

**SWP 18/97 SECURING QUALITY AUDIT(OR)S: ATTEMPTS
AT FINDING A SOLUTION IN THE UNITED
STATES, UNITED KINGDOM, CANADA AND NEW
ZEALAND**

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**SECURING QUALITY AUDIT(OR)S: ATTEMPTS AT FINDING A
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by

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SUMMARY

As a response to widespread criticism of auditors and the threat of government intervention in the profession's affairs, the professional bodies in the United States, United Kingdom, Canada and New Zealand (and elsewhere) have established peer review schemes to monitor auditors' performance. These schemes share a common rationale, objective and orientation but they differ in respect of the reviewee, reviewer, frequency of review visits, scope, confidentiality of review reports, public representation, and funding.

Despite their differences, the schemes' outcomes are very similar. In each case, the initial reviews found a high incidence of non-compliance with the profession's standards, particularly in terms of audit planning, control and, especially, documentation. Later reviews have noted a marked improvement in the quality of audit work. Further, the monitoring process is eliminating auditors who persistently fail to comply with the profession's standards. However, to restore public confidence in the profession, public representation in the review process is essential.

Key words: Monitoring auditors' performance, components of peer review, outcomes of peer review

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INTRODUCTION

The primary function of any profession is to offer service to the public in a specialised field of learning (e.g. O'Leary and Boland 1987; Benson 1980). However, because a profession's services are specialised, users of those services are usually not able to judge their quality. As a consequence, market forces cannot be relied upon to ensure that users of the services are well served and some form of regulation is needed (RRIWP 1996). Given the specialised nature of a profession's services, it is generally accepted that the profession itself—or the profession's governing body—is best equipped to evaluate work performed by, and thus to regulate, its members. However, no profession has an unquestioned right to self-regulation. It must demonstrate it can regulate its members effectively or risk losing public confidence in its regulatory mechanisms—and risk losing the associated privileges and responsibilities (RRIWP 1996). As Mautz (1983) has noted: “in return for privileges, society demands superior performance, high ethical behaviour, and very rare failures. Absent society's satisfaction and the profession's privileges are endangered.”

Flint (1988), referring to the auditing profession, focused on the importance of regulation to protect the public interest. He stated: “In a profession whose authority is dependent among other things on public confidence and whose social function requires a commitment to the public interest, a demonstrable concern, individually and collectively, ...to control and maintain the highest quality of audit work, is a matter of basic principle. ...It is necessary to demonstrate to the public that the auditing profession ...controls and maintains the quality of its work”. To Flint (1980), the key issue is minimising the prospect of audit failure. After noting that this is what society expects, he asserts: “this is what the professional

accountancy bodies as the regulatory authority have an obligation to pursue in the public interest”.

Yet, reports of audit failures abound. In 1986, Connor, Chairman of Price Waterhouse in the United States (U.S.), stated that the auditing profession faced “a liability crisis and a credibility crisis” (reported by Russell 1986) and, given the \$US180 million of damages awarded against the Big 8 international accountancy firms between 1980 and 1985, Connor’s claim seems well-founded. Reference to the news media reveals that the crises have not abated. In July 1994, audit firms in the U.S. alone faced liability claims of \$US30 billion and settlements in 1994 included \$US312 million by Deloitte and Touche in a case involving U.S. Federal regulators and \$US12 million by Horwath & Horwath in relation to their audit of the Australian National Safety Council (Economist 1994). Similarly, in 1995 in the United Kingdom (U.K.), damages of £105 million were awarded against the former BDO Binder Hamlyn partnership for their negligent audit of Britannia Security Group’s 1989 financial statements (Accountancy 1996). Deficient audits clearly have adverse consequences for the auditors concerned but, additionally, reports of such audits serve to fuel criticism of auditors and undermine public confidence in the profession as a whole.

Faced by widespread and often scathing criticism of auditors, and conscious of their responsibility to ensure that high quality audits are performed, accountancy bodies in many parts of the world have established mechanisms to monitor the performance of their members. This paper describes and compares the monitoring mechanisms, or peer review schemes, established in the U.S., U.K., Canada and New Zealand (N.Z.). More specifically, it defines peer review¹, identifies its rationale, key objective and orientation, examines differences in the schemes established in the countries named above, and discusses their effectiveness.

DEFINITION, OBJECTIVES AND RATIONALE OF PEER REVIEW

A definition of peer review, which captures the essence of the schemes established in the U.S., U.K., Canada and N.Z., is as follows: "A peer review is an assessment of an accounting firm's (or practitioner's) audit and/or other professional engagement procedures by one or more independent reviewers who come from within the accountancy profession. The reviewer(s) evaluate the adequacy of the accounting firm's (or practitioner's) quality control system" (adapted from Schiel 1991, 61).

Like the definition, the motives underlying peer review are common to the schemes established by the various professional bodies. Three related motives may be distilled from the Introduction above, namely, (1) to ensure auditors meet their obligation to society to provide professional work of the highest quality; (2) to sustain public confidence in the profession by demonstrating a concern for maintaining high standards of professional work; (3) to avoid the adverse consequences of sub-standard work and loss of public confidence. A review of professional literature reveals a fourth motive—that of demonstrating to the public, and more particularly the government, that the professional body is discharging satisfactorily its self-regulatory responsibilities. The New Zealand Society of Accountants (NZSA 1989b) notes, for example: "The successful introduction of Practice Review will help to illustrate that self regulation is a better proposition than direct control from the government. The Society must initiate programmes such as Practice Review to maintain the confidence of the public and the government alike". Similarly, in relation to peer review in the U.S., Cook and Robinson (1979) state: "AICPA leadership hoped that a strong self-regulatory program ...would satisfy the profession's critics in Congress who were calling for direct government regulation."

Given the similarity of the rationale underlying peer review in the various countries, it is not surprising that the key objective is also similar. In each case, it is to monitor the performance of members of the profession to ensure they are complying with the profession's

auditing (and other relevant) standards (e.g. Wallace 1991; Kemp 1993; ICAA 1994a). The schemes are also similar in their orientation: each of the professional bodies has emphasised that peer review is designed to be educational, not punitive. To reinforce the point, they have drawn attention to the distinction between the committee responsible for peer review and those responsible for investigations and discipline (e.g. ICAEW et al. 1992; NZSA 1989b; ICAA 1994a).

