

APPENDIX E – QUASI PEER REVIEW PROCESS

1 The Panel’s primary purpose was to examine whether the audit processes of the large firm members of the SECPS adequately serve and protect the interests of investors. The major element in this examination was the Quasi Peer Review (QPR) process. The QPR process was designed to make a comprehensive review of public company audits performed by the eight largest firms, to evaluate the way independent audits are performed and to assess the effects of recent trends in auditing on the public interest. The QPR process, which occurred during the summer and fall of 1999, gathered empirical data on the quality of a selected sample of SEC audit engagements with 1998 and 1999 year ends. In considering the effectiveness of the audits, the QPR:

- Evaluated the quality of work performed in specific key areas, including risk assessments, reviews of controls, and documentation
- Assessed whether the individuals who performed and reviewed the work had the necessary knowledge, skills and experience
- Determined whether the work was performed and reviewed on a timely basis
- Considered the adequacy of existing professional standards

Recommendations for improving audit effectiveness were developed from the Panel’s QPR findings.

QPR COMPARED WITH SECPS PEER REVIEW

2 While there were numerous similarities between the QPRs and SECPS peer reviews, there also were numerous differences. The differences included:

- In-depth interviews in the QPRs of engagement personnel at all levels
- Focusing the QPRs on specific identified areas, such as the risk assessments, the linkage of the risk assessments to tests of controls and substantive tests, and whether the people who performed the work had the necessary knowledge and skills, rather than on an overall assessment of the engagement (i.e., an overall assessment of conformity with generally accepted accounting principles and compliance with generally accepted auditing standards)
- More in-depth, subjective examinations in the QPRs of the areas reviewed
- Having a member of the Panel staff conduct an extensive debriefing session with the QPR reviewer at the conclusion of each engagement review
- Holding focus group meetings in the QPRs of managers and seniors in each office reviewed
- Not preparing “matter sheets” in the QPRs that describe the deficiencies noted by the reviewers
- Not preparing reports or letters of comments on individual offices or firms in the QPRs

3 During the Panel's development of the QPR, various constituencies, including the SEC, the POB, practitioners, the Panel and the Panel staff, identified specific areas that directly affect the overall effectiveness of an audit. The Panel determined that the QPR should focus on these specific areas. The QPRs examined these areas in more depth than the SECPS peer reviews typically do. These areas included:

- Risk assessments, including engagement risk, fraud risk, inherent risk and control risk
- Controls, especially those related to information technology
- Linkage of risk assessments to tests of controls and substantive tests
- Substantive procedures, including substantive analytical procedures, in selected areas
- Completion of the audit, including the resolution of issues, non-standard entries, final analytical review and waived adjustments
- Communications with audit committees
- Revenue recognition, asset impairments, and merger-related and restructuring reserves

4 The QPR reviewers sought to obtain an in-depth understanding of the engagement teams' thought processes in the areas reviewed. The QPR reviewers used in-depth interviews and reviews of working papers to obtain this understanding. All instances in which the QPR reviewers disagreed with the quality or sufficiency of the engagement teams' work were referred to the firms for appropriate follow-up.

5 Matter sheets, reports and letters of comments were not prepared during the QPRs to increase openness and candor and reduce the reviewees' defensiveness. The goal of the QPR was not to assess and report on specific offices or firms; rather, the purpose was to assess and report on the overall effectiveness of public company audits performed by the large firms. In order to elicit frank responses and full cooperation from those reviewed, the Panel agreed to hold the specific engagement results in confidence. Accordingly, the results of the QPR have been summarized on an overall basis that combines the results of all offices and firms.

QPR SCOPE

6 All the companies whose audits were reviewed were SEC registrants. The reviews covered the eight largest accounting firms in the United States, namely, the Big 5 firms of Arthur Andersen LLP, Deloitte & Touche LLP, Ernst & Young LLP, KPMG LLP and PricewaterhouseCoopers LLP, as well as the three next largest firms, BDO Seidman, LLP, Grant Thornton LLP and McGladrey & Pullen, LLP.

