

A STUDY OF THE IMPACT OF FIRM SIZE ON PEER REVIEW FINDINGS

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ABSTRACT

This study explores the potential relationship between the size of the accounting firm and the level of peer review findings that may be uncovered during peer reviews. The study also investigates whether peer reviews appear to be applied uniformly across states.

The findings of this study indicate that there is no significant difference between the peer review findings uncovered for large firms as compared to the findings of small firms. Furthermore, peer reviews do not appear to be applied uniformly across states.

INTRODUCTION

The American Institute of Certified Public Accountants' (AICPA) Board of Directors and Governing Council, The Peer Review Board, and other leaders of the accounting profession are in the middle of a campaign to convince members of the profession to support making peer review results transparent. The profession's position is that transparency implies communicating the facts clearly and truthfully to every one of our audiences- investors, regulators, management, and the public (AICPA Position Paper, p.13). A simpler, more direct description of transparency, as it relates to peer reviews, is making peer review findings publicly available. The AICPA is considering either making the information readily available to the general public by placing the findings on the AICPA's website, or by providing the information to state boards of accountancy.

Before such findings can be published, however, the AICPA must hold a member referendum on the issue. One question that members should consider prior to voting on the transparency proposal is will small businesses be unduly burdened by such disclosure?

The purpose of this paper is to determine whether the size of an accounting firm influences the likelihood of peer reviewers identifying findings during triennial peer reviews. A secondary purpose is to determine if peer reviews are applied uniformly across states.

All things being equal, small firms are expected to have a larger number of peer review findings than are large firms. The reason for this expectation is the personnel and resources available to large firms. Large firms have the manpower and the resources necessary to devote to establishing and maintaining a superior quality control system. Conversely, many small firms may have neither the personnel nor the resources required to support an adequate system.

Small firms, especially sole proprietorships, are expected to experience problems in at least two quality control areas. The areas are engagement performance and monitoring. Quality Control Section 20, Paragraph .18 indicates that policies and procedures for engagement performance should cover planning, performing, supervising, reviewing, documenting, and communicating the results of each engagement. Paragraph .19 indicates that personnel should refer to authoritative literature or other sources and consult, on a timely basis, with individuals within or outside the firm, when appropriate (QC Section 20).

Likewise, monitoring is an area of quality control that is ripe for peer review findings in small CPA firms. Even though pre-issuance and post-issuance reviews generally constitute monitoring, the reviews are not considered monitoring if performed by the person with final responsibility for the engagement (QC Section 30, Para. .08). Furthermore, when an individual inspects his or her own compliance, the firm may have a higher risk that non-compliance with policies and procedures will not be detected (QC Section 30). If a small firm with a limited number of management-level individuals does not recognize the need to engage a qualified

individual from outside the firm to monitor its system of quality control or if it finds engaging an outsider too costly, the likelihood of peer review findings increase.

These elements of quality control are suspect because they generally require the presence of internal personnel and or external contacts to function properly. Given the low number of professional personnel in these firms, there is a higher likelihood of findings being uncovered in these areas in small firms.

HISTORICAL PERSPECTIVE

Spurred on by high-profile bank failures and corporate bankruptcies of the late 1970s and the early 80s, the accounting profession instituted peer reviews in 1988. The AICPA convinced members to support peer reviews by making two promises. First, peer reviews were to be remedial rather than punitive. Second, peer review findings were to be kept confidential, except for those administering the program (AICPA, Position Paper, p. 5). However, members of the Center for Public Company Audit Firms (CPCAF) and Partnering for CPA Firm Success (PCPS) have made their peer reviews reports available to the public on the AICPA website (AICPA, Position Paper, p. 1). Other members are publishing their peer review reports in marketing literature.

The primary users of peer review reports have traditionally been the reviewed firms. However, other users are now seeking the reports to facilitate their assessment of the quality of CPA firms' practice. Both bank regulators and the Department of labor are on record supporting greater transparency of peer review reports for those accounting firms that audit financial institutions and pension plans (AICPA, March to Public Disclosure, p. 1). State Boards of Accountancy want access to peer review reports to facilitate the state licensing process (AICPA, Council Resolution). Consequently, the AICPA Board of Directors has decided to initiate an education program to persuade the membership to support the idea of making peer review reports transparency.

