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25 YEARS AGO >>

In the days before peer review

BY DAVE COTTON, CPA

It is easy to take for granted the way the profession is today — and assume it's always been that way. Ours is an evolving and dynamic profession. This column looks at the way we were a quarter-century ago.

The January 1990 issue of *Disclosures* featured an article by C. David Stauffer, Marie Macklin and Dale E. Rafal titled "How to Prepare for Your First Review." That's right — peer review was a fairly new (and quite controversial) concept 25 years ago. Some firms had been participating in voluntary peer reviews since the early 1980s. In 1988, American Institute of CPAs (AICPA) members voted to make peer review mandatory. The U.S. General Accounting Office (now known as the Governmental Accountability Office) made participation in an "external quality control review program" mandatory for firms doing audits starting in 1989. Mandatory peer review was phased in across the country, state-by-state, during the early- to mid-1990s.

Many practitioners resisted the requirement. I vividly recall one CPA telling me, "My daddy was the CPA in [his town] before me and I'm the CPA in town now. If I say the financial statements can be relied on, that's all anyone needs to know. Nobody needs to see my workpapers." To help assuage concerns of some of the early resisters, two "fundamental principles" of peer review were stressed:

- 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).

I think the first principle is still essentially intact. The unpleasantness our profession struggled with during the 2001–2002 era (Enron, WorldCom and so forth) swept the second principle aside as the public demanded more transparency.

The unfortunate fact of the matter was that some CPAs in the pre-peer review era were willing to cut corners. Some were even willing to "roll the dice" and simply issue audit reports without doing any audit work. The gamble: the financial statements are either fairly presented or they're not; if they're not, what are the chances that anyone might find out? Some clients just wanted or needed that audit report and did not really care how much quality audit work was done. Not much incentive to incur the cost of thorough and high quality audit work for those clients. Who knows how many CPAs succumbed to the corner-cutting temptations before we had peer review requirements.

To those of you who find the above characterization hard to swallow, let's focus on a more recent scenario that has taken place. A CPA named David Friehling issued audit reports for many years for an investment advisory firm. In 2009, Friehling admitted that he not only had not done high-quality audits of the firm, he had not done any audits at all; he simply issued audit reports that clients of the investment advisory firm relied on. The investment advisory firm: Bernard L. Madoff Investment Securities LLC. Friehling got away with it for years and years by simply evading the peer review process: he just told the AICPA and his state CPA society that he was not doing any audits. (Sadly, he was actually telling them the truth.) Friehling is still awaiting sentencing and faces a maximum sentence of 114 years. His former client, Bernie Madoff, is several years into his own 150-year sentence.

So, we've travelled a long way in 25 years in terms of audit quality and transparency. What might the future hold? I know of one CPA firm that decided several years ago to voluntarily undergo annual peer reviews instead of the once-every-three-years minimum requirement. That firm's view is that if the profession is serious about high quality audits, why just have a review every three years? Why not get 100 percent peer review coverage? We may look back in 25 years and be amazed that yearly peer reviews were not always required. Enlightenment?

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