PEER REVIEW IN THE U.S., U.K., CANADA AND N.Z.

Despite sharing a common rationale, objective and orientation, as is shown below, significant differences exist in the operation of peer review in the U.S., U.K., Canada and N.Z.

United States

Peer review in the U.S., in its present form, was introduced as a response to searing attacks on the auditing profession by the Moss and Metcalfe Committees and the spectre of government regulation of the profession had been raised. In 1977, the AICPA established a Division for CPA firms with two sections: a Securities and Exchange Commission (SEC) Practice Section (SECPS) and a Private Companies Practice Section (PCPS). In order to qualify for membership of either section, all of the firm's owners who are eligible for AICPA membership must be members, and a majority of the firm's owners must be AICPA members. Additionally, the firms must agree, inter alia, to subject their audit practices to peer review once every three years, to ensure their personnel meet minimum standards of continuing professional education, and to maintain minimum amounts of liability insurance (Wood and Sommer 1985). The AICPA also established an independent Public Oversight Board (POB) to oversee the activities of the SECPS. This Board oversees every peer review performed within

the Section and reports to the SEC and the public on its evaluation of the effectiveness of the Section's self-regulatory efforts (Cook and Robinson 1979).

Until 1989, joining the AICPA's Division of CPA firms was voluntary but, in that year, it became obligatory for all firms with AICPA members who engage in audits or other reporting assignments to join one of the sections of the Division of CPA firms or the newly established Quality Review Program.² In either case, the firm's membership requirements and quality controls are subject to peer or quality review at least once every three years. The key difference between the review programs is that, while peer review is intended to be "preventive" in nature (Wood and Sommer 1985), the thrust of quality review is "educational, rehabilitative and correctional" (Accountancy 1987). Thus, peer review is more exacting than quality review.

All firms with AICPA members are required to have a quality control system for their accounting and auditing practices which complies with the AICPA's *Statement of Quality Control Standards No.1: System of Quality Control for a CPA Firm*. This Standard embodies nine elements covering independence, consultation (ensuring assistance is sought when necessary), assignment of personnel to engagements, supervision, hiring, professional development, advancement (ensuring all levels of responsibility are filled by competent staff members), acceptance and continuance with clients, and inspection (conducting periodic internal reviews of the firm's quality controls). Peer and quality reviews focus on the adequacy of, and compliance with, the CPA firm's quality controls for each of the nine elements.

The reviews are conducted, at the reviewee's option, by either a review team appointed by the SECPS or PCPS peer review committee or the quality review committee (as applicable), or by another CPA firm. Where the reviewee elects to be reviewed by another firm, the firms must be independent of each other and reciprocal reviews are prohibited.

Further, where the reviewee is a member of the SECPS, a quality control review panel (of one to three members) is appointed by the SECPS review committee to oversee the review.

The review team reviews the reviewee's quality control documents, assesses whether the policies and procedures are appropriate to the size and nature of the firm and whether they are adequately documented and communicated to professional staff within the firm. The team also tests compliance with the documented policies and procedures by interviewing those responsible for the firm's quality control functions, interviewing other staff members, reviewing personnel and administration files, and reviewing accounting and auditing engagement working papers and reports.

At the conclusion of the review, the review team discusses its findings with appropriate people in the firm. In particular, it highlights deficiencies found in the firm's quality controls and instances of non-compliance. The review team writes a report, similar to an audit report, which may be unqualified or modified. In some cases, quality control deficiencies or non-compliance may be detected but do not warrant a modified report. However, whenever deficiencies in, and/or non-compliance with, controls are found, the review team issues a letter of comments which refers to matters that require corrective action. The review report and letter of comments are sent to the firm's managing partner, and the relevant peer review or quality review committee is informed the review is complete. The firm is required to send a copy of the report, the letter of comments and any response it wishes to make to the relevant review committee. For all peer reviews, the report, letter of comments and any response made by the firm are filed in the AICPA's public files. Reports and comments arising from a quality review are submitted on a confidential basis to the relevant AICPA State society's quality review committee.

If a firm subject to peer review receives a modified report, the relevant peer review committee reviews the report, the letter of comments and any response made by the firm and

decides on appropriate action. This may include an instruction to correct detected deficiencies, a follow-up peer review, a requirement for staff members to undertake additional continuing professional education, a fine, censure, or suspension from the relevant practice section. If a modified report follows a quality review, the action taken by the State society's quality review committee depends on the firm's plan for corrective action. Realistic plans are taken at face value but some form of monitoring may be imposed to give the committee assurance that the plans are implemented (Loscalzo 1979; CPA Journal 1989).

Surveys of peer review reports and letters of comments (e.g. CPA Journal 1987; Evers and Pearson 1990; Wallace and Wallace 1990) suggest that peer review has been beneficial in that deficiencies in CPA firms' quality control procedures have been detected and, generally, corrected. The impact which peer review may have on the quality of CPAs' professional work may be gleaned from an incident reported by Evers and Pearson (1990) in relation to the absence of proper consultation: "After one review, two of the firm's public clients had to restate their financial statements because the firm failed to consult with others about the proper accounting for a complex related-party transaction it had not dealt with before".

According to Evers and Pearson (1990), who surveyed the results of reviews conducted during 1986 and 1987, the most commonly encountered deficiencies relate to supervision (found in 83% of reviewed firms), inspection (30% of firms) and consultation (18% of firms). Inadequate documentation was responsible for a significant number of the deficiencies: for example, in relation to supervision, 11% of firms were found to have documented inadequately the performance of key audit procedures or conclusions reached in key accounting and auditing areas. Wallace and Wallace (1990) similarly note that over one third of the 232 files they examined covering peer reviews conducted between 1980 and 1986 contained comments relating to inadequate documentation.

United Kingdom

In the U.K., monitoring of auditors' work became a requirement under the Companies Act 1989. Since 1991 (1992 in the Republic of Ireland and 1993 in Northern Ireland), only registered auditors may be appointed as company auditors. Such auditors may be either individuals who, or firms which, are registered with a Recognised Supervisory Body (RSB). In order to become a RSB, a professional body must have rules covering, inter alia, auditors being fit and proper persons, technical standards applying to audit work, and procedures for maintaining competence, monitoring and enforcing the rules, investigating complaints and meeting claims arising out of audit work. Thus, monitoring auditors' compliance with auditing standards and other rules is a condition of a professional body gaining RSB status.

