



CALIFORNIA BOARD OF ACCOUNTANCY
2000 EVERGREEN STREET, SUITE 250
SACRAMENTO, CA 95815-3832
TELEPHONE: (916) 263-3680
FAX: (916) 263-3675
WEB ADDRESS: <http://www.dca.ca.gov/cba>



2008 PEER REVIEW REPORT

Presented to the California Legislature

**Senate Committee on Business,
Profession and Economic Development**

&

**Assembly Committee on
Business and Professions**

Submitted October 1, 2008

Because the report's attachments are voluminous and may cause downloading problems, they are not included with this report. If you are interested in receiving a compact disk of the attachments, please contact Veronica Daniel by telephone at (916) 263-3680.

**CALIFORNIA BOARD OF ACCOUNTANCY**

2000 EVERGREEN STREET, SUITE 250
SACRAMENTO, CA 95815-3832
TELEPHONE: (916) 263-3680
FAX: (916) 263-3675
WEB ADDRESS: <http://www.dca.ca.gov/cba>



October 1, 2008

The Honorable Mark Ridley-Thomas, Chair
Senate Committee on Business, Professions and Economic Development
State Capitol, Room 2053
Sacramento, CA 95814

Dear Senator Ridley-Thomas:

On behalf of the California Board of Accountancy (Board), I am pleased to provide the California Legislature with the Board's *2008 Peer Review Report*, prepared in compliance with Business and Professions (B&P) Code Section 5076.

Although B&P Code Section 5076 does not require the Board to submit its findings on mandatory peer review until September 1, 2011, the Board has elected to accelerate submission of this report to allow for potential legislative action in the coming legislative session. The Board believes that requiring mandatory peer review is beneficial to consumers by ensuring only qualified firms are practicing, and is advantageous to firms by ensuring their personnel maintain a currency of knowledge related to the services provided to clients.

This 24-page report, consisting of five sections, again examines the issue of peer review in California, and arrives at a recommendation to proceed with implementation of a mandatory peer review requirement. The report summarizes the prior Board and Task Forces' consideration of peer review, examines the current Board's consideration of peer review, addresses the recommendations presented in the *2005 Peer Review Report*, identifies the resources necessary to implement the requirement, and concludes with a discussion of the need for mandatory peer review.

Should you have any questions or need additional information, please contact Patti Bowers, Acting Executive Officer, by telephone at (916) 561-1740.

Sincerely,

Donald Driftmier
Board President

Enclosure

c: The Honorable Don Perata, President pro Tempore
The Honorable Karen Bass, Speaker of the Assembly
The Honorable David Cogdill, Senate Minority Leader
The Honorable Michael Villines, Minority Floor Leader
The Honorable Mike Eng, Chair, Assembly B&P
The Honorable Sam Aanestad, Vice Chair, Senate BP&ED
The Honorable Bill Emmerson, Vice Chair, Assembly B&P
Bill Gage, Chief Consultant, Senate BP&ED Committee
G.V. Ayers, Consultant, Senate BP&ED Committee
Amber Throne, Consultant, Senate BP&ED
Ross Warren, Chief Consultant, Assembly B&P Committee
Ted Blanchard, Consultant, Assembly B&P
Carrie Lopez, Director, DCA
Laura Zuniga, Deputy Director, DCA Division of Legislative/Policy Review
Bruce Allen, California Society of CPAs
Jeannie Tindel, California Society of CPAs
Hal Schultz, California Society of CPAs
Dorothy Calegari, Society of California Accountants
David Tolkan, Society of California Accountants
Susan Coffey, American Institute of Certified Public Accountants
Jim Brackens, American Institute of Certified Public Accountants
Richard Robinson, Robinson & Associates
Linda McCrone, CalCPA Peer Review Program
Julie D'Angelo Fellmeth, Center for Public Interest Law
Ed Howard, Center for Public Interest Law
Members, California Board of Accountancy

**CALIFORNIA BOARD OF ACCOUNTANCY**

2000 EVERGREEN STREET, SUITE 250
SACRAMENTO, CA 95815-3832
TELEPHONE: (916) 263-3680
FAX: (916) 263-3675
WEB ADDRESS: <http://www.dca.ca.gov/cba>



October 1, 2008

The Honorable Mike Eng, Chair
Assembly Committee on Business and Professions
1020 N Street, Room 124
Sacramento, CA 95814

Dear Assembly Member Eng:

On behalf of the California Board of Accountancy (Board), I am pleased to provide the California Legislature with the Board's *2008 Peer Review Report*, prepared in compliance with Business and Professions (B&P) Code Section 5076.

Although B&P Code Section 5076 does not require the Board to submit its findings on mandatory peer review until September 1, 2011, the Board has elected to accelerate submission of this report to allow for potential legislative action in the coming legislative session. The Board believes that requiring mandatory peer review is beneficial to consumers by ensuring only qualified firms are practicing, and is advantageous to firms by ensuring their personnel maintain a currency of knowledge related to the services provided to clients.

This 24-page report, consisting of five sections, again examines the issue of peer review in California, and arrives at a recommendation to proceed with implementation of a mandatory peer review requirement. The report summarizes the prior Board and Task Forces' consideration of peer review, examines the current Board's consideration of peer review, addresses the recommendations presented in the *2005 Peer Review Report*, identifies the resources necessary to implement the requirement, and concludes with a discussion of the need for mandatory peer review.

Should you have any questions or need additional information, please contact Patti Bowers, Acting Executive Officer, by telephone at (916) 561-1740.

Sincerely,

Donald Driftmier
Board President

Enclosure

c: The Honorable Don Perata, President pro Tempore
The Honorable Karen Bass, Speaker of the Assembly
The Honorable David Cogdill, Senate Minority Leader
The Honorable Michael Villines, Minority Floor Leader
The Honorable Mark Ridley-Thomas, Chair Senate BP&ED
The Honorable Sam Aanestad, Vice Chair Senate BP&ED
The Honorable Bill Emmerson, Vice Chair, Assembly B&P
Bill Gage, Chief Consultant, Senate BP&ED Committee
G.V. Ayers, Consultant, Senate BP&ED Committee
Amber Throne, Consultant, Senate BP&ED
Ross Warren, Chief Consultant, Assembly B&P Committee
Ted Blanchard, Consultant, Assembly B&P
Carrie Lopez, Director, DCA
Laura Zuniga, Deputy Director, DCA Division of Legislative/Policy Review
Bruce Allen, California Society of CPAs
Jeannie Tindel, California Society of CPAs
Hal Schultz, California Society of CPAs
Dorothy Calegari, Society of California Accountants
David Tolkan, Society of California Accountants
Susan Coffey, American Institute of Certified Public Accountants
Jim Brackens, American Institute of Certified Public Accountants
Richard Robinson, Robinson & Associates
Linda McCrone, CalCPA Peer Review Program
Julie D'Angelo Fellmeth, Center for Public Interest Law
Ed Howard, Center for Public Interest Law
Members, California Board of Accountancy

