



Peer Review in an Era of Transparency:

A Position Paper

Introduction

The AICPA Peer Review Program (Program) is dedicated to enhancing the quality of accounting, auditing and attestation services performed by AICPA members in public practice. Since 1977, more than 50,000 CPA firms have undergone more than 160,000 peer reviews, resulting in reports that provide insight into participating firms' stated quality standards and how they put those standards into practice in the conduct of their attest engagements. In a 1987 referendum, AICPA members voted to make peer review mandatory, but also to keep the results confidential. The issue essentially required a member with an accounting or auditing practice to practice in a firm enrolled in a peer review program.

Over the years, peer review reports have been increasingly sought after by and made available to a variety of parties seeking to assess the quality of a firm's practice. Since 1977, members of the AICPA's SEC Practice Section - now the Center for Public Company Audit Firms - (CPCAF) and the Private Companies Practice Section - now Partnering for CPA Firm Success - (PCPS) have made their peer review reports available to the public. These reports are available for anyone to see, accessible from the AICPA website.

In addition, many other firms that are not part of CPCAF or PCPS make their reports available to entities outside the firm because of regulatory requirements, in response to a client request, or as part of their effort to demonstrate to potential clients their firm's commitment to quality. For example, firms performing audits under the Government Auditing Standards seeking to enter into a contract to perform an audit in accordance with Government Auditing Standards are required to provide their most recent peer review report and letter

of comment to the party contracting for the audit. Also, several boards of accountancy require the submission of peer review reports as a requirement for renewing the firm or individual licenses.

In fact, among one subset of peer-reviewed firms, those that perform audits, roughly 11,000 of 16,000 currently make some aspects of their peer review results available outside their firm.

At its spring 2004 meeting, the AICPA's Governing Council approved a resolution expressing its support for increased transparency in the peer review process. In their discussions, some Council members raised the point that greater transparency will show that our members are not only willing to go through the peer review process, but are not afraid to show the public its results. If this is true, greater transparency in peer review will increase the public's level of trust in the profession and enhance the CPA's image.

Council also authorized a member education program to inform members about peer review and the related transparency issues and to assess their desire for greater transparency. A substantive increase in transparency can only be put in place after AICPA members have had the opportunity to vote on the change. This white paper is intended as the starting point for the member education program authorized by Council. It is aimed at providing a broad perspective on the beginnings of the AICPA peer review program, how it has changed over the years, the current environment which is provoking a demand for greater transparency, and the various ways increased transparency might be achieved.

PART ONE: HISTORY OF PEER REVIEW

In the Beginning

A system of internal inspection was first used regularly in the early 1960s, when a number of large firms used it to monitor their accounting and auditing practices and to make certain their different offices maintained consistent standards. Firm-on-firm peer review emerged in the 1970's partly as a result of SEC disciplinary actions against some of the larger firms. There was no real uniformity to the process until 1977, when the AICPA's Governing Council established the Division for CPA Firms to provide a system of self regulation for its member firms. Two voluntary membership sections within the Division for CPA Firms were created, the SEC Practice Section (SECPS) and the Private Companies Practice Section (PCPS).

One of the most important membership requirements common to both Sections was that once every three years firms had to have a peer review of their accounting and auditing practices to monitor adherence to professional standards. The requirements also mandated that the results of certain peer review information be made available in a public file. Each Section formed an executive committee to administer its policies, procedures, and activities and a peer review committee to create standards for performing, reporting, and administering the peer reviews.

The peer review process was quickly recognized as a rigorous process that produced tangible results. In many members' minds it showed the profession could effectively police itself. But the fact that peer review participation was voluntary led many others, inside and outside the profession, to doubt that the profession could effectively self-regulate. Many members within the AICPA believed that it would have to be made mandatory for all firms if the profession was to avoid Congressional action.

Peer Review Becomes Mandatory

A referendum to make peer review mandatory was one of the most important recommendations of the Special Committee on Standards of Professional Conduct, commonly known as the "Anderson Committee" after its chairman, George Anderson. To a large extent, the Anderson Committee was spurred by the high-profile bank failures and corporate bankruptcies of the late 1970s and early '80s. At that time, Congress, the SEC, and the Federal Trade Commission were all pressuring the accounting profession to accept additional responsibilities or be prepared to have the federal government take those responsibilities from it. In addition to mandatory peer review and new educational requirements, the member ballot also included a new code of professional conduct, which the Anderson report characterized as "an unswerving commitment to honorable behavior even at the sacrifice of personal advantage."