At present there are five SRBs, namely, the Institute of Chartered Accountants in England and Wales (ICAEW), the Institute of Chartered Accountants of Scotland (ICAS), the Institute of Chartered Accountants in Ireland (ICAI), the Chartered Association of Certified Accountants (ACCA), and the Association of Authorised Public Accountants (AAPA). Their monitoring function is discharged by two units: the Joint Monitoring Unit (JMU), which operates on behalf of the three Institutes, and the ACCA unit which monitors auditors registered with the two Associations. The monitoring is performed by full-time staff of the monitoring units.

The focus of monitoring is the audit firm. At 31 December 1995 there were about 12,700 registered audit firms in the U.K. and Ireland but the number and profile of firms registered with the three Institutes and two Associations differed markedly. Some 9650 firms were registered with the Institutes: about 65.5% were sole practitioners, 34% had between 2 and 50 principals, and 0.5% (16 firms) had more than 50 principals. Further, 147 (1.5%) firms had listed company clients. By comparison, about 3050 firms were registered with the Associations; approximately 81% were sole practitioners and the remaining 19% had between

2 and 50 principals. Few of the Associations' audit firms had listed clients (ICAEW et al. 1995; ACCA 1995). It is possibly because of differences in the number, size and nature of audit firms registered with the Institutes and Associations, respectively, that initially the JMU and ACCA monitoring unit approached the task of sampling firms for monitoring rather differently. The JMU differentiated between firms with and those without public interest clients and developed a policy of visiting annually about 30 (20%) firms with listed clients and a random sample of about 150 (1.5 %) other firms.³ The ACCA monitoring unit sought to review 20% of its audit firms each year. According to Moizer (1994) the difference in the sampling approaches of the two monitoring units reflects a difference in their intent: "The purpose of the [JMU] visits has been to gather evidence on what is wrong [in the few firms visited] and then to educate all the audit firms registered with the three Chartered Institutes to correct the identified weaknesses. ...The purpose of the visit [is] not primarily to improve the practices of the firm visited, but to improve the practices of the general population. In contrast, the ACCA and AAPA have taken the view that the monitoring process is concerned primarily with improving the quality of each firm visited".

In 1995, the JMU adopted a new risk-based approach to monitoring. This involves:

- i) conducting a 'desk top' analytical review of detailed annual returns submitted to the JMU by all audit firms registered with the three Institutes. This is designed to highlight areas of concern;
- ii) visiting each year:
 - about 30 (20%) firms with listed clients (as previously);
 - 1000 firms without listed clients. These are selected primarily on the basis of 'risk indicators' which are applied in the desk top reviews of the annual returns but some are chosen at random as a means of checking on the review process (ICAEW 1996b).

With this approach, Institute registered audit firms with non-listed clients can expect a routine monitoring visit once every eight years—instead of once every 65 years as under the former regime. Monitoring visits to ACCA and AAPA registered auditors and Institute registered firms with listed clients remain at once every five years (ICAEW 1996b; ICAEW et al. 1995; Moizer 1994).

The remit of the monitoring units is to ascertain whether registered auditors are complying with the audit regulations. Thus, their monitoring activities embrace matters such as the fit and proper status of audit principals and employees, audit work being conducted competently and with integrity, maintenance of independence, adherence to auditing standards, regular reviews of compliance with the regulations, and the adequacy of professional indemnity insurance.

A JMU visit focuses on the firm's audit compliance review (ACR) and any areas of risk identified in the desk top analysis of the firm's annual return. To check the firm's ACR, the inspectors reperform a selection of audit file reviews undertaken by the firm and also review a selection of other files. Training and appraisal records, and extracts from manuals, are generally also reviewed (ICAEW 1996b).

At the conclusion of the visit, the JMU inspectors meet with the firm's audit compliance principal (and such others the firm wishes to be present) to discuss their findings and, where applicable, the firm's proposed corrective action. The firm is required to submit notes of the closing meeting to the JMU, detailing the visit's findings and any agreed corrective action. The JMU then prepares a report. Where no matters requiring correction are found, or minor problems were encountered but the JMU is satisfied with the firm's corrective measures, the JMU or Secretariat of the relevant Institute conveys this to the firm. The relevant Institute's Audit Registration Committee (ARC) is also informed. Where problems which may prompt regulatory action are encountered, a copy of the JMU's report is sent to the firm and the latter

is requested to comment. The firm's closing meeting notes, the JMU's report and the firm's comments thereon, are then sent to the relevant Institute's ARC. The ARC reviews the documents and decides on appropriate regulatory action. It may accept the firm's proposals to correct the deficiencies and/or impose other requirements. If the ARC considers a firm's non-compliance with the audit regulations is serious but does not warrant de-registration, it usually requires a follow-up visit by the JMU to confirm that remedial action has been taken. The ARC may also impose conditions on the firm's registration (e.g. it may prohibit the firm from accepting new audit clients) or, alternatively, withdraw a firm's registration (ICAEW 1996b). In 1995, of the 1165 routine visits made by the JMU, 62% did not require referral to the ARCs, 20% resulted in the ARC requiring specified improvements and 8% resulted in the ARCs placing restrictions on the firm's registration. In 2% of cases registration was withdrawn and a further 3% of firms surrendered their registration following the JMU's visit (ICAEW 1996a; ICAEW et al. 1995).

The most common deficiencies encountered by the JMU relate to lack of evidence of audit planning, lack of assessment of the adequacy of clients' accounting systems, audit reports not complying with the auditing standard, and failure to ensure that required financial disclosures have been made (ICAEW et al. 1993; Moizer 1994). However, since the commencement of monitoring, the JMU has noted a significant improvement in audit firms' performance, especially in the areas of audit planning and the provision of audit evidence to support an audit opinion. As noted above, 62% of firms visited in 1995 had no matters requiring referral to the ARCs. This compares with 33% in 1994 and 46% in 1993—and was achieved, notwithstanding that, in 1995, the majority of firms visited were identified by the desk top review of annual returns as potentially having areas of concern (ICAEW et al. 1994; 1995).

Monitoring by the ACCA unit follows essentially the same process as that adopted by the JMU. However, the ACCA unit seeks to grade audit firms into one of four categories as follows: Grade A - satisfactory; Grade B - less than satisfactory but an early revisit is a low priority; Grade C - less than satisfactory, an early revisit is required; Grade D - unsatisfactory, to be referred to the Authorisation Committee (ACCA 1992; 1993). While all JMU visits likely to result in regulatory action are referred to the relevant Institute's ARC (i.e. all cases equivalent to those receiving Grade C or D by the ACCA's unit), only those resulting in Grade D from an ACCA unit visit are referred to the relevant Authorisation Committee (AC).