CALIFORNIA BOARD OF ACCOUNTANCY

2008 PEER REVIEW REPORT

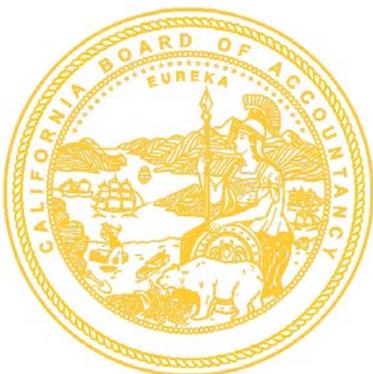
Presented to the California Legislature

*Senate Committee on Business,
Professions and Economic Development*

&

*Assembly Committee on
Business and Professions*

*Prepared in compliance with
Business and Professions Code Section 5076
Submitted: October 1, 2008*



2008 PEER REVIEW REPORT

TABLE OF CONTENTS

INTRODUCTION	1 -
PRIOR BOARD AND TASK FORCES' CONSIDERATION OF PEER REVIEW	3 -
2002-2003 PEER REVIEW TASK FORCE	4 -
2004-2005 PEER REVIEW TASK FORCE	5 -
CURRENT BOARD'S CONSIDERATION OF PEER REVIEW	6 -
MAY 2007	6 -
Overview of the AICPA Peer Review Program and Exposure Draft.....	6 -
SEPTEMBER 2007	7 -
Participation	7 -
Enforcement.....	7 -
Transparency	8 -
JANUARY 2008	9 -
Program Administration.....	9 -
Program Oversight.....	10 -
Document Submission Requirements	10 -
FEBRUARY 2008	10 -
Program Oversight.....	10 -
MAY 2008.....	10 -
Draft Peer Review Report	11 -
Staffing Needs and Cost Analysis	11 -
Draft Statutes and Regulations	12 -
JULY 2008.....	12 -
ADDRESSING THE RECOMMENDATIONS FROM THE 2005 REPORT	13 -
RESOURCE IDENTIFICATION AND IMPLEMENTATION	18 -
LICENSING DIVISION.....	19 -
ENFORCEMENT DIVISION	19 -
TOTAL PROJECTED COSTS	20 -
CONCLUSION	21 -
THE NEED FOR MANDATORY PEER REVIEW	21 -
Improving Services of California Firms.....	21 -
Increased Consumer Confidence and Protection.....	22 -
FINAL RECOMMENDATION.....	22 -

Attachments

- Attachment 1 – Business and Professions Code Section 5076 – Peer Review
- Attachment 2 – Excerpts of the *2003 Sunset Review Report*
- Attachment 3 – *2005 Peer Review Report*
- Attachment 4 – Minutes from the October 2004 Peer Review Task Force meeting
- Attachment 5 – Minutes from the February 2005 Peer Review Task Force meeting
- Attachment 6 – Minutes from the July 2005 Peer Review Task Force meeting
- Attachment 7 – Excerpts from the May 2007 Board meeting minutes
- Attachment 8 – Excerpts from the September 2007 CPC and Board meetings minutes
- Attachment 9 – Excerpts from the January 2008 CPC and Board meetings minutes
- Attachment 10 – Excerpts from the February 2008 Board meeting minutes
- Attachment 11 – Excerpts from the May 2008 CPC and Board meeting minutes
- Attachment 12 – July 2008 CPC meeting minutes
- Attachment 13 – Excerpts from the AICPA April 16, 2007 Exposure Draft “Proposed Revisions to the AICPA Standards for Performing and Reporting on Peer Reviews”
- Attachment 14 – AICPA Peer Review Board *Annual Report on Oversight*
- Attachment 15 – Results of AICPA Oversight Visit of CalCPA, 2006
- Attachment 16 – Peer Review Cost Analysis – Licensing Division
- Attachment 17 – Peer Review Cost Analysis – Enforcement Division

PEER REVIEW REPORT
October 2008
Prepared in Compliance with
Business and Professions Code Section 5076

INTRODUCTION

With the growing demand for increased transparency in all areas of business, the California Board of Accountancy (Board) believes that mandatory peer review built on a platform of both education and enforcement components, and encompassing all California-licensed firms providing accounting and auditing services, is necessary and advantageous to both California consumers and the profession.

Peer review is a study, appraisal, or review of the accounting and auditing work of a firm by a licensed Certified Public Accountant who is unaffiliated with the firm being reviewed, and is done in accordance with applicable professional standards. The goal of peer review is to promote quality in the accounting and auditing services provided by a firm, thereby enhancing the products received by consumers.

Forty-one state boards of accountancy presently require mandatory peer review for licensure or license renewal, using the peer review program developed and managed by the American Institute of Certified Public Accountants (AICPA). For California to remain a leader in the regulation of the profession and to enhance consumer protection, it must move forward with a mandatory peer review requirement.

A peer review requirement is in keeping with the Board's mission to protect the public welfare by ensuring only qualified persons and firms are licensed to practice public accountancy and that appropriate standards of competency and practice, including ethics, objectivity, and independence are established and enforced. As a means to achieving its mission – specifically, protecting consumers by ensuring only qualified firms are practicing, the Board is recommending a peer review process that requires firms performing accounting and auditing services have a systematic review to ensure that work performed conforms to professional standards.

With mandatory peer review, the Board seeks to increase consumer protection in two crucial areas. First, the peer review requirement helps to monitor a certified public accountant (CPA) firm's accounting and auditing practice (*practice monitoring*). The goal of the practice monitoring, and peer review itself, is to promote quality in the accounting and auditing services provided by CPA firms. This goal serves the public interest and protects the consumer. Secondly, the Board recommends it be given the authority to pursue enforcement actions against firms receiving substandard peer reviews. To this end, the Board proposes that firms receiving peer review ratings of

substandard¹ be required to submit the reports and additional peer review documents within 30 days of receipt. These consumer protection mechanisms will provide assurance that only qualified licensees are practicing and providing services to consumers in California. Consumer confidence will increase from knowing California-licensed firms must answer to tough, verifiable standards.

Peer review will also enhance the profession. With ongoing changes to generally accepted accounting principles designed to ensure the accuracy and quality of accounting and auditing engagements, it is imperative that products and services provided to consumers meet adopted professional standards. Firms going through the rigor of peer review will be better equipped to perform quality accounting and auditing engagements. Through preparing for and undergoing a peer review, firms can design internal quality control systems to ensure work is performed to professional standards. The experience and expertise offered by a peer reviewer is value added. This is especially beneficial to small firms and sole proprietors, better enabling them to deliver high quality products and services to their clients.

Establishing a peer review requirement that mandates firms undergo peer reviews administered by a Board-authorized provider, to include the AICPA Peer Review Program, combined with oversight provided by the Board's Peer Review Oversight Committee, will provide the means for maintaining high standards for the peer review process while enhancing consumer protection.

