to the peer reviewer.

The sixth question identified actions that would allow a reviewed firm to not follow relevant professional standards and still receive a clean peer review. The research question asked the respondent firm whether the firm had, at any time, neglected to fulfill any relevant professional standards on any engagement because the firm believed that the engagement had a low or nonexistent chance of being selected for peer review by the peer reviewer.

The seventh question identified actions that would allow a reviewed firm to perform documented procedures for multiple engagements only once for those engagements. The research question asked the respondent firm whether the firm had, at any time, completed work papers on any engagement that were copied for use on other engagements.

The questionnaire also contained demographic questions on which peer review programs the respondent firm was a member of, how recent the respondent firm's most recent peer review was performed and the type of peer review performed (system, engagement, report or other), size of the respondent firm, position within the firm of the respondent individual and years of service with the respondent firm for the respondent individual.

## Results

A total of 133 responses to the first mailing were received, yielding a 26.6 percent response rate, and 67 responses to the second mailing, a 13.4 percent response rate. The 200 total responses were a 40 percent total response rate. Although this response rate was significantly lower than the 68.4 percent response rate of McCabe *et al.* (1993) questionnaire sent to a sample from a similar population, it was satisfactory response rate for survey research. Due to incomplete questionnaires and some respondent firms that had not yet undergone their first peer review, the number of firms answering the seven research questions ranged from 138 to 182.

### *Profile of respondent firms and individuals*

As shown in Table I, most (180 or 90.0 percent) of the respondent firms received their most recent peer review as a member of the AICPA Peer Review Program, while three respondent firms were members of the SEC Practice Section, and 11 respondent firms were members of a peer review program sanctioned by the firm's state board of accountancy.

The mean and median time since the respondent firms received their most recent peer review was 1.5 years. As expected, no respondent firm had received their most recent peer review more than 3 years prior to completing the questionnaire.

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| Panel A: Respondent firms | | | Panel B: Respondent individuals | | |
|---|---|---|---|---|---|
| Sample size | 500 | | Total usable responses | 200 | |
| Responses | | | Title/position | | |
| First mailing | 133 | 26.6 percent | Partner/director/sole proprietor | 193 | 96.5 percent |
| Second mailing | 67 | 13.4 percent | Senior | 1 | 0.5 percent |
| Total | 200 | 40.0 percent | Other | 2 | 1.0 percent |
| Total usable responses | 200 | | Missing | 4 | 2.0 percent |
| Peer review program | | | Number of years with firm | | |
| AICPA Peer Review Program | 180 | 90.0 percent | Mean | 17.1 years | |
| SECPS | 3 | 1.5 percent | Median | 17 years | |
| State Board QAR | 11 | 5.5 percent | | | |
| None | 6 | 3.0 percent | | | |
| Time since last review | | | | | |
| Mean | 1.5 years | | | | |
| Median | 1.5 years | | | | |
| Type of review | | | | | |
| System review | 71 | 35.5 percent | | | |
| Engagement review | 53 | 26.5 percent | | | |
| Report review | 58 | 29.0 percent | | | |
| Other review | 2 | 1.0 percent | | | |
| None | 16 | 8.0 percent | | | |
| Size of firm | | | | | |
| Midsize ($25-$250 million annual revenue) | 1 | 0.5 percent | | | |
| Small (less than $25 million annual revenue) | 194 | 97.0 percent | | | |
| Missing | 5 | 2.5 percent | | | |

**Table I.**
Profile of respondent firms and individuals

The type of peer review received by respondent firms was fairly evenly distributed, with 35.5 percent of the respondent firms receiving a system review, 26.5 percent receiving an engagement review, 29 percent receiving a report review.

All but one respondent firm classified themselves as a small (less than $25,000,000 in annual revenue) firm. Ninety-six and one-half percent of the respondent individuals classified themselves as a partner, director, or sole proprietors, with one respondent individual classifying him/herself as a senior, and two others classifying themselves as office managers. The mean number of years that the respondent individual was affiliated with the firm was 17.1, with a median number of years of 17, thus indicating that all respondents are experienced auditors.

*Analysis of research questions*

Research questions 1 and 2 received few positive responses. Only 2.5 percent of respondent firms indicating they had deliberately omitted one or more engagements eligible for peer review from the list of engagements submitted to the peer reviewer.