THE PEER REVIEW PROGRAM

The AICPA has found that the members of the accounting profession do not fully understand the peer review program (AICPA, Member Perception). The peer review program is designed to enhance the quality of accounting, auditing, and attestation services performed by AICPA members in public practice. This enhancement is accomplished by identifying CPA firms with inadequate systems of quality control, detecting performance that departs from professional standards, and imposing corrective actions.

The profession currently has a three-tiered approach to peer reviews (system, engagement, and report reviews). Firms that perform engagement under auditing standards (SAS), government auditing standards (Yellow Book), or examinations of prospective financial statements have peer reviews called system reviews (AICPA, Standards for Performing and Reporting Peer Reviews). The reviewer expresses an opinion regarding proper quality controls design and compliance with control policies and procedures. Firms that perform compilation engagements under Statements on Standards for Accounting and Review Services (SSARS) that omit substantially all disclosure have report reviews. Firms that perform accounting and examination services that do not meet the criteria above have peer reviews called engagement reviews. The reviewer provides only limited assurance on engagement reviews.

The expectations of this study are that if both small firms and large firms provide the services mentioned above, small firms are likely to experience more difficulty maintaining high levels of quality. Small firms are more likely to violate quality standards and have to respond to peer review findings.

EMPIRICAL MODEL

The study investigates whether there is an inverse relationship between the number of peer review findings and the size of the firm. The model can be summarized as follows:

Levels of Peer review findings is a function of the firm's size

Where,

Peer review findings are determined by counting the number of findings identified by reviewers of sample firms.

Firm size is the number of professionals employed in the firm, including the owner(s).

SAMPLE SELECTION

The AICPA's peer review public file was used to obtain the sample used in this study. The file contains peer reviews for the years from 1999 through 2005. Data for firms in the states of Alabama, Louisiana, and Mississippi were examined. The firms were included in the sample if peer review documents were available online. As shown in Table 1, the sample consisted of 286 peer review reports.

TABLE 1
Sample Selection

<i>State</i>	<i>Number of observations</i>
Alabama	123
Louisiana	96
Mississippi	67
Total	236

The AICPA's peer review public file separates firms by states. The file further separates firms by size using the number of professionals. Using this scheme, seven categories are presented, ranging from sole proprietorships, to firms with more than 100 professionals. Each peer review document was read and the number of different findings for each firm, if any, was enumerated. Firms with from one professional (sole proprietorship) to 19 professional employees were classified as small firms, while firms with 20 or more professional employees were classified as large firms.

RESULTS

The two independent-sample T test procedure was used to perform hypothesis tests. The first null hypothesis is that there is no statistically significant relationship between the size of the accounting firm and the number of peer review findings uncovered during triennial reviews. The alternative hypothesis is that there is an inverse relationship between the size of the firm and the number of peer review findings.

Table 2
Independent-Samples T Test of Peer Review Findings to Firm Size

Group Statistics

	Staff size	N	Mean	Std. Deviation	Std. Error Mean
Review findings	>= 4.00	84	.5000	1.16681	.12731
	< 4.00	202	.7327	1.36328	.09592

		Levene's Test for Equality of Variances		t-test for Equality of Means						
		F	Sig.	t	df	Sig. (2-tailed)	Mean Difference	Std. Error Difference	95% Confidence Interval of the Difference	
									Lower	Upper
Review findings	Equal variances assumed	1.809	.180	1.369	284	.172	-.23267	.16993	-.56716	.10182
	Equal variances not assumed			1.460	180.025	.146	-.23267	.15940	-.54721	.08186

Table 2 summarizes the two independent-sample T test results for comparing peer review findings in small firms with the peer review findings in large firms. Although the signs of the coefficients are as expected, none of the t statistics are significant at the 5% level, which means that we fail to reject the null hypothesis. No significant difference exists between peer review findings for large firms as compared to such findings in small firms. These findings would indicate that making peer review findings transparent would place no more of a burden on small firms than the exposure would place on large firms. This is not the end of the story, however.