The California Board of Accountancy has examined and considered peer review as a front-line topic since 2000. The Board organized a Peer Review Task Force that held public meetings between 2002-2005, and has issued two reports to the Legislature – an interim report in 2003 and a full report in 2005. Business and Professions (B&P) Code Section 5076 (See **Attachment 1**) presently requires the Board to review and evaluate whether to implement mandatory peer review in California and make a third report of its findings to the Legislature no later than September 1, 2011. The Board has elected to accelerate this effort in order to allow for potential legislative action in the 2009-2010 legislative session.

The interim report issued in 2003 concluded that insufficient information was available at the time to make a meaningful evaluation on the need for peer review. (See **Attachment 2** for excerpts from the *2003 Sunset Review Report* specific to peer review.)

The 2005 report supplemented the 2003 interim report and provided updated information and analysis pertinent to whether peer review should be mandated in California and, if so, what form the program should take. (See **Attachment 3**.) The 2005 report was comprised of five parts – a history of the peer review statute and the Board's study of the issue, a review of relevant changes in federal law, a focus on the impact of changes in state law, a discussion on changes in professional standards, and

¹ For firms undergoing peer reviews administered by the AICPA Peer Review Program, the Board defines firms receiving a peer review rating of *fail* to have received a substandard report.

Board recommendations. The Board recommended delaying implementing mandatory peer review, and to continue to evaluate options for implementation and make a recommendation to the Legislature no later than the submission of the Board's September 2009 Sunset Review Report.

This report, consisting of five sections, again examines the issue of peer review in California, and arrives at a recommendation to proceed with implementation of a mandatory peer review. First, the report summarizes the prior Board and Task Forces' consideration of peer review. Second, it examines the current Board's consideration of peer review. Third, it addresses the recommendations presented in the *2005 Peer Review Report*. Fourth, it identifies the resources necessary to implement the requirement. Finally, the report concludes with a discussion of the need for mandatory peer review.

PRIOR BOARD AND TASK FORCES' CONSIDERATION OF PEER REVIEW

The Board first proposed mandatory peer review as part of its 2000 *Sunset Review Report*. At that time, the reason for mandating peer review was twofold: (1) the Board had proposed eliminating the attest experience requirement for licensure² and concluded that maintaining competency in attest services could best be addressed by post-licensure requirements, including mandatory peer review, and (2) the Board believed that a mandatory peer review program would enhance consumer protection.

As a result, in 2001 the Legislature enacted Assembly Bill (AB) 585 and Senate Bill (SB) 133 (Chapters 704 and 718 respectively) which added B&P Code Section 5076 to the Accountancy Act. Section 5076 requires peer review as a condition for registration renewal for all firms providing attest services³ other than sole proprietors and small firms (four or fewer licensees). Section 5076 left much of the policy and administrative aspects of a peer review program for later development through the rulemaking process.

Shortly after enactment of AB 585 and SB 133, the unprecedented audit failures at publicly-held companies focused national attention on weaknesses in the regulation of the public accounting profession, and called into question the effectiveness of peer review and the self-regulation of the profession in preventing significant audit failures. These events led to the federal Sarbanes-Oxley Act of 2002 and creation of the Public Company Accounting Oversight Board (PCAOB) to oversee and inspect firms that perform audits of public companies.

² The Board proposed eliminating the attest requirement for initial licensure since only 13 percent of CPAs considered audits to be their primary area of practice, and fulfilling the attest experience requirement was considered a barrier to becoming licensed.

³ B&P Code Section 5076 defines attest services as the issuance of an audit or a review of financial statements, as well as an examination of prospective financial information. Compiled financial statements (compilations) are not considered attest services.

Throughout this crisis, the California Legislature and the Board assumed a proactive role, organizing a special task force and holding extensive public hearings early in 2002. The Board issued recommendations that contributed to the development of major reform legislation in California. Included in this reform legislation were amendments to B&P Code Section 5076 to add Subdivision (d), mandating that the Board reevaluate mandatory peer review in light of the changes in the oversight and regulation of the public accounting profession.

2002-2003 PEER REVIEW TASK FORCE

In late 2002, the Board established the Peer Review Task Force (Task Force) to reevaluate mandatory peer review in California. The Task Force consisted of licensees, public Board members, and also public members who had expertise in the areas of regulation and consumer protection. Task Force discussions and deliberations occurred in a public forum, with extensive input from members of the public, professional groups, and consumer protection advocates.

During early 2003, the Task Force reviewed and analyzed the following information:

- History of peer review and the Uniform Accountancy Act (UAA).
- History of peer review in California, including the findings of the Board's earlier Peer Review/Attest Firm Task Force and the Board's 2000 Sunset Review Report.
- Statutory changes at the federal and state levels.
- Status of implementation of the PCAOB's inspection program.
- Status of proposed changes to the AICPA's peer review program for public accounting firms that provide attest services to nonpublic companies.
- Other states' peer review programs.

Based on this review and analysis, the Task Force and the Board concluded that the information needed for a full and thoughtful response to the Legislature's mandate was not yet available. For example, the PCAOB's inspection program was still under development and was not expected to be operational until sometime in 2004. Also, though the AICPA had proposed revisions to its peer review standards (which would be applied in a mandatory peer review process), final standards had not been issued. Further, reform legislation enacted in 2002 – AB 270 (Chapter 231), AB 2873 (Chapter 230) and AB 2970 (Chapter 232) – that significantly expanded the Board's self-reporting and audit documentation requirements (and made other law changes related to the Board's Enforcement Program) had not been in place long enough to manifest a consumer protection impact. Due to these constraints, in the interim report⁴ dated

⁴ The interim report to the Legislature was provided as part of the Board's 2003 Sunset Review Report.

September 2003, the Board requested an extension of the deadline for submission of the final peer review report.

2004-2005 PEER REVIEW TASK FORCE

The Board's Peer Review Task Force resumed its work in the fall of 2004, with representatives of the profession, including individuals from the California Society of Certified Public Accountants (CalCPA), and representatives from consumer groups attending meetings to discuss the relevant issues. At the October 2004 meeting, the Task Force heard detailed reports from senior AICPA representatives about the AICPA's Peer Review Program and the Center for Public Company Audit Firms (CPCAF) Peer Review Program. (See **Attachment 4** for the minutes of the October 2004 meeting.)

The February 2005 Peer Review Task Force meeting focused on policy considerations and a review of the costs and benefits of four different options for mandatory peer review in California, ranging from full implementation of the AICPA's peer review program with Board monitoring and oversight, to a pared-down program that focused on providing information to consumers. The Task Force and meeting attendees also discussed the costs, benefits, and limitations of other existing peer review programs and posited alternatives. (See **Attachment 5** for the minutes of the February 2005 meeting.) Decisions reached by the Task Force at the February 2005 meeting led to the development of the draft *2005 Peer Review Report*.

The final public meeting in July 2005 focused on a review of the *2005 Peer Review Report* in draft form. Revisions were recommended to clarify the position of the Task Force, and it was unanimously carried to recommend that the Board approve the report with revisions made at the meeting and direct the Task Force Chair and the Board President to finalize the report for presentation to the Legislature. (See **Attachment 6** for the minutes of the July 2005 meeting.)