During the year to 31 December 1995, the ACCA unit monitored 394 firms: 54% were classed as Grade A, 16% as Grade B, 14% as Grade C, and 16% as Grade D (ACCA 1995). The main problems encountered derive primarily from inadequate planning and recording of audit work and inadequate assessment and documentation of clients' accounting systems (ACCA 1995). Like the JMU, the ACCA unit has noted a general improvement in audit firms' performance. In 1995, 54% of firms were found to be satisfactory compared with 44% and 49% in 1993 and 1994, respectively. However, the proportion of firms referred to the AC for unsatisfactory performance in 1995 (16%) was greater than that in 1993 (10%) but less than in 1994 (18%) (ACCA 1995).

Unlike peer review reports in the U.S., the JMU and ACCA unit's reports are not accessible to the public; further, at present, there is no provision for public scrutiny of the monitoring process by a body similar to the POB. However, in cases where regulatory action seems appropriate, the JMU reports are reviewed by the Institutes' ARCs and these include non-accountant members. The Institutes view the inclusion of such members as important "in order to demonstrate [their] determination to act in the public interest even where that may conflict with members' interests in the short term" (ICAEW et al. 1993). The Associations' monitoring process does not provide for public representation. Monitoring visit reports are

reviewed by the Associations' ACs if the firm is classed as Grade D, but these committees do not include non-accountants. However, the situation is poised for change as the professional accountancy bodies in the U.K. and Republic of Ireland have agreed that an "independent body should be established to ...consider and review the extent to which the different schemes of regulation and discipline of the [accountancy bodies] serve the public interest in enhancing and maintaining the standards of work of professional accountants" (RRIWP 1996). The proposed Review Board will have oversight, amongst other things, of the monitoring of registered auditors.

Canada⁴

In Canada, each State's Institute of Chartered Accountants (ICA) has implemented its own Practice Review program but differences between the States are minor. The scheme operating in Alberta is used here as a representative example.

In Alberta, every accountants' office registered with the ICA of Alberta (ICAA) is subject to practice review once every four years. The reviews are conducted by full-time staff of the ICAA supplemented by practising ICAA members who are contracted by the ICAA to conduct reviews. Unlike peer review in the U.S. and monitoring in the U.K., the scope of practice review does not embrace compliance with membership/registration requirements but it covers both accounting and auditing practices. Its purpose is to determine whether the reviewed office's practices comply with the Canadian Institute of Chartered Accountants' (CICA) accounting and auditing standards and the ICAA's Rules of Professional Conduct. In order to achieve this objective, practice reviews focus on "evaluat[ing] whether a reviewed office's quality control policies and procedures for its accounting and auditing practice are appropriately comprehensive and suitably designed" (ICAA 1994c).

Prior to a review visit, the reviewee completes a Confidential Information Questionnaire (CIQ). This is used to plan the visit and the files to be examined. During the visit, the office's quality control policies and procedures are reviewed to determine whether they are appropriate, adequate and effectively communicated to all staff. Selected accounting and auditing engagement files are also examined to determine whether professional standards have been met. Any deviations from the standards are noted and discussed with the practitioner in charge of the review.

The visit concludes with an exit interview at which the reviewers discuss their findings with the practitioner responsible for the review (and/or other partners and staff members). A draft report of the reviewers' findings and any recommendations for improvement is then prepared and sent to the reviewed office for comment. The report and comments thereon are returned to the ICAA for consideration by the Practice Review Committee (PRC). The report is regarded as highly confidential and is presented to the PRC in a manner which protects the identity of the reviewee, its members and its clients. The reviewee may make oral representations to the PRC if it so wishes but, in this event, it loses its anonymity.

The PRC passes the reviewers' report and its recommendations regarding the reviewee to the Joint Standards Directorate (JSD). A copy of the PRC's recommendations is also sent to the reviewee. The JSD may accept, reject or modify the PRC's recommendations and the reviewee is notified accordingly. Where reviewees are found not to be complying with the profession's standards, a follow-up review is conducted within 12 months of the initial review. The ICAA (1994a) notes: "it is expected that the [Practice Review] Committee's recommendations will be implemented and ...continued failure to improve standards, after sufficient follow-up reviews have been made, may result in the office being referred as a discipline complaint". In conformity with the confidential nature of practice review, only the

formal review report and CIQ are retained by the ICAA once an office has been found to comply with the profession's standards and practice review fees are paid (ICAA 1994c).

During the practice review cycle from 1990/1 to 1993/4 some 86% of the 615 offices reviewed were found to be complying with the profession's standards at their initial review, a further 11% were complying by their first follow-up review and another 1% were complying by their second follow-up visit. Thus, by the end of the review cycle, 98% of offices were complying with the profession's standards. However, nearly 2% of offices were referred to the disciplinary committee (ICAA 1994a). Given this data, it appears that practice review is an effective means of ensuring that practitioners comply with the profession's accounting, auditing and ethical standards. The ICAA (1994b) observes: "the present system, which allows for follow-up review visits, has been very effective in helping members keep current and well informed on relevant professional matters".

New Zealand

Practice review in N.Z. is similar to that in Canada but, in N.Z., the reviewee is not a CA office but an individual holding a public practice certificate of the NZSA. Nevertheless, all practitioners holding a public practice certificate who work in the same office are reviewed during the same practice review visit. Further, in N.Z., the review cycle is five not four years as in Canada, and the scope of the reviews includes compilation, review, and agreed-upon-procedures engagements in addition to accounting and auditing practices. However, it does not explicitly include compliance with the NZSA's ethical guidelines.

As in Canada, reviewers in N.Z. are full-time staff of the NZSA's Practice Review Unit supplemented by experienced practitioners contracted to assist with the reviews. Prior to a visit, the reviewee is required to provide the reviewer(s) with a profile of his/her professional work. The reviewee may also provide information on the office's quality control procedures

and, if the reviewers consider these are effective and reliable the number of engagement files reviewed for each practitioner in the office is reduced accordingly. When reviewing the engagement files, the reviewers focus on the practitioner's compliance or otherwise with the NZSA's technical standards.