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Slightly less (1.0 percent) of respondent firms had inadvertently omitted one or more engagements eligible for peer review from the list of engagements submitted to the peer reviewer.

Research questions 3 and 4 received many positive responses. More than 17.5 percent of respondent firms acknowledged that the firm's peer reviewer had allowed the firm to self-select engagements to be reviewed. Of those firms that were allowed to self-select engagements to be reviewed, 42.9 percent self-selected the engagements least likely to receive negative peer review comments.

Research question 5 received the most positive responses of any research questions. Nearly half (40.0 percent) of respondent firms had reviewed engagement working papers selected for peer review before submitting the engagements to the peer reviewer.

Research question 6 received the least positive responses of any research question. Only 1.0 percent (two respondents) of respondent firms had neglected to fulfill any relevant professional standards on any engagement because the firm believed that the engagement had a low or nonexistent chance of being selected for peer review by the peer reviewer.

Research question 7 received a relatively small amount of positive responses. Only 9.0 percent of respondent firms completed work papers on an engagement that were copied for use on other engagements. Table II presents summary statistics for the research question responses.

Table III presents an analysis of the research questions by type of review performed. The results of Chi-square testing indicate the only significant difference ($p = 0.013$) for the variable "Peer reviewer allowed engagement self-selection." All other variables are not significant at either the 0.05 or 0.10 levels. Significant differences to responses by the type of review performed would indicate that firms are taking greater advantage of the rules for that type of peer review compared to the other types of peer reviews.

## Conclusions

The purpose of this study is to identify potential loopholes within peer review that could lead to Type II errors, that is, loopholes that would allow reviewed firms to pass

**Table II.** Research question responses

| | Yes | | No | | Missing | |
|---|---|---|---|---|---|---|
| | No. | Percent | No. | Percent | No. | Percent |
| (1) Deliberately omitted engagements from engagement list | 5 | 2.5 | 164 | 82.0 | 31 | 15.5 |
| (2) Inadvertently omitted engagements from engagement list | 2 | 1.0 | 167 | 83.5 | 31 | 15.5 |
| (3) Peer reviewer allowed engagement self-selection | 35 | 17.5 | 134 | 67.0 | 31 | 15.5 |
| (4) Self-selected the "best" engagements | 15 | 7.5 | 124 | 62.0 | 61 | 30.5 |
| (5) Reviewed selected engagements for errors | 80 | 40.0 | 88 | 44.0 | 32 | 16.0 |
| (6) Neglected to fulfill professional standards | 2 | 1.0 | 181 | 90.5 | 17 | 8.5 |
| (7) Duplicated work papers | 18 | 9.0 | 164 | 82.0 | 18 | 9.0 |

Total responses: 200

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| Research question | Response | Type of review Systems | Engagement | Report | $\chi^2$ | $p$ |
|---|---|---|---|---|---|---|
| (1) Deliberately omitted | Yes | 1 | 2 | 2 | | |
| engagements from engagement list | No | 64 | 47 | 50 | 0.870 | 0.833 |
| (2) Inadvertently omitted | Yes | 1 | 0 | 1 | | |
| engagements from engagement list | No | 64 | 49 | 51 | 0.919 | 0.821 |
| (3) Peer reviewer allowed | Yes | 6 | 11 | 17 | | |
| engagement self-selection | No | 59 | 38 | 35 | 10.849 | 0.013 |
| (4) Self-selected the "best" | Yes | 3 | 6 | 6 | | |
| engagements | No | 51 | 35 | 35 | 3.017 | 0.389 |
| (5) Reviewed selected engagements | Yes | 28 | 27 | 23 | | |
| for errors | No | 36 | 22 | 29 | 1.722 | 0.632 |
| (6) Neglected to fulfill professional | Yes | 1 | 1 | 0 | | |
| standards | No | 70 | 52 | 56 | 1.010 | 0.799 |
| (7) Duplicated work papers | Yes | 8 | 7 | 3 | | |
| | No | 63 | 45 | 52 | 2.304 | 0.512 |

**Table III.** Chi-square analysis by type of review

their peer review when they should not pass. Arguably, one of the best methods to test whether the identified loopholes are occurring would be to re-review a sample of peer reviews. This method not being feasible, a questionnaire was sent to a sample of reviewed firms to solicit their responses. The selected research, while much more practical, contains some limitations.