The *2005 Peer Review Report* indicated that because of the constraints and uncertainties identified by the Task Force, especially in the area of transparency, "it would not be prudent to recommend that the Board embrace the AICPA program at [that] time." The Task Force believed the AICPA program had merit as a private-sector, voluntary, educational program; however, it was concerned that the AICPA program may not be "an appropriate vehicle for Board regulation." Additionally, the Task Force was concerned that if the Board were to adopt the AICPA program, the public may inaccurately perceive it as a regulatory program fully under the Board's control.

The Task Force also noted that at the time no readily available alternative to the AICPA program existed. The Task Force expressed that it was cost-prohibitive for the Board to implement its own quality monitoring program, and the two or three other peer review providers in existence were too small in size and range of services to provide a feasible alternative to the AICPA's program. Based on the Board's recommendations from the *2005 Peer Review Report*, SB 503 (Chapter 447) required that the Board review and

evaluate whether to implement mandatory peer review and report its findings to the Legislature, and the Department of Consumer Affairs by September 1, 2011.

CURRENT BOARD'S CONSIDERATION OF PEER REVIEW

In an effort to allow potential legislative action to occur in the 2009-2010 legislative session, the Board began reexamining the implementation of mandatory peer review in early 2007. The merits of implementing peer review were analyzed by the Board over the course of four meetings – May and September 2007 and January and February⁵ 2008. At these meetings the Board heard presentations regarding the AICPA Peer Review Program and the AICPA's recent release of an Exposure Draft related to standards for performing and reporting on peer reviews. The Board also explored various policy issues related to implementing mandatory peer review, specifically, participation; transparency; enforcement; program administration; program oversight; and document submission requirements. During these meetings the Board took into consideration how these policy issues were addressed within the AICPA Peer Review Program and PCAOB Inspection Program and by other state boards of accountancy⁶, as well as taking into consideration the recommendations of the prior Task Forces.

MAY 2007

Overview of the AICPA Peer Review Program and Exposure Draft

Since the Board's issuance of the *2005 Peer Review Report*, 11 new Board members have been appointed. Therefore, for its May 2007 meeting, the Board requested representatives from the AICPA and the CalCPA provide an overview of the AICPA Peer Review Program to educate new Board members regarding the AICPA's and CalCPA's administration of the peer review program. During the presentation, questions were raised by Board members regarding various aspects of the program in order to obtain a clearer understanding regarding peer review. (See **Attachment 7** for excerpts from the May 2007 Board meeting minutes.)

In addition to the overview presented by the AICPA and CalCPA, the Board heard an additional presentation related to the proposed changes to the AICPA's *Standards* (included in **Attachment 7**), at which time, Board members provided comments and feedback regarding the proposed changes to the *Standards*.

⁵ The February 2008 meeting was a special Board meeting called to examine outstanding critical policy issues.

⁶ The Board forwarded a survey to all state boards of accountancy asking various questions related to mandatory peer review in their state. The Board received 33 responses, with 29 indicating they had mandatory peer review. The Board used the data received from the survey when considering how other states regulate peer review.

SEPTEMBER 2007

At the September 2007 meeting, the Board began examining key policy issues related to implementing mandatory peer review, looking first at participation, enforcement, and transparency. (See **Attachment 8** for excerpts from the Committee on Professional Conduct (CPC) and Board meetings minutes.) Conclusions reached by the Board in each of these three areas follows.

Participation

The first policy issue considered by the Board at the September 2007 meeting was participation. As part of its deliberations, the Board evaluated enrollment/participation requirements of the AICPA's program, registration requirements of the PCAOB, and exemptions provided by other state boards of accountancy. It was noted that for both the AICPA and PCAOB programs, enrollment was not based on firm size, but rather on the work performed. Therefore, any firm, regardless of size, performing work subjecting them to participation must enroll in the programs. Also, during discussions on participation, the Board examined whether any other states exclude participation in peer review solely based on firm size. It was noted that only one state offered such an exemption, and it was much more common to exempt firms based on work performed.

Taking note of how peer review participation is treated nationally, the Board elected to recommend removing the provision in B&P Code Section 5076 that excluded sole proprietors and small firms from undergoing mandatory peer review. Instead, the only exclusion from mandatory peer review will be based on the type of services performed, for example, engagements subject to inspection by the PCAOB.

Enforcement

The second policy issue deliberated at the September 2007 meeting focused on enforcement activities tied to peer review results, looking at how enforcement was realized in the AICPA's program, the PCAOB program, and other state boards' requirements. It was noted that the AICPA's program was intended to have peer reviews' objective be educational rather than disciplinary. Conversely, the PCAOB inspection program was developed to engender market confidence and provide for broad investigative and disciplinary authority. Finally, it was noted that an overwhelming majority of states with a mandatory peer review requirement had the ability to take corrective actions against firms that receive a deficient peer review.

In addition to evaluating various programs and other state boards, the Board also considered the impact that a mandatory peer review requirement with an enforcement component would have on existing staff resources. The problems the Board presently faces regarding the inability to increase Investigative CPA salaries and the resultant recruitment and retention difficulties in the Enforcement Division were recognized. It was noted, however, that when making policy decisions regarding safeguarding of consumers, the Board should base the decision of creating an enforcement component

to mandatory peer review on the supposition there will be sufficient enforcement staff available.

Taking into consideration the above elements, the Board elected to establish an enforcement component to mandatory peer review. Specifically, in those instances where a firm receives a substandard peer review, the Board could impose additional remedial measures or discipline, including an expedited peer review, suspension of a firm's attest authority, monetary penalties, and suspension or revocation of a firm's ability to practice.

Transparency

The final area the Board considered at the September 2007 meeting focused on transparency. Again, the Board examined how the AICPA, PCAOB, and other state boards of accountancy handled the issue of transparency. During its discussion, the Board took note of the AICPA's newly developed Peer Review Facilitated State Board Access Web site, and its design to allow peer reviewed firms to voluntarily post peer review information on a Web site that state boards with a mandatory peer review requirement would have access to view. When reviewing the PCAOB inspection program, it was noted that all reports, with only very specific information restricted, were available for public inspection on the PCAOB Web site. Finally, pertaining to other state boards of accountancy, information was provided illustrating that the general trend was to keep the reports confidential and not available for public release.

In addition to deliberations on other organizations, the Board considered the following: the role of the Board, the needs of the public, and the legality of posting peer review reports. There was discussion that the Board's primary role was enforcement and licensing. Therefore, if a firm maintains a license then consumers can presume the firm has completed the peer review process, and in those instances where discipline was warranted, the information would be made available on the Board's Web site.

The Board also discussed the needs of the public, and where peer review information would best be obtained. Members were sensitive to ensuring that information was made available that firms are required to undergo a peer review, but concluded that the Board should not be responsible for posting the peer review results. Instead, information should be made available that peer review is required, and if a prospective or current client desires peer review information, he or she should request the peer review results directly from the firm.