At the conclusion of the review, the reviewers draft a report of their findings and, where applicable, make recommendations for improvement. Following discussions with the practitioner, a final report is sent to the NZSA's Practice Review Board (PRB). This Board decides on appropriate action. It may be to take no further action, to require the reviewee to undertake additional continuing professional education, and/or to make improvements and be subject to a follow-up review (NZSA 1989b). As in Canada, the review process is regarded as highly confidential. The reviewee's identity is not disclosed to the PRB and, in cases where no further action is required, the only record retained is that a review requiring no further action took place (NZSA 1989a).

Between October 1990 (when Practice Review commenced in N.Z.) and June 1992, more than half of the practitioners subject to review were visited. In just 13% of cases no further action was required; 75% of those reviewed were required to send to the PRB, after a period of six months, a declaration of compliance with the NZSA's technical standards and a set of financial statements; the remaining 12% of practitioners required a follow-up review (Gray 1992). According to Gray (1991), the Director of Practice Review, the main problem encountered by the reviewers was the inability of small practices to properly plan and document an audit.

Like the ICAA, the NZSA has emphasised that the thrust of practice review is educational and that it seeks to raise practitioners' professional work to acceptable standards without resorting to the disciplinary process. However, it states (NZSA 1989b): "If after a follow-up review the member has refused to cooperate in the review process, or has made no

effort to implement the suggestions offered by the reviewer, then the [Practice Review] Board will be obliged to give serious consideration to whether or not to refer to the Investigation Committee a complaint against the member”.

EVALUATION OF THE DIFFERING APPROACHES TO PEER REVIEW

From the above descriptions of the operation of peer review in the U.S., U.K., Canada and N.Z., it is evident that significant differences exist. As is shown in figure 1, these apply, inter alia, in respect of the reviewee, reviewer, frequency of review visits, scope, confidentiality of review reports, the public's representation in the process, and funding. These differences exist notwithstanding that, as noted earlier, the rationale, key objective and orientation of the schemes are very similar. Examining the differences in the light of the schemes' rationale, objective and orientation provides insight into their effectiveness.

Reviewee

The key objective of peer review is to ensure that members of the profession comply with auditing and other professional standards. Thus, it might be expected that individual practitioners would be the focus of reviews. However, all of the professional bodies have adopted the view that, where a firm (or CA office) has effective and reliable quality controls, compliance is likely to be achieved. As a consequence, peer review has sought to examine a firm's (or office's) quality control policies and procedures, and compliance therewith by individual practitioners (as reflected in engagement files). Even in N.Z., where technically the reviewee is an individual practitioner, practitioners in any one office are reviewed at the same time, and the number of engagement files examined is directly affected by the quality of the controls operating within the office. In the U.S. and U.K., the reviewee is an audit firm. As a consequence, all the offices of multi-office firms are reviewed at the same time. This seems to

Figure 1: Significant differences in the various peer review schemes

Peer Review Element	United States		United Kingdom	Canada	New Zealand
	Peer Review	Quality Review	Monitoring	Practice Review	Practice Review
Reviewee	Firm with majority of AICPA members	Firm with at least one AICPA member	Audit firm	CA office	Individual practitioner
Reviewer	Review team appointed by Peer Review Committee or Peer CPA firm	Review team appointed by Quality Review Committee or Peer CPA firm	JMU or ACCA monitoring unit	Practice review staff and peers	Practice review staff and peers
Frequency of visits (excluding follow-up visits)	Once every three years	Once every three years	ACCA & AAPA firms & firms with listed clients once every 5 years; other firms once every 8 years	Once every 4 years	Once every 5 years
Scope of peer review	Membership requirements; audit and other reporting engagement quality controls	Membership requirements; audit and other reporting engagement quality controls	Registration requirements; audit quality controls	Compliance with accounting, auditing and ethical standards	Compliance with auditing, accounting and other professional engagement standards
Confidentiality of report	Placed in public files	Kept confidential	Kept confidential	Kept confidential	Kept confidential
Public representation	Public Oversight Board	None	Lay members on Institutes' Registration Committees (Independent Review Board planned)	None	None
Funding	Reviewees	Reviewees	CAs: registered auditors; ACCA: practising members; AAPA: all members	Reviewees	NZSA members; public practitioners; reviewees

imply an assumption that the firm's quality controls are implemented and adhered to uniformly in all offices of the firm. Certainly, some measure of uniformity may be expected as the firms have firm-wide quality control policies and procedures and they are also required to conduct internal quality reviews (or inspections). However, it is suggested that each office is likely to develop its own norms for standards of professional work and these may vary quite significantly from office to office. Given the objective of peer review and the above observations it is submitted that the most appropriate unit for peer review is a CA office as applies in Canada.

Reviewer

Flint (1988) notes that reviewers may be full-time staff of a regulatory or professional body (as in the U.K.), staff seconded from other firms at the request of the body responsible for the review, a combination of full-time staff and seconded practitioners (as in Canada and N.Z.), or another audit firm (as in the U.S.). Advantages and disadvantages attach to each option. For example, full-time staff of a regulatory or professional body may be regarded as independent and objective and as having no self-interest in a competitor's audit files. Further, as Flint (1988) observes, "where the emphasis of [peer review] is educational ...full-time staff of a professional body may be thought to be more appropriate and also more cost-effective". However, both reviewees and outsiders may consider such reviewers to be insufficiently familiar with the practice issues they are reviewing.

Where the review is conducted by another audit firm or by practitioners seconded from other firms, the reviewers should be familiar with practice issues but they may be regarded by outsiders as too sympathetic to practice problems and by reviewees as having unwelcome access to client files (Flint 1988). Additionally, concerns may arise about possible 'backscratching'. The likelihood of this occurring may be reduced, as in the U.S., by requiring

the reviewee and reviewer to be independent of each other and by prohibiting reciprocal reviews.

Given the objective of peer review, it is important that reviewers understand practice management and difficulties commonly encountered in securing compliance with quality controls and auditing (and other professional) standards. This suggests that practitioners from other firms are appropriate reviewers. However, given the declared educational orientation of peer review and Flint's observation (above), full-time staff of the relevant professional body may be preferable. Following from this, it is suggested that a combination of full-time staff of the professional body supplemented by suitably qualified and experienced practitioners from other firms (as applies in Canada and N.Z.) is the most appropriate option.