The Anderson Committee proposed some rather stringent new requirements for membership. Many people both inside and outside the profession believed that the Committee's most controversial recommendations had little chance of passage. Particularly uncertain were the new proposed requirements for mandatory peer review and continuing professional education (CPE). At more than one Council meeting, AICPA members expressed the concern that if the Anderson recommendations were implemented, the AICPA could experience a substantial erosion of membership. Some believed members would resign from the AICPA rather than agree to these new requirements.

While recognizing the possible repercussions, the AICPA Governing Council and Board of Directors nevertheless decided the measures were necessary to protect the public, raise the stature of the profession, and improve the quality of practice. In preparation for a membership vote, the AICPA launched an ambitious member education program to explain the proposed changes.

The leadership took considerable heat for its aggressiveness. Critics were particularly concerned about the impact the proposals would have on smaller

firms. But the leadership, and in the end, the membership as a whole, believed that firms that subjected themselves to the rigor of the peer review process were best equipped to perform quality accounting and auditing engagements.

AICPA members voted overwhelmingly to adopt, effective in January 1988, a series of seminal changes to its professional standards, including a new code of professional conduct, a requirement that new members must have at least 150 hours of college-level education, continuing professional education and mandatory peer review.

Taken together, this *Plan to Restructure* represented a radical change for the accounting profession, which was widely praised for demonstrating the profession's commitment to the public interest. Even Congressman John Dingell (D-Michigan), heretofore Congress' most vocal critic of the profession's self-regulatory efforts, was impressed. Dingell announced that "their decisive and timely action, as well as their willingness to work with the subcommittee on further improvements, is commendable."

Although there was some membership attrition that could be traced to the new requirements, it was much less than some predicted.

Members' acceptance of mandatory peer review, demonstrated both through their votes and through their membership renewals, was predicated on two fundamental principles:

- Peer review would be remedial rather than punitive in nature, and
- The results of the peer review would be confidential except to those administering the program (and to third parties to whom reviewed firms chose to make the information available).

Firms were given a choice between enrolling in the newly created AICPA Quality Review Program, or becoming a member in the Division for CPA Firms and undergoing an SECPS or PCPS peer review. Firms enrolling in the AICPA Quality Review Program that had audit clients would now undergo on-site peer

reviews to evaluate the firm's system of quality control, which included a review of selected audit and accounting engagements. Firms without audit clients, which only performed engagements under the attestation standards or compilation and review services, would undergo off-site peer reviews which also included a review of selected engagements to determine if they were in compliance with professional standards.

From its inception, peer review has identified deficiencies within firms, a process which has led to those deficiencies being corrected. For firms that perform audits and certain other engagements, the peer review is accomplished through procedures that provide the peer reviewer with a reasonable basis for expressing an opinion on whether the reviewed firm's system of quality control for its accounting and auditing practice has been designed appropriately and whether the firm is complying with that system. These procedures include determining whether the firm:

- Has policies and procedures that confirm that the firm is independent and objective in performing attest engagements,
- Appropriately manages its attest engagement personnel,
- Only services clients it has the capability of serving,
- Performs engagements in accordance with professional standards, and
- Appropriately monitors each of the above.

If deficiencies are detected, the peer reviewer attempts to determine their root cause to assess whether they are isolated or systemic. This process results in the issuance of a report and, where applicable, a letter of comments that articulates the peer reviewer's comments and recommendations for corrections and improvements. In that case it also includes the firm's letter of response describing the actions it has taken or is planning to take with respect to each matter. The Peer Review Committee then reviews these and other peer review materials to determine if the reviewed firm should be required to complete any

additional follow-up actions as a condition of the peer review being accepted. If the Peer Review Committee requires the firm to complete a follow-up action, it is described in the acceptance letter submitted to the firm.