Although these findings are not consistent with expectations, there are plausible explanations for the findings. One explanation is that small firms are doing a better job of providing quality services than originally posited by this study. Conversely, small firms may be

performing less professional services that could lead to peer review findings. That is, small firms may need larger internal staffs to ensure compliance with quality control standards, or small firms may find the cost of compliance with quality standards disproportional to the revenue generated from clients that could trigger such reviews. Consequently, some small firms may not serve these clients. If a CPA firm only audits one to two clients, for example, and the firm has to incur substantial cost to meet the quality standards related to the audits, the logical solution may be to opt out of providing audit services. A promising area for further research is an examination of whether firms have discontinued serving certain types of clients because the firms do not want to be bothered with the current and anticipated heightened costs of quality compliance. Anecdotal evidence obtained from reading several response letters to peer review findings indicated that some practitioners are opting out of some services areas for this reason.

The second null hypothesis is that peer reviews are applied uniformly across states. The Alternative hypothesis is that firms in some states are likely to have to respond to more findings than firms in other states.

Table 3
Independent-Samples T Tests of Peer Review Findings to States (Louisiana versus Mississippi)

Group Statistics

	State Name	N	Mean	Std. Deviation	Std. Error Mean
Review findings	Louisiana	96	.9688	1.68244	.17171
	Mississippi	67	.4478	1.04857	.12810

		Levene's Test for Equality of Variances		t-test for Equality of Means						
		F	Sig.	t	df	Sig. (2-tailed)	Mean Difference	Std. Error Difference	95% Confidence Interval of the Difference	
									Lower	Upper
Review findings	Equal variances assumed	13.911	.000	2.247	161	.026	.52099	.23184	.06315	.97883
	Equal variances not assumed			2.432	159.194	.016	.52099	.21423	.09788	.94409

Table 4
Independent-Samples T Test of Peer Review Findings to States (Louisiana versus Alabama)

Group Statistics

	State Name	N	Mean	Std. Deviation	Std. Error Mean
Review findings	Louisiana	96	.9688	1.68244	.17171
	Alabama	123	.5447	1.05000	.09467

		Levene's Test for Equality of Variances		t-test for Equality of Means						
		F	Sig.	t	df	Sig. (2-tailed)	Mean Difference	Std. Error Difference	95% Confidence Interval of the Difference	
									Lower	Upper
Review findings	Equal variances assumed	15.432	.000	2.284	217	.023	.42403	.18569	.05806	.79001
	Equal variances not assumed			2.163	150.694	.032	.42403	.19608	.03661	.81146

Tables 3 and 4 summarize the two independent sample T test results for comparing peer review findings across states. Statistically significant differences exist between the numbers of findings uncovered in Louisiana as compared with Alabama. There is also a significant difference between findings in Louisiana as compared to Mississippi. These differences could be the results of one of two factors or a combination of both. One possibility is the practitioners in Louisiana are slackers, resulting in more findings. Otherwise, the reviewers are harsher in some states as compared to other states. Future studies could explore reasons for the differences that exist between reviews performed across state lines. No significant difference existed between the numbers of peer review findings uncovered in Alabama as compared with Mississippi.

CONCLUSION

Practitioners, especially small practitioners, will soon have to make a decision. Should the AICPA's proposal to publicize peer review findings be supported or rejected? There are no easy answers. However, there is an approach that can be used to answer these questions. The costs and the benefits of publishing the findings should be considered. At a personal level, practitioners should ask themselves, "What's in it for me?" Given the results of this study, any negative consequences of publishing the review finding will not disproportionately impact small firms more than the findings impact large firms. However, further studies need to be conducted

to determine if the levels of peer review findings are similar between large firms and small firms because the firms are performing at the same quality level or because a large percentage of small firms have discontinued performing certain services to avoid peer review problems. If firms are found to be opting out of offering certain services to avoid having to deal with peer review findings, the AICPA should consider this behavior in making its decision about peer review transparency.

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