Finally, considerable discussion centered on the legal implications of posting peer review reports. Concerns were raised by legal counsel and Board members that making peer review reports publicly available could expose the Board to possible legal violations. The Board believed that for substandard reports received by the Board, an investigation regarding the allegations raised in the peer review report needed to be conducted by Board staff prior to any disclosure of materials. Without performing some level of review, the Board would be posting unverified allegations, which are not

generally disclosed because they have not been subjected to a hearing and not been approved in an administrative adjudication.

After consideration of the information gathered from the AICPA, PCAOB, and other state boards of accountancy, as well as discussing the Board's role, the needs of the consumer, and the legality of publicizing substandard reports, the Board adopted a policy of Board-only transparency – disclosing peer review information only if an accusation is filed. The Board did stress, however, its intent to develop educational material that will be added to the Board's Web site to explain to consumers the value of the peer review process and that consumers, as part of doing business with an accounting firm, should request the firm's peer review report.

JANUARY 2008

At the January 2008 meeting, the Board continued its consideration of key policy issues regarding the implementation of mandatory peer review. For this meeting the Board focused on the following three areas: (1) program administration, (2) program oversight, and (3) document submission requirements. (See **Attachment 9** for excerpts from the January 2008 CPC and Board meetings minutes.)

Program Administration

During deliberations on program administration, the Board considered the adoption of the AICPA's existing, fully operational program versus the development of a California-specific program. It was noted at the meeting that to develop and establish a California-specific program, the Board would be required to address the following:

- Creating standards for planning, performing, reporting on, and acceptance of peer reviews
- Establishing peer reviewer qualifications, including required continuing education; recruitment; and selection
- Developing policies and procedures for maintaining statistics and record keeping
- Developing forms, checklists, reports, and correspondence
- Formulating policies and procedures for handling disputes that arise during peer reviews

Additionally, should a California-specific program be adopted, it might result in firms having to participate in multiple peer reviews and impact mobility for California firms. Given that the AICPA's program addresses all of the above elements, in contrast to the fact that it would take several years for the Board to develop and implement a California-specific program, the Board determined that relying on the AICPA's program appeared the most effective alternative, and chose to adopt the AICPA *Standards*, by reference, into regulation as the minimum standards.

Program Oversight

The second policy issue considered at the January 2008 meeting centered on a program oversight component to mandatory peer review. At that time, the Board considered the prior Task Force's recommendation on oversight, the National Association of State Boards of Accountancy's (NASBA) stance that state boards need to take an active role in ensuring compliance with state boards' rules, and that many other boards of accountancy either have or are considering oversight of peer review. Giving weight to the prior Task Force's recommendation, as well as noting national trends, the Board elected to establish a Peer Review Oversight Committee (PROC). However, discussions regarding the composition of the PROC and the number of meetings the PROC would hold each year were deferred for deliberation until a special February 2008 Board meeting.

Document Submission Requirements

The final policy issue examined in January 2008 focused on document submission requirements. As part of its deliberations, the Board considered the stated needs of the Board's Enforcement Division, materials a peer reviewed firm may have at the conclusion of a peer review, and public disclosure of peer review materials. At the meeting, the Board determined that for the initial roll-out of the peer review requirement, firms receiving peer review ratings of *fail* must submit various peer review documentation; and firms receiving *pass* and *pass with deficiencies* will be required to submit various peer review materials upon Board request.

FEBRUARY 2008

Program Oversight

The Board revisited the issue of program oversight at its final meeting to consider policy issues related to implementing a mandatory peer review requirement. (See **Attachment 10** for excerpts from the February 2008 Board meeting minutes.) At the meeting the Board considered the following in relation to an oversight component with mandatory peer review: purpose of the PROC, committee composition, oversight of the CalCPA, oversight of organizations not affiliated with the AICPA's program, Board representation at AICPA Peer Review Board meetings, and conducting PROC meetings and reporting to the Board.

MAY 2008

At the May 2008 meeting, the Board's focus shifted from considering policy issues to the steps needed to implement mandatory peer review. First, the Board deliberated on a draft of this report. Second, the Board reviewed a staff-prepared memorandum outlining the anticipated staffing needs and cost analysis relative to implementing a mandatory peer review requirement. Finally, the Board reviewed a set of revised

statutes and draft regulations. (See **Attachment 11** for excerpts from the May 2008 CPC and Board meetings minutes.)

Draft Peer Review Report

The report was provided so that Board members could provide feedback and comments related to the conceptual presentation and content of the Draft Peer Review Report. Staff indicated that based on feedback provided by the Board, a Final Peer Review Report would be prepared and presented for Board approval at the July 2008 Board meeting. The Board offered various suggestions related to further clarifying the Board's position and strengthening the report. The Board recommended to accept the Draft Peer Review Report, while directing staff to incorporate modifications.

Staffing Needs and Cost Analysis

For the May meeting, staff prepared a memorandum discussing the projected staffing needs and cost that would be accompanying implementation of mandatory peer review – both for the Board's Licensing and Enforcement Divisions.

During the subsequent deliberations, members voiced concern that many firms going through the peer review process for the first time may receive *fail* reports. Members expressed the view that peer review should be educational, and that a real possibility existed that an excessive number of reports would be referred to the Board's Enforcement Division for investigation.

In the course of deliberations, consideration was given regarding whether to use the proposed PROC or the Board's Administrative Committee⁷ (AC) as a means to "filter" *fail* reports received by the Board. Additional consideration also was given to whether the Board should take action on a firm's first *fail* report, or not respond until a firm received a second-consecutive *fail* report.

Finally, members offered that some first-time *fail* reports may show high levels of incompetence or be so egregious that disciplinary action may be warranted and cannot wait for a second review. Members then suggested that guidelines be developed to determine which first-*fail* reports would be referred directly to the Board's Enforcement Division.

It was subsequently recommended that the Board use the AC to review all *fail* reports and remediation responses and refer those reports that indicate the need for investigation to the Board's Enforcement Division. In addition, the AC will provide

⁷ The Administrative Committee assists the Board in an advisory capacity with its enforcement activities by receiving and investigating complaints against licensees. The committee monitors enforcement investigations, conducts investigative hearings, and may recommend a course of action upon the conclusion of investigations. The committee also considers, formulates and proposes policies and procedures related to the Board's Enforcement Program.

feedback to the licensee organization and will have the ability to request additional evaluations within the three-year period.

Draft Statutes and Regulations

The final two areas of consideration were draft statutes and draft regulations. As it related to the statutes, the Board reviewed additional changes for B&P Code Section 5076, as well as reviewing two new statutes related to oversight of and expenditure authority to implement a mandatory peer review requirement. The Board elected to adopt the proposed amendments to B&P Code Section 5076.

Staff indicated that when drafting the proposed regulations, it used the policy decisions reached by the CPC and the Board at the September 2007 and January and February 2008 meetings as a framework. The Board elected to adopt the proposed regulations with minor revisions.