Frequency of visits

The frequency of peer review visits ranges from three years in the U.S. to eight years for some firms in the U.K. (see figure 1). Given the rationale and objective of peer review, a review cycle of more than five years seems inappropriate. It is difficult to conceive how reviews conducted less frequently than once every five years can demonstrate to the public (and the government) that the profession is able to ensure its members provide high quality professional work and that members' performance is adequately monitored. Given the dynamic nature of the corporate world, the rapid rate of change of accountancy firms (in particular, through mergers and disaggregations), and the rapid changes which are occurring in auditing and accounting standards, a review cycle of even five years seems questionable.

In 1993, peer review in the U.S. applied to 105,000 professionals in 1,214 firms in the SECPS alone, and these firms audited some 14,750 SEC clients (Moizer 1994). Thus, the extent of peer and quality review in the U.S. is far greater than in the U.K. (where about 150 firms audit the 2500 or so listed companies), Canada and N.Z.. Yet, in the U.S., a peer review

cycle of three years is found (presumably) to be cost-beneficial. However, in the U.S., the level of litigation against auditors is higher, and criticism of auditors by politicians such as Congressman Dingell is more widespread and scathing, than in the other countries. Thus the benefits of peer review in terms of restoring public and political confidence in the ability of the profession to regulate itself may be greater than elsewhere. Weighing these factors, and conscious that litigation against, and criticism of, auditors in countries other than the U.S. has risen sharply in recent years—particularly in the U.K.—it is suggested that a review cycle of three years is desirable.

Scope of peer review

It is evident from figure 1 that the scope of peer review varies from country to country. This paper is concerned with securing high quality audits and each of the peer review schemes under consideration includes monitoring auditors' compliance with relevant technical standards. However, ensuring compliance with the profession's ethical standards (including independence, integrity and competence) also seems to be relevant to securing high quality audits. This is embraced by all of the schemes other than in N.Z. where attention is confined to compliance with technical standards.

Confidentiality of peer review reports and public representation in the review process

In all of the countries other than the U.S., peer review reports are kept confidential. Further, the public is represented in the peer review process only in the U.S. (where the POB has been established) and in the U.K. (where lay members are included on the Institutes' ARCs). Given that peer review has been introduced primarily to restore public and political confidence in the profession and its ability to regulate its own affairs, the general absence of public involvement in the peer review process is difficult to understand. Even more difficult to

understand are the measures taken in Canada and N.Z. to protect the identity of CA offices and practitioners, respectively, found to be in breach of the profession's standards. It may be that the professional bodies share Mautz's (1984) view that "the issue of confidentiality is a complex one, involving private rights, the public interest, the litigious nature of our society and a widespread misunderstanding of the role, rights and responsibilities of ...auditors". It may also be that the professional bodies are concerned that, should the public become aware of deficient performance by auditors—as revealed in peer review reports—this would further undermine, rather than restore, public confidence in the profession and its work. A further concern expressed by Moizer (1994) is that, if the review reports are placed in the public arena, this may result in less detailed and forthright reporting and thus in reduced effectiveness of the review process.

Nevertheless, if public and political confidence in the profession's ability to regulate itself is to be gained, the review process must be seen to be operating effectively: this requires the public to be represented in the process. The U.S. experience demonstrates that this can be achieved without the feared adverse consequences. Further, placing peer review files in the public domain has enabled detected deficiencies to be analysed, not just by the public but, more importantly, by academics and practitioners. The latter groups have used the reports to identify key, commonly occurring deficiencies and this has provided the basis for educating members of the profession and effecting general improvements in the quality of audit work. Additionally, the POB has given the review process in the U.S. a measure of credibility. As Wood and Sommer (1985) explain: "[T]he AICPA believed it was essential that a process conceived by the profession be subjected to oversight and review by people not associated with the profession. Thus, provision was made for a board of five experienced, competent and independent people mainly drawn from fields other than accounting to oversee the process, to review how it functions, to criticize it when it needs criticizing, to report to the public on its

warts and moles and, yes, its achievements". The POB takes its role seriously: it monitors every aspect of the peer review program and its staff oversee every SECPS peer review (Wood and Sommer 1985).

In the U.K., neither the ACCA nor the AAPA have provided for laypersons to be involved in the monitoring process but the Institutes include non-accountants on their ARCs. As members of these committees, the non-accountants review reports on registered auditors visited by the JMU. In 1992, the four non-accountant members of the ICAEW's ARC included a report in the Institutes' report to the Department of Trade and Industry (DTI) on audit regulation. In this they note that they see their role as, "firstly protecting the public interest and, secondly, protecting the interests of the firms". They also report that, in their view, "decisions [of the ARC] have always been taken properly and fairly, and in the public interest" (ICAEW et al. 1992, 56).

Unlike the POB, the laymembers of the ARCs do not have a remit to report to the public on the monitoring process but including a report in the Institutes' annual report to the DTI seems to be a step in this direction. However, since 1992 such a report has not been included in the Institutes' reports to the DTI. Nevertheless, as noted earlier, the U.K. professional bodies plan to establish an independent Review Board to oversee the various bodies' regulatory and disciplinary schemes. Assuming this Board will have independence and powers at least equal to those of the POB (as is proposed), it should increase significantly the credibility of the monitoring process in the U.K.

Funding

As is shown in figure 1, in the U.S. and Canada the cost of peer review is borne by the reviewees. In the U.K., the Institutes spread the cost across all registered auditors, the ACCA allocates it to all practising members, and the AAPA recoups it from all members. In N.Z., it is

allocated progressively to members of the NZSA, members holding public practice certificates, and reviewees.

Given that the intent of peer review is to restore public and political confidence in the profession's ability to regulate itself and to ensure its members provide high quality professional work, it is suggested that all members of the profession stand to benefit from the peer review process. However, practitioners working in the areas covered by peer review (auditing in the U.K., auditing and other reporting engagements in the U.S., accounting and auditing in Canada, and accounting, auditing and other professional engagements in N.Z.) seem likely to gain additional benefits from education and advice provided as an outcome of the review process. In addition, reviewees, whose quality controls and engagement files are reviewed, seem likely to gain further benefits from having specific deficiencies detected. It is thus suggested that the pattern of funding adopted in N.Z., where the incidence of peer review costs reflects the benefits derived therefrom, is appropriate. It appears that in the other jurisdictions reviewees (or, in the U.K., registered auditors) carry too much of the burden.