In 1990, a new amendment to the AICPA bylaws mandated that AICPA members who practice public accounting with firms that audit one or more SEC client must be members of the SECPS. In 1994, AICPA Council approved a combination of the PCPS Peer Review Program and the AICPA Quality Review Program under the name, AICPA Peer Review Program. Thereafter, the Private Companies Practice Section, which as a result of this vote no longer had a peer review program, became a voluntary membership alliance for CPA firms and in 1997 renamed itself Partnering for CPA Practice Success (PCPS). A public file remains a PCPS firm membership requirement.

Peer Review Today

In July 2002, the Sarbanes-Oxley Act of 2002 established the Public Company Accounting Oversight Board (PCAOB) as a private-sector regulatory entity to replace the accounting profession's existing self-regulatory structure as it relates to public company audits. One of the PCAOB's primary activities is the operation of an inspection program that periodically evaluates registered firms' SEC issuer audit practices.

As a result, effective January 1, 2004, the SECPS was restructured and renamed the AICPA Center for Public Company Audit Firms (CPCAF). The CPCAF Peer Review Program became the successor to the SECPS Peer Review Program, with the objective of administering a peer review program that evaluates and reports on the non-SEC issuer accounting and auditing practices of firms that are registered with and inspected by the PCAOB. Since many state boards of accountancy and other governmental agencies require a peer review of a firm's entire auditing and accounting practice, the CPCAF peer review provides a bridge from the PCAOB inspections to allow member firms to meet their state board of accountancy licensing and other state and federal governmental agency peer review requirements.

This brings us to where we are today, with two Institute-approved practice-monitoring programs. Approximately 900 firms are subject to the CPCAF Peer Review Program, and about 33,000 firms are subject to the AICPA Peer Review Program.

For more than 25 years, peer review has shown significant value to its participants and has worked to protect the public. During that time, peer review statistics show a marked improvement in firms' accounting and auditing practices. In the early 1990s, for example, only 80 – 85% of firms received a “clean” or “unmodified” peer review report. That has now increased to about 94%. Furthermore, the occurrence of unmodified reports for firms that have already undergone a peer review is much higher than for those undergoing their initial review. Not only do peer review statistics show a marked improvement in firms' accounting and auditing practices, but there has also been an increased demand by the public for information on the results of these reviews.

The States and Peer Review

Since 1992, both the AICPA and the National Association of State Boards of Accountancy (NASBA) have supported mandatory peer review at the state level through the inclusion of such requirements within the Uniform Accountancy Act (UAA). Section 7(h) of the UAA Act requires that firms performing the attest function undergo a peer review every three years. The principle of confidentiality is affirmed through section 7(h)(4), which acknowledges the remedial nature of peer review. Section 7(h)(3) recognizes the need for state boards to have a process in place to ensure that the peer review programs it has approved are operating effectively. These sections also make clear that neither the state board nor a third party shall have access to materials developed during the course of the peer review.

Currently, 37 state boards of accountancy have provisions that provide for some form of periodic firm quality monitoring or peer review program. All 37 have accepted AICPA sponsored peer review programs as meeting their monitoring requirement. Certain federal governmental agencies, such as the

Government Accountability Office (GAO), Federal Deposit Insurance Corporation (FDIC), Office of Thrift Supervision (OTS) and the Department of Agriculture's Rural Utility Service (RUS), also require peer review as a condition for performing such audits.

PART TWO: PEER REVIEW AT A CROSSROADS

Confidentiality

Peer review was originally designed as an educational and remedial program to strengthen quality control, to prevent recurrences of problems and to correct deficiencies in the practices of member firms. It was not intended to duplicate or facilitate state or federal enforcement responsibilities. From the very beginning, its role was corrective, rather than punitive. Members expected, and the AICPA delivered, confidentiality throughout the process.

In today's environment, however, this kind of confidentiality is becoming increasingly difficult to support. In the 1990's and even more so in the aftermath of highly publicized corporate failures and accounting scandals, the Sarbanes-Oxley Act of 2002 and new corporate and financial reporting requirements, there is an increasing public demand for all professions to promote transparency, disclosure and responsibility.

Peer review was originally designed as a way for members to enhance the quality of their accounting and auditing practices. It was not designed to meet regulatory requirements. Today, in this new world of heightened accountability however, the universe of people that relies on peer review has greatly expanded and now includes not only CPA firms, but regulators, clients and many different kinds of credit grantors. All these constituents expect greater transparency, but will be unable to evaluate peer review reports as long as that information remains confidential.