However, during deliberations on the proposed regulations, representatives of the Society of California Accountants (SCA) requested that the Board consider an additional exclusion from a mandatory peer review requirement. SCA requested that firms whose highest level of work is the issuance of non-disclosure Other Comprehensive Bases of Accounting (OCBOA) financial statements be excluded from completing a peer review. The CPC requested that staff examine the SCA's request and report its findings to the CPC and Board at the July 2008 meetings.

JULY 2008

The primary focus of the July meeting centered on a potential problem identified by staff related to incorporating the AICPA *Standards* by reference into regulations. Staff indicated at the meeting that based on a regulations training course staff had attended and a follow-up meeting held with the Office of Administrative Law, the present direction of an incorporation-by-reference of the AICPA *Standards* was no longer feasible. Staff presented this conflict for consideration by Board members as part of the Board's CPC meeting. (See **Attachment 12** for the July 2008 CPC meeting minutes.)

Following deliberations in which Board members, legal counsel, and members of the public offered suggestions on methods to address the dilemma, it was determined that the best course of action was to establish statutory and regulatory authority that provides the Board with *flexibility* to approve those peer review programs that meet its standards. To assist in developing new statutory and regulatory language, the CPC requested that legal counsel work with staff to provide the Board with a plan or options to meet its goal.

Additionally, the Board considered whether to include an exemption from a mandatory peer review requirement for firms providing OCBOA financial statements as their highest level of work. The Board concurred with staff's recommendation not to incorporate an OCBOA exemption based on the following two factors: (1) according to

CAMICO Mutual Insurance Company, approximately 10 percent of the claims received relate to compiled financial statements, many of which are performed on an OCBOA basis, and (2) when surveying other state boards of accountancy that have a mandatory peer review requirement none indicated an exclusion for firms performing financial statements on an OCBOA basis.

ADDRESSING THE RECOMMENDATIONS FROM THE 2005 REPORT

This section of the report will focus on the seven recommendations the Board made in its *2005 Peer Review Report* regarding the implementation of mandatory peer review and discuss how the recommendations have been addressed, resulting in the Board's recommendation to institute a mandatory peer review requirement.

1. Do not embrace the AICPA program at this time.

At the time of the 2005 report, the Task Force believed it was not prudent to support the AICPA Peer Review Program due to various constraints and uncertainties associated with the program. And although the Board intends on establishing standards in regulations that will allow the Board to recognize a myriad of potential providers, it fully intends on recognizing the AICPA Peer Review Program as a Board-recognized peer review provider as part of the regulations. The Board feels confident in embracing the AICPA Peer Review Program at this time since significant changes have been made by the AICPA since the program was previously considered by the prior Task Force.

Since 2005, the AICPA has set about revising the *Standards* for its program, which culminated in an April 2007 Exposure Draft titled "Proposed Revisions to the AICPA Standards for Performing and Reporting on Peer Reviews." The Exposure Draft indicated the desire to create a more effective and efficient peer review process and identified 21 modifications to the *Standards*. (See **Attachment 13** for excerpts from the Exposure Draft.) Some of the more notable revisions were (1) creating *Standards* that are more principles based, (2) reengineering the reporting process, and (3) including audits of non-Security and Exchange Commission (SEC) issues performed pursuant to the standards of the PCAOB.

The AICPA recognized that although firms undergoing peer review represent a broad spectrum of size and practice, at the core they all provide the same services using the same professional standards. This led to a restructuring of the *Standards* to be more principles based so that the *Standards* are applicable to a diverse population of users.

Additionally, taking feedback from groups vested in the peer review process, such as reviewed firms, peer reviewers, and peer review committee members, as well as recognizing the needs of regulators' expectations, the new *Standards* reengineer the reporting process design – emphasizing a report that is more understandable and usable. Some of the specifics regarding this change are (1) clearly defining the type of report; (2) shortening the length of the report; (3) developing a more standardized report

that requires very little tailoring; and (4) revising the grading system to more clearly define the opinion reached.

Finally, the AICPA Governing Council has designated the PCAOB as a body to promulgate technical standards. The new peer review *Standards* broaden the potential scope of a peer review by including audits of non-SEC issuers performed pursuant to the standards of the PCAOB.

The new *Standards* were issued in April 2008 and take effect January 1, 2009. The Board believes the newly adopted *Standards* are a significant improvement over previously considered versions of the AICPA *Standards*.

In addition, the AICPA *Standards* are nationally accepted by most state boards of accountancy to satisfy their peer review (quality review) requirement. As the AICPA proposes modifications to the *Standards*, the changes are exposed by the AICPA, and all stakeholders, including the Board, are afforded the opportunity to review and provide comments and feedback on the proposed changes. Further, the Board believes the proposed oversight committee, discussed later in this report, will provide adequate safeguards to ensure that peer reviews performed under the AICPA Peer Review Program are effective in monitoring the quality of services provided by firms.

Finally, recognizing the AICPA Peer Review Program eases the burden for those firms with multi-state practices and multi-state licenses. If the Board were to not recognize the AICPA Peer Review Program, the impact on these licensees could prove unnecessarily burdensome. A multi-state licensed firm could be required to undergo a California-specific peer review as a condition for license renewal in this state, as well as an AICPA peer review to maintain licensure in another state. This situation could further be exacerbated should the firm also be required to undergo an inspection by the PCAOB. In a worst-case scenario, a multi-state licensed firm could be required to endure three different reviews to maintain its ability to practice. This creates not only a significant time commitment for the firm, but also a significant fiscal impact that would, in all likelihood, be passed on to the clients.

2. *Continue to evaluate options for implementation of mandatory peer review in California and make a recommendation to the Legislature no later than the submission of the Board's September 2009 Sunset Review Report. Revise Business and Professions Code Section 5076 to indicate that the time frames for peer review implementation will be determined by the Legislature as part of the sunset review process.*

Although the Board's original plan was to require that organizations desiring to administer peer reviews in California use the AICPA *Standards*, it later determined that the best course of action was to establish standards in regulations that allow the Board flexibility to recognize multiple peer review programs. This approach will allow the Board to accept not only the AICPA Peer Review Program, but also any potential programs submitted to the Board that meet the standards outlined in regulation.

This course of action offers several benefits not previously realized with strictly requiring organizations to use the AICPA *Standards*. First, it provides business opportunities to organizations desiring to administer peer reviews in California. With an estimated 2,000 peer reviews required each year for California-licensed firms, businesses may use this opportunity to establish peer review programs and provide peer review services in California. Second, should other providers become authorized by the Board, a competitive market environment could result, thereby reducing the costs incurred by firms required to complete a peer review.