The most significant limitation of this study is the potential for respondent bias. The sample may not be representative of all firms receiving peer reviews. Further, if improprieties were occurring within any respondent firms, those respondent firms could conceivably fear some form of backlash from answering the questions truthfully, thus limiting the usefulness of the responses received. Despite the study's limitations, however, the positions and tenure of the respondent individuals indicate that those individuals should be quite aware of the firm's peer review activities.

Although the responses to research questions 1 and 2 indicate that submitting incomplete engagement lists is not a widespread problem, users of audited financial statements and the accounting profession would benefit from bringing the number of firms submitting incomplete engagement list closer to zero. Indeed, the AICPA's (2005a, b) revisions to the standards, which are a step in the right direction, will require reviewed firms to provide a representation that the submitted engagement list is complete. Requiring reviewed firms to provide representation as to the completeness of submitted engagement lists should work to discourage firms from deliberately omitting engagements eligible for peer review from engagement lists submitted to peer reviewers. Reducing inadvertent omissions of applicable engagements from engagement lists will most likely not be reduced by requiring a representation as to the completeness of engagement lists, however. To reduce inadvertent omissions, practitioners must be better educated as to the types of engagements that are susceptible to peer review. Particularly, since most respondent firms that have inadvertently omitted applicable engagements from engagement lists may not have answered the second question in the affirmative because they have not yet become aware of their inadvertent omissions, the actual number of firms inadvertently

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omitting applicable engagements from engagements lists is almost certainly higher than the 1.0 percent reported. Additionally, it is possible that when a firm believes an engagement is not applicable to peer review, it is also believed that the engagement is not applicable to certain professional standards either.

Allowing firms to self-select engagements is certainly an area of peer review that needs to be researched further. The results of this study indicate that a significant amount of firms that are given the option of self-selection choose to self-select the "best" engagements. In reality, it is hard to believe that any firm allowed to self-select engagements for peer review would not self-select the "best" engagements. In fact, anecdotal evidence reported to the authors indicated that an auditor chose not to fulfill a particular professional standard on an engagement because that auditor knew the firm would be able to keep the engagement from being peer reviewed due to the firm's peer reviewer allowance of engagement self-selection. As long as this type of situation is allowed to occur, the peer review system will not be as effective as it could be.

Allowing firms to review engagements selected for peer review before submitting them to the peer reviewer is another area of the peer review process that merits further research. Some professionals may argue that allowing firms to review engagements selected for peer review before submitting them actually improves the quality of the firms' engagements because it provides the firm with upfront feedback on errors that are occurring. However, it also presents the opportunity for firms to perform substandard quality if firms know that the engagements selected for peer review can simply be "cleaned up" before they are peer reviewed. This is not the type of opportunity that financial statement users and the profession should be comfortable with and hopefully the results of this study provide impetus for further research.

The two (1 percent) respondent firms that neglected to fulfill relevant professional standards because the firms felt there was an insignificant chance of the engagements being selected for review may seem of limited concern; however, this response provides *prima facie* evidence of a Type II error occurring (assuming the firm passed their peer review). This loophole is the most serious problem with peer review. One of the most important purposes of peer review is to ensure that firms are complying with professional standards and the profession must work to ensure that the current peer review system does not allow standards violators to slip through the cracks. Several comments received from respondents with the returned surveys indicated that they felt most firms were acutely aware that the current peer review system provides a 2-year window for performing substandard work by subjecting to peer review only the engagements performed within the year prior to the peer review. If all engagements performed since the last peer review were subjected to peer review, reviewed firms would conceivably be less likely to perform substandard work during the "2-year window."

Nine percent of the respondent firms indicated they had duplicated work papers and used them in subsequent audits. One peer reviewer with a local firm that was interviewed by the authors indicated he is particularly concerned that some firms he is aware of have completed documentation for engagements but were not actually doing the procedures required because work papers were simply duplicated and incorporated into the files of multiple engagements. In effect, these firms are adhering to the form of

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the professional standards while not adhering to the substance of those standards. This particular activity would be a tough activity to curb; however, it is an issue that needs to be addressed because it points to the possibility of other activities where substance is disregarded for form.