EFFECTIVENESS OF PEER REVIEW

Notwithstanding differences in the operation of the peer review schemes, the professional literature reveals that the schemes' outcomes are remarkably similar. Surveys conducted in the various countries have found that, in general, practitioners consider that peer review has been educational and has resulted in an improvement in the quality of audit work. This improvement has been achieved primarily through improved quality control systems and documentation (e.g. Evers and Pearson 1990; Wallace and Wallace 1990; Gray 1992; Fearnley and Page 1992, 1993; Moizer 1994). The deficiencies most frequently encountered by the reviewers—that of inadequate audit planning and, more particularly, documentation—are also common to all of the countries. The same applies to the high level of deficiencies detected,

especially in small firms, during the initial round of reviews. Bruce's (1993) observation that "audit regulators, while always fearing the worst, have been privately staggered at how bad so much of the audit work at the small end of the market has proved to be", although written in relation to the U.K. could equally have been written about the initial findings of peer review in the U.S., Canada or N.Z.. Explaining the high incidence of inadequate documentation, the ACCA (1992) notes that, although auditing standards require auditors to document their audit work, historically compliance with this requirement, especially in small practices, has been poor. It states: "Discussions suggest that most auditors have carried out most of the necessary work, but they have not recorded it. ...Small firms did not have the culture or structure of supervision and review which required them to make a detailed record of the work done and as a result there was little incentive to do so. The advent of audit monitoring has provided such an incentive".

Moizer (1994) is somewhat critical of the approach adopted by the peer review process and suggests that finding inadequate documentation is almost inevitable. He notes: "As a result of [the] difficulty of challenging the judgements made by an audit partner, the [reviewers] have not attempted to evaluate such judgements when assessing audit working papers ...[they] have looked only at the documentary evidence available. ...The [review process] has concentrated on testing whether firms have complied with audit standards and regulations. This approach inevitably leads the [review] process to be concerned with the documents produced by the firms". However, Moizer's implied conclusion that focusing on compliance with auditing standards does not facilitate evaluating the appropriateness of audit opinions, is subject to question. Wood and Sommer (1985), recounting achievements during the early years of SECPS peer reviews in the U.S., observe: "95 audits (out of some 3200 reviewed) were deemed to be substandard by the peer reviewers. In 17 cases, the firms were required to

withdraw their opinions and have the financial statements revised and reissued.... In 15 cases, the auditors were required to perform the procedures they had improperly omitted”.

As indicated above, the review process, with its focus on quality controls and documentation, has had greatest impact on small firms. Large firms, as a consequence of their size, have well-developed quality control systems and procedures for documenting audit work. Small firms often saw no need for such systems and procedures. Further, auditing standards are required to be adhered to in all external financial statement audits, irrespective of the size of the audit client. However, the standard-setting bodies are dominated by members drawn from the large accountancy firms (which have large audit clients) and large corporates (e.g. Porter 1991; Moizer 1994). Thus auditing standards have been set with large audit clients in mind: until recently, little attention seems to have been given to their application in a small client setting.⁵ Similarly, quality control standards, such as the AICPA's *Statement of Quality Control Standards No.1: System of Quality Control for a CPA Firm*, have been developed to achieve desired results in large accountancy firms: little attention has been given to their suitability for small firms. Those conducting peer reviews may adjust the level of compliance with auditing and quality control standards expected of small firms (e.g. CPA Journal 1989) but, in all of the countries where it has been implemented, peer review has resulted in small firms developing (or upgrading) quality control systems and documentation procedures. This has resulted in high set-up costs for these firms. In a survey in the U.K. in 1992, Fearnley and Page (1993) found that set-up costs for firms with three or fewer partners amounted to some £4900. It is not known whether these costs have generated commensurate benefits in terms of improved audit judgements.

It is suggested that the educational, rather than punitive, orientation of peer review is, at least in part, a result of the professional bodies' awareness of the unequal impact of peer review on small, *vis à vis* large, firms. It is noticeable that during the initial years of peer

review the educational aspects are emphasised and possible disciplinary action is downplayed. For example, when introducing practice review, the NZSA (1989b) stated: "It is intended the benefits arising from Practice Review will be educative and informative ...Overseas experience reveals that the necessity to invoke disciplinary processes seldom arises". Similarly, in its report to the DTI, the ACCA (1992) noted: "The Association sees its role in the early stages of monitoring as one of providing guidance and constructive advice to firms which are genuinely trying to improve". However, once peer review has become established and firms have been given the opportunity to set their house in order, it seems likely that reviewers will be less tolerant of breaches of professional standards, and disciplinary action will feature more prominently. This is reflected, for example, in comments by Gray (1992) in N.Z.: "During the first five-year cycle, the [Practice Review] Unit's basic approach has been to concentrate on ensuring that all those in practice have understood the rules and are given time to bring their standards up to the necessary level. The second five-year round may well see a firmer approach, less latitude being given to those with a cavalier approach to the standards".

It is also pertinent to note that, despite the professional bodies' emphasis on the educative role of peer review, when reporting on its achievements attention is drawn to sanctions imposed on errant members. For example, in their report to the DTI (ICAEW et al. 1993), the U.K. Institutes report: "of the 13 follow-up visits considered by the ARCs by 30 September 1993, 5 resulted in the withdrawal of the firms' registration. This clearly demonstrates that the ARCs will take decisive regulatory action where necessary by withdrawing registration". Similarly, Wood and Sommer (1985), state: "The self-regulatory [peer review] program has preventive, not punitive, effects ... [However] the SECPS can, and does, take actions that are tantamount to sanctions. ...Failure of a firm to take any corrective action deemed necessary by the peer review committee ...can result in the most severe

sanction available ...expulsion of the firm from membership in the SECPS accompanied by public disclosure of this sanction”.

It seems that, in trying to use peer review as a vehicle for both education and regulation, the professional bodies have conflicting interests which are difficult, if not impossible, to satisfy simultaneously. The same may be said of their trying to act as protector of both members' and the public interest. Those who consider the professional bodies protect members' interests at the expense of the public interest point to the large number of auditors who have been criticised in peer review reports and the few who have faced disciplinary action (e.g. Jack 1993). Such arguments are re-inforced in countries other than the U.S. (and, to some extent, the U.K.) by attention being drawn to the absence of public scrutiny in the review process. Those who contend that the public interest is protected at the expense of members' interests note the high cost of regulation which is borne by members of the profession⁶ (Jack 1993).