Another factor that has increased the need for greater transparency is that at the same time more businesses are asking for or accessing peer review information to assess the work of their accounting firms, more firms are quietly trumpeting their positive reviews to clients and others. Many firms make peer review results part of their marketing literature and routinely include it in any response to a request for proposal. Increasing the importance of these reports further is that most states now make peer review part of their qualification for licensure, and many states that do not yet do so have announced that they are

actively considering moving in that direction. In addition, approximately twenty states not only require peer review as a condition of licensure, but also under certain circumstances mandate the submission of some information related to the peer review.

Council Supports Greater Transparency and Member Education Campaign

At its spring 2004 meeting, the AICPA's Governing Council approved a resolution expressing its support for increased transparency. It also directed the AICPA Peer Review Board to assist members in complying with state licensing requirements if the member firm gives its approval to make the information available to the state board. Specifically, it has asked the AICPA Peer Review Board to work with members to give State Boards of Accountancy access to certain peer review information on two conditions:

- If, as a condition of licensure, the State requires mandatory peer review and the remittance of peer review information, and
- If the member agrees to allow the Peer Review Board to remit that information.

There seems to be an inevitable march toward greater transparency. More than a year before the Council resolution, the AICPA's Peer Review Board recommended that the AICPA Board of Directors address the possibility of making certain peer review information available to the general public. In addition, NASBA has recently released a rule that would require that licensees remit peer review materials under certain circumstances. The Peer Review Board has weighed in by taking steps to achieve greater transparency through greater clarity in the language used in peer review reports.

Council's discussions in early 2004, however, were about going beyond making peer review reports more understandable. They were focused on expanding access to peer review information. This is an important distinction, focusing on the "how" and "to whom" rather than "the what" of increased transparency. It was with this in mind that Council's May 2004 resolution directed the AICPA staff to initiate a member education program, similar to the

one conducted prior to the 1988 vote making peer review mandatory. Its purpose is to inform members about peer review and the related transparency issues, to assess their desire for greater transparency and to incorporate their feedback into the process of developing a more open peer review program.

PART THREE: GREATER TRANSPARENCY

Defining Transparency

According to the Merriam Webster dictionary, the word transparent comes from the Latin, *transparen*, meaning “to show through.” It has two primary definitions: “having the property of transmitting light so that bodies lying beyond are seen clearly,” and “free from pretense or deceit.”

For one hundred years, transparency has been a goal of the accounting profession. We have always strived to make everything we do -- the financial statements we audit, the advice we dispense, the tax returns we prepare -- transparently communicate the facts clearly and truthfully to every one of our audiences – investors, regulators, management, and the public. Now the question on the table is how we can be equally transparent when it comes to our own internal rules and procedures, most particularly our peer review program.

The Environment for Transparency

There is clearly a trend among the general public demanding more transparency in all businesses and business transactions. People and businesses want assurances that they can trust their professional advisors. One way to ensure that we continue to be among the most trusted professions is to let people know what independent assessments have to say about firms that have taken on the public interest responsibility of attest functions. Greater peer review transparency would also reaffirm that we are a profession that does not tolerate those who break the rules, since it would allow regulators, potential clients and the public to become aware of those who fail to comply with the rules or have practice quality issues.

The accounting profession has a long and profound commitment to the public interest. As a great profession, we have on many occasions demonstrated a willingness to raise the bar on ourselves. The question for the profession is, can we remain and grow as a great profession - and one that controls its own destiny - without greater peer review transparency?

What is “Greater Transparency”?

The AICPA Council resolution authorizing a member education program specifically states that:

The AICPA Council directs the AICPA staff to initiate a member education program for the purpose of creating a consistently informed membership on the issue of granting access to peer review information with the goal of holding a member referendum on the issue of increased transparency for peer review information.

The first step in achieving these goals is to address two critical questions:

- What is meant by increased transparency?
- Who should be granted access to peer review information?

Increased transparency could mean, for example, merely clarifying the language of peer review reports or making them more understandable. These are worthy objectives, which have been aggressively been pursued since February 2003. A more fundamental view, however, is that greater transparency means removing barriers to access by making peer review files available to parties beyond the firms themselves.