7 To facilitate the selection of the individual offices to be reviewed, the Panel staff requested these firms to provide detailed demographic information by office.¹ The staff selected the offices to be reviewed to achieve diversity in their size, geographic location, clients and risk characteristics. For each of the Big 5 firms, the Panel staff selected four offices. The Panel staff selected only two or three offices for each of the other three firms because of their smaller size. In all, audit engagements at 28 offices were reviewed.

8 The selected offices then were requested to provide detailed demographic information about each SEC registrant audited by the office, as well as information regarding certain office-wide quality control and risk matters.² The Panel staff used this data, as well as other information,³ to determine the specific engagements to be reviewed. The engagements were chosen to achieve a diverse sample of engagements in terms of size, industry and engagement characteristics.⁴ For the Big 5 firms, the Panel staff generally selected five engagements per office, resulting in approximately 20 engagements reviewed for each firm. For the other three firms, the Panel staff selected approximately 10 engagements per firm to review. Overall, the staff selected 130 engagements, of which results were tabulated for 126 engagements representing 320,790 audit hours. The other four engagements were used to pilot test the QPR process. Based on the pilot tests, the staff made certain modifications to the QPR questionnaire to improve the effectiveness of the QPR process. The Panel members exercised oversight throughout the selection process.

QPR PROCESS

9 The firms' regular peer reviewers (from another audit firm) conducted the 28 office reviews under the close supervision of the Panel staff, including at least one senior member of the Panel staff. Virtually all the reviewers were partners with relevant industry and SEC experience.

Training

10 Before the QPRs were performed, the Panel staff conducted a training session for the eight firms' QPR coordinators and the review team captains from the reviewing firms. One member of the POB, a Panel member, and members of the staffs of the AICPA, SEC, POB and SECPS also attended the one-day session.

11 At the beginning of the review in each office, the reviewers and reviewees attended an orientation session conducted by the Panel staff. The purpose of these training and orientation sessions was to explain the purpose and objectives of the QPRs, how they

¹ See Table 1, Demographics Considered in Office Selection.

² See Table 2, Demographics Considered in Engagement Selection.

³ Other information included the "Top 50" restructuring charges, in-process research and development charges, merger charges, and write-downs in 1998; information regarding the fastest growing companies; and the SEC's "hot topics."

⁴ See Table 3, Industries of Reviewed Engagements, Table 4, Audit Hours of Reviewed Engagements, and Table 5, Engagement Characteristics of Reviewed Engagements.

differed from the SECPS peer reviews and how the Panel would use the results of the reviews.

Office Reviews

12 Each office review was approximately one week long and consisted of:

- An interview of the partner-in-charge of the office's audit practice
- Discussions with groups of audit seniors and managers (referred to as "the focus groups")
- Engagement reviews comprising interviews of engagement personnel, reviews of selected working papers and completion of the QPR questionnaire
- Interviews of the consulting partners responsible for the delivery of non-audit services, if any, on the engagements reviewed
- An exit conference with office management

13 Panel members attended most of the office reviews, participated in the focus groups and interviews, and observed the engagement reviews.

Interview of the Partner-in-Charge

14 The interview of the partner-in-charge of the office's audit practice focused on the adequacy of the professional development of auditors, the overall "tone at the top" in the office, and the performance measures used by the office in evaluating, compensating and promoting audit personnel. The partner's views on audit effectiveness and governance of the profession also were obtained. The QPR team captain conducted the interview, which was attended by a member of the Panel staff, and in many instances by one or more Panel members.

Focus Groups

15 The objective of the focus group discussions was to provide the Panel with added insight from audit seniors and managers about matters that they viewed favorably and matters that they believed needed improvement or would require changes in the future. There were two focus group meetings in most offices, one comprising five to eight senior managers and managers, and another comprising a similar number of seniors. At some of the smaller offices, one combined focus group meeting of managers and seniors was held. The focus group participants generally were not assigned to the engagements being reviewed. The sessions, which were conducted by the Panel staff, addressed such topics as the environment, auditors' knowledge and skills, and audit methodology. In many instances, one or more Panel members attended the sessions.