This study presented survey research data and is intended to bring peer review loopholes to the profession's attention so further research and analysis will be performed. While many of the loopholes discussed in this paper are not supported by results showing large percentages of firms violating the substance of the peer review standards, these results indicate there are serious problems in the peer review process. Many of the violations are so significant (e.g. auditor's intentionally violating auditing standards), that even few violations could harm the profession. Perhaps, it is time for the profession to consider making peer review more punitive in nature rather than educational and remedial. While it is important for practicing auditors that violate the standards to be well educated with regard to the standards of peer review, the findings of this study suggest that some auditors will take advantage of available loopholes in the standards, which defeats the spirit of the peer review system. In these cases, if the standards contained penalties, auditors may be less inclined to take advantage of the system which would benefit the entire profession.

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## Further reading

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## Appendix. Survey instrument

Please answer the following questions. Please select only one choice, unless the question specifically asks you to select all choices that apply. *Remember that your answers are completely confidential.*

(1) Of which peer review program(s) is your firm a member? Please check all that apply. If you check "other," please describe your position.

AICPA/State Society.______
SECPS. . . . . . . . . . . . . . . ______
State Board QAR. . . . . ______
Other. . . . . . . . . . . . . . . . . ______ Describe ______________________
None. . . . . . . . . . . . . . . . . ______

(2) How long ago was your firm's most recent peer review performed (rounded to the nearest half year)?__________

(3) During your firm's most recent peer review, which type of review was performed? Please check the appropriate category. If you check "other," please describe your position.

System review. . . . . . . . . ______
Engagement review . . . . ______
Report review. . . . . . . . . ______
Other. . . . . . . . . . . . . . . . . . . ______ Describe ______________________
Not applicable. . . . . . . . . ______

(4) How would you classify the size of your firm? Please check the appropriate category.

Large firm ($250 million + in sales). . . . . . . . . . . . . . ______
Midsize firm ($25 to $250 million in sales). . . . . . ______
Small firm (up to $25 million in sales). . . . . . . . . . ______

(5) How would you classify your title/position within the firm? Please check the category that best fits your position. If you check "other," please describe your position.

Partner/director. . . ______
Manager. . . . . . . . . . . ______

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Senior.................______

Staff.................______

Other.................______ Describe ______________________

(6) How many years have you worked at the firm (rounded to the nearest half year)? ______

The remaining questions ask for a response as to whether your firm has done the activity in question. When responding, please only consider the activities that you have direct knowledge of or that have been verified by you or someone else.

(7) When submitting to the peer reviewer(s) your firm's list of engagements subject to peer review standards, has your firm ever omitted any engagements from the list because your firm knew that the engagement(s) would have a high likelihood of causing the peer reviewer(s) to issue a qualified or adverse report?

Yes.................______

No.................______

(8) When submitting to the peer reviewer(s) your firm's list of engagements subject to peer review standards, has your firm ever omitted any engagements from the list because, at the time, your firm was not aware that the engagement(s) was subject to the peer review standards, including engagements which should have included an accountant's report but did not?

Yes.................______

No.................______

(9) During any peer review, has the peer reviewer(s) allowed your firm to select one or more engagements to be reviewed, including allowing the firm to select an engagement(s) from a list of possible engagements?

Yes.................______

No.................______

(10) If you answered yes to question 9, did your firm select the engagement(s) that was most likely to receive the fewest negative peer review comments?

Yes.................______

No.................______

Not applicable.....______

(11) When the peer reviewer(s) has given you the list of engagements to be peer reviewed, did your firm review the engagements for any errors prior to submitting the engagements to the peer reviewer(s)?

Yes.................______

No.................______

(12) During any engagement subject to peer review standards that you have worked on, has anyone on the engagement team ever neglected to fulfill any relevant standards because they believed the engagement had a low or nonexistent chance of being selected for review during the next peer review?

Yes.................______

No.................______

(13) Has your firm completed any work papers (including programs and checklists) that were duplicated for other engagements? An example might be completing a planning program

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for an audit of a city and making copies of the program for the work papers for an audit of a different city.

Yes. . . . . . . . . . . . . . . . . .______

No. . . . . . . . . . . . . . . . . . .______



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