With this in mind, various measures could be considered, including public disclosure of peer review information only in certain circumstances, such as for peer reviews of firms that perform audits as their highest level of service or for adverse and modified reviews. Another option might be a voluntary system of public disclosure, similar to PCPS and CPCAF. Consideration might also be given to adopting the GAO model and requiring firms to remit peer review information to clients prior to accepting any engagement. A list of options considered is included in the appendix to this white paper. While many of these have merit, an analysis of the options shows that many would not represent a

significant evolution in making peer review more transparent. In addition, the administrative and logistical complexities associated with these variations would likely pose a barrier to successful execution.

For the sake of clearly analyzing the issues at hand, the AICPA is focusing on “how” and “to whom” peer review information should be made available. Two approaches in seeking greater transparency are being contemplated – one providing online access to the public and another facilitating access to the reports by State Boards of Accountancy. A comprehensive discussion and debate on these two options will be essential to moving forward on this issue.

State Board Regulatory File

A mandatory state board regulatory file would likely mean that all CPA firms subject to peer review would be required to place certain information, like the peer review report, letter of comments and letter of response, in an electronic file maintained by the AICPA. State boards of accountancy in only those states where the firm is licensed would have access to the information through a secure password protected web interface.

For example, if Smith & Jones, CPA is licensed in Texas and New York, only the Texas and New York state boards would be given access to Smith and Jones’ peer review information. This would happen regardless of whether those state boards required peer review or whether they required the remittance of the information as a condition of licensure.

Under a state board regulatory file scenario, peer information would not be directly accessible by the public. Instead, access to the AICPA files would be given to state licensing bodies via special permissioning to an electronic file. It is important for members to understand, however, that the information contained in a state board regulatory file could also be considered public information. This is because, depending on the state’s confidentiality rules, peer review documents might be obtained from the state board through a Freedom of Information Act (FOIA) request. Still, at the very least it would be much more cumbersome for the media, a competitor, or any member of the public to gain access to any

particular peer review report under this scenario. While not creating the same degree of disclosure that a PCPS - model public file would provide, a state board regulatory file would nevertheless represent a significant move forward in the effort to achieve greater transparency.

Public File

Currently, about 6,400 firms post their peer review results on the AICPA website as members of the Partnering for CPA Practice Success, the AICPA Alliance for CPA Firms (PCPS), the Center for Public Company Audit Firms (CPCAF), the Employee Benefit Plan Audit Quality Center (EBPAQC) or the Governmental Audit Quality Center (GAQC). These files are accessible by anyone with internet access by going to www.aicpa.org/centerprp/publicfile .

Moving to a mandatory public file for all CPA firms would mean expanding the current public peer review file to include all firms that currently undergo peer review as a condition of AICPA membership. Just as PCPS, CPCAF, EBPAQC and GAQC members do today, firms would make certain peer review information available to the public through the AICPA website.

Members Will Make Ultimate Decision

Ultimately, any kind of mandatory disclosure of peer review information – whether a true public file or a state board regulatory file – would be a bold move for the profession and can only occur with a two-third membership vote.

Members Concerns

Many members have expressed concerns about how making their peer review information public will affect their practices. After all, peer review was made mandatory sixteen years ago, as a result of a vote that may have been different without the promise of confidentiality. However, as we have discussed, the marketplace and the regulatory environment in which all CPAs and businesses operate have changed significantly since mandatory peer review was

approved. The CPA profession has always reacted to new realities by making every effort to increase its public interest responsibilities.

There is also a concern among some members that the prospect of greater transparency may cause some peer reviewers to protect a firm from an adverse impact on its practice by showing restraint in the reports they issue. If this were true, greater transparency could lead to less meaningful reviews. It is important to remember, however, that during the quarter of a century that members of PCPS and CPCAF/SECPS have had a public file, there have been tens of thousands of reviews of thousands of firms available for anyone to look at. In all that time, there has been little evidence to suggest that the quality of reviews has suffered. Furthermore, the AICPA Peer Review Board is currently pursuing a system of enhanced oversight to help ensure the diligence of peer reviews, preventing reviewers from “turning the other cheek” or “back scratching.”