Engagement Reviews

16 The engagement reviewers began the review process by reviewing information from the prior year's audit and making their own preliminary risk assessments before interviewing the engagement partner, concurring partner, manager, senior and selected staff. Then they reviewed selected working papers based on the information obtained. The reviewers documented their observations and findings by completing a detailed questionnaire that included basic and supplemental sections. Panel members and staff participated in some of the interviews.

The Basic Questionnaire

17 The basic questionnaire included 426 data gathering, evaluative, best practice and improvement questions, as well as space for the reviewer's comments. The questionnaire was designed to elicit narrative responses from the reviewers to help identify best practices and areas for improvement and to eliminate the "check the box" mentality that can occur when questionnaires are used to gather information. The data gathering and evaluative questions were organized in a manner that was consistent with the audit risk model. Panel members reviewed and commented on the questionnaire before it was issued.

18 The questionnaire covered the following areas at the financial statement level:

- Engagement risk assessment and linkage to the inherent risk and control environment assessments
- Inherent risk and control environment assessments
- Fraud risk assessment

19 The reviewers generally selected three high-risk areas for review as well as one material area that the engagement team had assessed as having "low" or "moderate" (i.e., not high) risk. For these areas, the reviewers evaluated the:

- Inherent risk assessment
- Internal control risk assessment and evaluation
- Linkage of risk assessments (inherent, control and fraud risks) to substantive tests
- Design and performance of substantive tests

20 In order to obtain data regarding other important areas that affect audit effectiveness, the questionnaire required the reviewers to consider:

- Completing the audit
 - Resolution of issues
 - Non-standard entries

- Final analytical review
- Relations with the audit committee
- Personnel assigned to the engagement and changes in the engagement in recent years

21 The reviewers had to make numerous subjective evaluations when completing the questionnaire. These judgments related to the quality of the audit work performed, the knowledge and skills of those who performed the work, and whether the reviewer agreed with the engagement team's decisions. The reviewer's judgments on these matters were not limited to the engagement team's compliance with firm policies or professional standards, since the purpose of the QPRs was to address change and identify potential improvements.

The Supplemental Sections

22 The reviewers completed the following supplements to the basic questionnaire when they were applicable:

- Fraud risk assessment – misappropriation of assets
- Use of internal audit
- Revenue recognition
- Merger-related and restructuring reserves
- Impairment of long-lived assets and long-lived assets to be disposed of
- Going concern/severe liquidity
- Multi-location audits
- Non-audit services
- Former firm personnel in client management

23 Also, the reviewers described the audit approach in each of the four key areas and completed a supplemental questionnaire on the use of analytical procedures as substantive procedures in five additional areas that the reviewers selected with guidance from the Panel staff.

Debriefing Sessions

24 At the end of each engagement review, the reviewer met with a Panel staff member to communicate the reviewer's findings and evaluation of the engagement, with emphasis on the:

- Appropriateness of the risk assessments
- Level, general business and industry experience/expertise, knowledge and skills of those who performed and reviewed the work

- Nature, timing and extent of the partner's involvement in the engagement
- Nature and extent of the controls testing and substantive procedures performed, including the use of analytical procedures as substantive procedures
- Adequacy of documentation in the areas reviewed

Panel members attended some of these sessions.

QPR Exit Conferences

25 An office exit conference was held at the completion of the QPR process in most offices to summarize the results of the review. The conferences were conducted by the QPR team captain and generally were attended by the office's accounting and auditing leaders, a Panel staff member and, in some offices, a Panel member.

26 An overall exit conference was conducted with most of the firms to summarize and discuss the firm's overall QPR results. The firm's accounting and auditing leaders generally attended the meeting, which focused on the scope of the QPR and the best practices and areas for improvement noted during the review.