3. *The California Board of Accountancy must oversee mandatory peer review.*

As indicated earlier, at its January and February 2008 meetings the Board elected to establish a program oversight component for mandatory peer review. As established, the PROC will be responsible for the following:

- Overseeing the activities of organizations related to how peer reviews are processed and evaluated.
- Ensuring the organizations administering peer reviews adhere to the standards approved by the Board.
- Ensuring that peer reviewers are properly qualified.
- Ensuring that peer reviews are being accepted in a consistent manner by the organization's report acceptance body.
- Conducting site visits of organizations and their peer review committees.
- Performing random sampling of peer review reports.
- Representing the Board at the AICPA's Peer Review Board meetings.
- Evaluating entities' peer review programs to ensure they meet the Board's standards/guidelines adopted in regulation, and recommending for approval to the Board.

The PROC, charged with the above-outlined responsibilities, is designed to engender confidence in peer review from consumers and the profession. In addition, should an organization administering peer reviews fail to adhere to the standards adopted by the Board, the Board will have the authority to rescind its recognition.

4. *In any future study of mandatory peer review, consideration should be given to the transparency of peer review.*

The issue of transparency has long been a debate among peer review stakeholders as it relates to disclosing peer review results. Peer review was originally developed to provide an educational tool for firms to assess the quality of their accounting and auditing practice; as a result, there has been reluctance to make peer review findings public. As the program has expanded and become a requirement for the vast majority of state boards of accountancy there has been a general push to make peer review reports more transparent. The prior Task Force believed that transparency to the state boards of accountancy and to the consumer were of critical importance, and noted that

in any future study the nature, timing, and availability of peer review documents needed to be considered.

To further research the national trends regarding public disclosure of peer review reports, the Board, prior to the September 2007 meeting, surveyed all other state boards of accountancy to determine their level of transparency. Of the 20 states that indicated they required submission of peer review documents, only six states made the documents available to the public. Of these six states, three indicated either a limited retention time for documents, or release only the letter of acceptance.

It should also be noted that subsequent to the last study of peer review in 2004-2005, the AICPA Peer Review Program has made significant strides in creating a more transparent program. First, the AICPA has developed a Peer Review Facilitated State Board Access Web site that allows voluntary disclosure by a firm or sole practitioner to selected state boards. Secondly, the AICPA has begun posting various documents related to the oversight of its program. These documents include the Peer Review Board's *Annual Report on Oversight* and the results of administering entity oversight visits conducted by the AICPA. (See **Attachments 14** and **15**.) These materials will assist the Board's oversight committee in assessing the continued reliance on the AICPA's program.

The AICPA also makes select peer review reports available on its Web site – www.aicpa.org.⁸ The Peer Review Public File, which displays peer review information on member firms, is accessible to anyone and includes the firm's most recent peer review report and letter of comments (if any). Approximately 11,000 AICPA-member firms currently make their peer review results public, accounting for one-third of the 33,000 AICPA member firms subject to peer review.

Further, the PCAOB Inspection Reports are made public and posted to the PCAOB's Web site – www.pcaob.org. The public portions of the Inspection Report include detailed descriptions of the types of matters on which the PCAOB focused its inspection and the procedures carried out by PCAOB staff to examine those matters. In addition, the reports contain issues identified by PCAOB staff while reviewing a firm's performance on selected audit engagements. These issues may include apparent departures from auditing or other related attestation, ethical, or independence standards, as well as a firm's own systems of quality control measures.

Although the Board elected to have Board-only transparency, it intends to employ active measures to ensure that consumers are informed about firms' peer review requirement. Through its Web site the Board will encourage consumers to actively request peer review results and encourage consumers to question those instances where firms fail to provide their peer review results. The Board will also identify and provide contact

⁸ Certain AICPA-member firms are required to post their reports to a public file, such as those enrolled in the AICPA's Governmental Audit Quality Center, Employee Benefit Plan Audit Center, Private Companies Practice Section or Center for Public Company Audit Firms. Additionally, some firms are required to provide their reports to state or federal regulators.

information for other resources, such as the AICPA and PCAOB, where consumers can obtain certain firms' peer review/inspection reports.

5. *Exclude from any Board-mandated peer review program audits otherwise encompassed by the PCAOB inspection program.*

At its September 2007 meeting, the Board evaluated what types of firms and what kind of work should be subject to mandatory peer review. One element considered was the PCAOB and whether to exclude firms participating in the PCAOB's inspection program. As noted in the 2005 report, and which continues today, "the PCAOB represents an unprecedented effort by the federal government to enhance oversight of the public accounting profession in the area that most broadly affects the American public – the audits of public companies." The Board, therefore, elected to exclude from mandatory peer review any of a firm's work subject to inspection by the PCAOB inspection program.

6. *Any future study of mandatory peer review should include a re-evaluation of the provision in current law which excludes sole proprietors and small firms from the peer review requirement.*

The prior Task Force concluded no consumer protection benefit was achieved in excluding sole proprietors and small firms which provide attest services from mandatory peer review; rather, the Task Force believed that significant consumer benefits would result if sole proprietors and small firms underwent the same peer review requirement imposed on larger firms.

The Board agrees with the prior Task Force recommendation and, as noted earlier, elected to recommend amending B&P Code Section 5076 to eliminate the prior exclusions for sole proprietors and small firms. The Board believes that although sole proprietors' and small firms' primary focus may not be accounting and auditing, "occasional audits" cannot be considered lightly – consumers rely on the accuracy of the product provided. Further, with the professional standards constantly being revised and new requirements enacted, it is important to ensure that *all* firms and sole proprietors stay abreast of the changes. Peer review is a tool designed to assist in ensuring that firms' and sole proprietors' accounting and auditing personnel maintain a currency of knowledge on the latest standards and trends in accounting and auditing. It also provides them with an opportunity to learn new or improved ways to provide accounting and auditing services to their clients and the tools necessary to meet the challenges of practice in the future.

7. *In any future study of mandatory peer review, consideration should be given to consumer education to communicate a more realistic understanding of the benefits and limitations of peer review for public accounting firms.*

As part of its consumer outreach related to peer review, through its Web site and other materials, the Board intends to inform consumers about the expectations (benefits and

limitations) for firms undergoing peer review. This will highlight that the primary purpose for mandatory peer review is education. And although enforcement actions may arise from information gained during the peer review process, the requirement is not being instituted to provide the Board with an enforcement tool.

In addition, the Board will inform consumers that based on the type of work performed by the peer reviewed firm, it will undergo varying types of peer reviews, and stress the objectives, scope and inherent limitations of the peer review. For example, the Board will highlight that the AICPA Peer Review Program operates two types of peer reviews – System and Engagement. The Board will inform consumers that the objective of System Reviews is to provide the peer reviewer with a *reasonable*, not absolute, assurance that the system of quality control used by the firm when performing accounting and auditing work is designed in conformity with the professional standards and that the firm is complying with the system. For Engagement Reviews, the Board will note that the objective is to evaluate whether the firm’s reports are issued and procedures performed appropriately in accordance with the applicable professional standards. As additional peer review programs become authorized, the Board will perform its due diligence in informing consumers related to peer reviews performed by those organizations.

Finally, the Board will emphasize that consumers can, and more importantly should, request their existing or prospective firm’s most recent peer review report. By requesting the report, consumers can make informed decisions whether to maintain or establish a business relationship with a particular firm.