In fact, greater transparency may well raise the bar on the quality of reviewers. The AICPA is working with peer review administrators to increase the supply of reviewers by exploring such options as:

- Offering more opportunities for peer reviewers to take required peer reviewer courses.
- Reconsidering allowing senior firm engagement personnel who are not owners of the firm to be team captains on peer reviews, and
- Creating more demand for high quality peer reviews by communicating to the user community about the benefits of peer review.

There also are concerns that greater transparency could make it easier for peer review information to be used in litigious or competitive situations. But even under our current system, any good litigator could obtain that same information. Nevertheless, in the 25 years that we have had peer review public files for PCPS and CPCAF/SECPS, rarely have courts looked to this information without going

directly to the firm. While it is always possible that some firms may choose to use peer review information to create a competitive advantage, this too has never become an issue except for when a firm is touting the fact that it has made its own peer review information available for the public to view.

In 1987 many members feared that making peer review mandatory would cause members to resign in droves. There is a similar concern now among some members about imposing greater transparency. While any attempt to “raise the bar” may make some members unhappy, our profession takes pride in protecting the public interest and providing information that helps the public make informed decisions. Through the years, the AICPA has taken numerous steps to increase the professional stature of its members, and to their credit, most members have responded positively.

It has also been suggested that if regulators, clients or members of the public need peer review information, they can request it directly from the CPA firm. This may be true, but having a system that helps AICPA members disseminate peer review information facilitates the process of greater transparency. Having a profession-wide policy that establishes a process to make peer review information more transparent demonstrates our profession’s commitment in a way that piecemeal disclosure will not. Most importantly, if a firm knows that the results of its peer review will become available to more audiences, it will likely do everything possible to increase the quality of its practice in order to ensure that the results of the review are positive.

The AICPA is also sensitive to any new requirements that would impose a financial burden on firms, particularly small firms. The Institute will be working closely with the state societies to minimize the financial impact. Making the reports public, for example, should translate to only nominal incremental costs, since a structure that puts the reviews of CPCAF and PCPS firms into a public file and makes the reports of thousands of firms available to state and federal regulators is already in place.

Finally, some members may also believe that it is not the profession’s job to take the lead in enforcing greater transparency. These members might argue

that instead, it is the regulators job to regulate, not the profession's responsibility to impose an ever-expanding number of requirements on its members. But great professions control their destiny and do not wait for the regulatory community to impose actions on them.

Throughout its history, the accounting profession has had a long-standing commitment to the public interest and a reputation for taking voluntary steps to support that commitment through measures that reflect our core values, protect the public, and maintain our historically high public regard. The regulatory community, our clients, and the public have always been inclined to trust CPAs because we have continually taken the initiative to self-impose a transparent system that will provide the information they need to make informed decisions. The bottom line is that all our constituents are more apt to trust a profession that takes the initiative to meet its regulatory challenges.

Your Feedback is Needed

The degree of transparency in peer review reporting has clearly evolved over the years. However, formalizing this ongoing shift from a confidential peer review process to one that includes disclosure in the public interest will only be achieved through a membership referendum. Any such member vote can only follow a period of healthy exchange of the ideas included in this paper.

As part of the member education program, the AICPA welcomes feedback from members who want to dialogue about the impact greater transparency could have on the profession, their own practice, and on the peer review process itself. We urge members to register their opinions and suggestions at peerreviewtransparency@aicpa.org .

Options for Achieving Greater Transparency

1. **Public file for system reviews only**
2. **Public file for adverse and second modified (or equivalent) only**
3. **Voluntary public file repository**
4. **Access only to state boards that require peer review for licensure**
5. **Access of *all* peer review reports, letters of comment and letters of response *only* to state boards that require peer review and document remittance for licensure**
6. **Access of peer review reports, letters of comments and letters of response *for firms that receive adverse and consecutive reports that are not unmodified* and *only* to state boards that require peer review and document remittance for licensure.**
7. **Firm would be *required* to remit peer review information to client prior to accepting the engagement. – the GAO model**
8. **Mandatory public file for all peer review reports ***
9. **Electronic file only accessible by state boards of accountancy ***

*** Focus of for the position paper and the member awareness program**