TABLE 1

Demographics Considered in Office Selection

To facilitate the selection of the individual offices to be reviewed, the Panel staff requested the eight firms to provide the following information by office:

- Audit engagement hours for the most recent 12-month period
- Number of audit partners
- Number of other audit personnel
- Average hours per audit partner
- Ratio of other audit personnel to audit partners
- Number of SEC engagements
- Number of IPOs effective since December 31, 1997
- Number of new SEC clients for which the firm's first report covered a period ending after November 30, 1997, with separate identification of the number of clients for which the predecessor auditors had resigned or reported a disagreement
- Number of SEC engagements with management consulting fees that exceeded the audit fees
- Number of SEC engagements considered "high risk"
- Number of cases reported to the Quality Control Inquiry Committee since January 1, 1997
- Number of restatements issued since December 31, 1997 (both SEC and non-SEC clients)
- Number of withdrawals of opinion since December 31, 1997 (both SEC and non-SEC clients)
- "Top five" industries by audit hours

TABLE 2

Demographics Considered in Engagement Selection

The selected offices were requested to provide detailed information by SEC registrant including:

- Engagement hours, industry, revenues, percentage of assets used in foreign operations and percentage of revenues from foreign operations
- Whether the following characteristics were present:
 - Significant derivative financial instruments
 - Going concern issues
 - Revenue recognition issues
 - In-process research and development (IPR&D) charges
 - Restructuring charges
 - Significant use of electronic data interchange (EDI)
 - Internal audit outsourcing services provided by the firm
 - IPO effective since December 31, 1997
 - The firm's first report covered a period ending after November 30, 1997
 - The firm's first report covered a period ending after November 30, 1997 and the predecessor auditors had resigned or reported a disagreement
 - The management consulting fees exceeded the audit fees
 - The client is considered "high risk"
 - A reproposal within the past three years
 - A partner or manager had left the firm to become the client's chairperson, CEO, COO, CFO or controller within the past three years

In addition, the selected offices were asked to list any:

- Cases reported to the Quality Control Inquiry Committee since January 1, 1997
- Restatements issued since December 31, 1997 (both SEC and non-SEC clients)
- Withdrawals of opinion since December 31, 1997 (both SEC and non-SEC clients)

TABLE 3**Industries of Reviewed Engagements**

Industry	Number of Engagements
Manufacturing	28
High technology	25
Financial services	17
Telecommunications	14
Consumer business	12
Health care	8
Real estate	8
Utilities	8
Gaming	2
Transportation	2
Aerospace & defense	1
Travel	1
Total engagements	126

TABLE 4**Audit Hours of Reviewed Engagements**

Audit Hours	Number of Engagements	% of Total Engagements
0 – 500	18	14%
501 – 1000	27	21%
1001 – 2000	38	31%
2001 – 3000	15	12%
3001 – 4000	10	8%
4001 – 5000	4	3%
More than 5000	14	11%
Total engagements	126	100%

TABLE 5**Engagement Characteristics of Reviewed Engagements**

Engagement Characteristics	% of Total Engagements
Initial audits	15%
IPO within the past 3 years	25%
Predecessor auditors resigned or declined to stand for re-election	6%
Client classified as “high risk”	44%
Reproposal within the last 3 years	6%
Restated financial statements in the past 3 years	11%
Significant use of EDI	13%
Foreign operations	44%
Work of a specialist used	33%
Significant work referred to an affiliated firm	24%
Significant work referred to an unaffiliated firm	4%
Significant work referred to other U.S. offices	12%
Internal audit was given significant audit consideration	16%
Restructuring charges or reserves	29%
Impairment of long-lived assets	28%
Going concern issues	39%
Revenue recognition issues	27%
Merger-related charges or reserves	20%
In-process R&D write-offs	6%
Significant use of derivatives	7%
Significant audit adjustments	29%
Significant disagreements with management	0%
Services other than audit or tax provided	29%
Former partner or manager of the firm in position of client chairperson, CEO, CFO, COO or controller	13%
Communications about fraud or illegal acts	8%
Communications about reportable conditions	12%