Some commentators and politicians such as Dingell in the U.S. and Mitchell in the U.K. have suggested that auditing the performance of auditors is too important to be left to the auditing profession and that an independent regulatory body should be established. But, who would fund and operate such a body? As Bruce (1993) has pointed out: “If it came to the crunch any government would run a mile from direct supervision and control. If you can get the profession to come up with its own millions to pay for the scheme why bother the taxpayer? And, more important, this way round you can blame the profession whenever anything goes wrong”.

Viewed in this light, practitioners may well question the high price paid by the profession for the right to self regulation. Such questions become more pointed when it is remembered that, particularly in the U.K., the profession has been granted the right to regulate its own affairs—providing it does so within the parameters set by government. In the U.S., the

profession is less bounded than in the U.K. with respect to its self-regulatory activities, but the watchful eye of the SEC is never far away and one of the functions of the POB is to report to the SEC on the effectiveness of peer review. In Canada and N.Z., at the present time, the profession is able to regulate itself comparatively free from government pressures. This may explain the extreme levels of confidentiality which are maintained in the review process in these countries. As noted earlier, the anonymity of reviewees is protected even from the committees responsible for reviewing practice review reports. It is suggested that this level of protection of members' interests leaves the profession open to allegations of putting members' interests ahead of the interests of those who rely on auditors' work.

CONCLUSION

Peer review was introduced by the accounting profession in the U.S., U.K., Canada and N.Z. primarily as a response to widespread criticism of auditors and the threat of government intervention in the profession's affairs. The schemes differ in their *modus operandi* but their results are remarkably similar. In each case, the initial reviews found a high incidence of non-compliance with the profession's standards (particularly in small firms) especially in respect of audit planning, control and, more particularly, documentation. Surveys have shown that, in general, reviewees consider that the review process has prompted improvements in their quality control systems and auditing procedures. Whether it has also resulted in improved audit judgements is a moot point (e.g. Moizer 1994; Fearnley and Page 1994). However, it may be argued that, with improved audit planning, review and documentation, critical steps in the audit process and vital clues in the evidence gathered of matters requiring closer scrutiny, are less likely to be missed. Further, as noted earlier, at least in the U.S., peer review has uncovered instances of faulty audit judgements and resulted in revised audit opinions. In most instances, the outcome of peer review has been less dramatic but, nonetheless, wherever it has

been introduced, it has uncovered numerous instances of non-compliance with professional standards—and generated numerous suggestions for improvements in audit procedures and practice management. It is also likely that the 'threat' of review visits has motivated practitioners to effect improvements in their control systems and audit procedures prior to the visit. Further, the professional bodies, when reporting on the effectiveness of their peer review schemes, have drawn attention to the large number of reviewees who received qualified or adverse reports on their initial reviews but who 'cleaned up their act' before the follow-up visit. The professional bodies have also noted that members who persist in defective performance are disciplined and, if necessary, excluded from the profession.

Given the improvements which peer review has apparently brought, it may be asked why audit failures still occur. In answer, commentators such as Wood and Sommer (1985) note that it is not known how many audit failures have been avoided as a result of auditors being required to conform to prescribed standards. They also point out that peer review focuses on quality control systems and that no system can prevent *all* undesirable events from occurring. Woodley (1991) echoed this theme when, on the eve of peer review being introduced in the U.K., he stated: "It would be foolish to believe that there will be no audit failures in the future. No amount of monitoring can eliminate the possibility of errors of judgement or failures to follow laid down procedures. But ...the extra emphasis on quality control procedures, the possibility of a [peer review] visit, and the dire consequences of failing to comply with the regulations [should] result in fewer audit failures in the future". Wood and Sommer (1985), amongst others, also note that, although peer review cannot prevent all errors from occurring, society has other checks in place to ensure those responsible for causing harm to others as a result of sub-standard work do not go unpunished. For example, when questions of audit failure arise, authorities such as the SEC in the U.S. and DTI in the U.K. investigate and, if justified, appropriate sanctions are imposed on the culprits. Additionally, except in the U.K.

where the *Caparo* decision may operate to preclude legal action by third parties, those harmed as a result of auditors' sub-standard work may seek redress through the courts.

The findings of peer review suggest that prior to its introduction auditors' performance was, in many cases, not in accord with the profession's standards. It seems that public and political criticism of auditors was not without foundation. The peer review process has apparently raised the overall quality of audit work—especially at the small end of the market—and is also weeding out those who persistently refuse to meet the required standards. However, it is submitted that, if the public is to be assured that the auditing profession is adequately auditing the quality of members' work, the peer review process must not only be effective, it must be *seen* to be effective. This necessitates exposing the process to public scrutiny. If peer review is to achieve its aim of restoring and maintaining public and political confidence in the profession and its work, at the least, a body equivalent to the POB in the U.S. needs to be established to oversee the regulatory process.

ENDNOTES

1. In this paper, the term peer review is used to mean peer and quality reviews in the U.S., monitoring in the U.K. and practice review in Canada and N.Z.
2. Firms which do not qualify for membership of the Division of CPA firms but have at least one AICPA member must join the Quality Review Program. The peer review program, to which all firms belonging to the Division of CPAs are subject, operates on a national basis. The quality review program is run by the AICPA State societies.
3. In addition to visiting firms, the JMU required all audit firms registered with the three Institutes to file annually a detailed return. This provided information on matters such as the number of principals and employees, ownership and control of the firm, number and nature of audit clients, fee income, fit and proper status of principals and employees,

maintenance of principals' and employees' competence, and audit compliance reviews conducted by the firm (JMU, 1994).

4. The quality review programmes introduced in Australia by the Institute of Chartered Accountants in Australia in 1991, and the Society of Accountants in 1993, are based on the practice review scheme in Canada. Thus the description of practice review in Canada applies in all essential details to the schemes operating in Australia. The primary difference is that a five year review cycle applies in Australia, compared to a four year cycle in Canada.
5. In recent times, the professional bodies have considered this issue; e.g. in 1996, the U.K. Auditing Practices Board issued a Consultation Draft of a Practice Note: *The audit of small businesses*.
6. In 1995 the cost of monitoring in the U.K. alone was nearly £4.5 mill (ICAEW et al. 1995; ACCA 1995).

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