RESOURCE IDENTIFICATION AND IMPLEMENTATION

Section 5076(d) requires that the Board “identify the resources necessary for implementation.” This section of the report provides projected staffing needs and estimated cost the Board expects to incur to institute its recommended mandatory peer review requirement. The staffing needs and cost analysis is divided into two sections – Licensing Division and Enforcement Division.

It is anticipated that amendments to Business and Professions Code Section 5076 Peer Review – will be signed in September 2009 and will become effective January 1, 2010. Once the legislation becomes effective, the Board will submit the necessary Budget Change Proposals (BCPs) to acquire adequate staffing resources. Firms subject to the peer review requirement – specifically, *all* firms and sole proprietors performing accounting and auditing services – will begin reporting peer review information beginning July 1, 2011. The phase-in period for peer review, which will be established in regulation, will continue until December 31, 2014. Also, beginning on January 1, 2011, PROC will begin holding public meetings and performing its oversight responsibilities.

LICENSING DIVISION

Although for Fiscal Year (FY) 2010-2011, firms will not be required to report any peer review information, the Licensing Division will be responsible for drafting informational materials, creating forms and letters, development of a database, and staffing the PROC, along with coordinating oversight and meeting responsibilities. Once firms begin reporting peer review information (FY 2011-2012), the Licensing Division will be responsible for database maintenance, drafting deficiency letters, responding to telephonic and written inquiries (including e-mails), and staffing and coordinating the duties of the PROC.

Below are two assumptions related to the Licensing Divisions involvement in the peer review process:

1. It is estimated that approximately 2,000 firms and sole proprietors will be required to undergo a peer review annually beginning FY 2011-2012.
2. PROC activities will include, attendance at all CalCPA Peer Review Committee (PRC) meetings;⁹ attendance of four CalCPA Report Acceptance Body (RAB) meetings; attendance at all American Institute of Certified Public Accountant's Peer Review Board meetings;¹⁰ conducting, at a minimum, an annual administrative site visit of CalCPA's Peer Review Program; performing, at a minimum, an annual review of CalCPA's Peer Review Committee; performing, at a minimum, four annual reviews of CalCPA's Report Acceptance Body; and conducting four, one-day public PROC meetings.¹¹

Beginning FY 2010-2011, it is anticipated the Board's Licensing Division will require one additional Associate Governmental Program Analyst (senior-level analyst). **Attachment 16** provides a cost analysis anticipated for the Licensing Division, which includes one-time expenses, salaries, and cost of the PROC. It is projected the costs for the Licensing Division for FY 2010-2011 will be \$106,594, and for FY 2011-2012 and ongoing will be \$113,819. It should be noted that as additional programs become authorized by the Board, the Board will need to reevaluate its staffing needs relative to coordinating the PROC's oversight activities.

ENFORCEMENT DIVISION

Once firms begin submitting peer review information in FY 2011-2012, the Board's Enforcement Division will have an active role in the peer review process. Firms receiving a substandard peer review rating will be required to submit the peer review

⁹ At this time, CalCPA holds two, two-day PRC meetings annually.

¹⁰ Generally four per year.

¹¹ Since it is presumed that the AICPA Peer Review Program will be the only Board-recognized peer review provider at the roll-out of the requirement, the PROC activities are based on oversight of the AICPA program.

report, as well as additional materials required by regulation, within 30 days of the report's acceptance by a Board-authorized administering organization. Once received, the Board's Administrative Committee in conjunction with the Board's Enforcement Division will review these materials. Formal investigations will be opened whenever two consecutive peer reviews result in substandard reports, or whenever evidence of egregious unprofessional conduct is disclosed in a single substandard report. Many of these investigations are expected to conclude with some form of disciplinary action.

Below are two assumptions related to the Enforcement Division's involvement in the peer review process:

1. It is estimated that 100 firms annually will receive a substandard peer review rating resulting in submission of the report. After review, it is estimated the Enforcement Division will open an investigation on approximately 20 matters.¹²
2. Of the 20 new investigations, it is estimated that four cases will result in either closure, cite/fine, or additional continuing education. The remaining 16 cases will be referred to the Attorney General's office, eight resulting in Administrative Hearings, and eight resulting in some type of Stipulated Settlement.

It is anticipated that the Board's Enforcement Division will require one new Investigative CPA beginning FY 2011-2012 and ongoing in order to address the expected new investigative workload. **Attachment 17** provides an analysis of costs projected for the Enforcement Division, including one-time expenses, salaries, AC meeting costs, and costs incurred from the Office of the Attorney General and Office of Administrative Hearings, which is summarized in the table below.

TOTAL PROJECTED COSTS

	FY 2010/11	FY 2011/12	FY 2012/13
Licensing Division	\$106,594	\$113,819	\$113,819
Enforcement Division	--	\$296,771	\$289,871
Total	\$106,594	\$410,590	\$403,690

¹² Of the 20 matters, 10 will be second consecutive substandard reports and 10 will be first substandard reports considered sufficiently egregious to warrant referral by the AC for investigation.

CONCLUSION

The final section of this report will focus on the Board's belief that mandatory peer review in California is instrumental to its mandate to protect the public, as well as identify the increased benefits a mandatory peer review requirement will have for consumers and the profession.

THE NEED FOR MANDATORY PEER REVIEW

With a legal mandate pursuant to B&P Code Section 5000.1, the Board has a fiduciary responsibility to protect consumers. This includes ensuring only qualified individuals are issued a CPA license, and that licensees maintain a currency of knowledge to competently perform in a dynamic and ever-evolving accountancy profession.

In reviewing past Board deliberations on peer review, as well as testimony presented during the Board's present deliberations, there is a sense that the concept of peer review has never been considered a "bad idea" for California. In fact, the Board previously maintained an education program that reviewed licensees' work – the Report Quality Monitoring (RQM) Program.

The RQM Program consisted of a committee of volunteer licensees that did report reviews on a limited number of licensees annually. There were, however, significant weaknesses with the program; first and foremost, it simply did not reach a sufficient number of licensees each year. For calendar year 2001 (the last time the Board reported RQM statistics), the total number of licensees reviewed was 580. Secondly, the program looked at the report issued on a single engagement that was selected by the licensee. Unlike peer reviews, the Report Quality Monitoring Committee's (RQMC) review of a report on a single engagement selected by a licensee cannot provide reviewers sufficient information to ensure reports are issued and procedures performed appropriately in accordance with applicable professional standards. Lastly, the review performed by the RQMC was limited to the report issued and did not provide any opportunity for a review of the engagement documentation or the system of quality control used by the firm.

Improving Services of California Firms

Firms going through the rigor of peer review will be better equipped to perform quality accounting and auditing engagements. This benefit will be realized through firms having independent accounting and auditing professionals (peer reviewers) review their accounting and auditing practice.

With over 150 pronouncements regarding generally accepted accounting principles designed to ensure the quality and accuracy of accounting and auditing engagements, it is imperative that work products provided to consumers adhere to adopted professional standards. Through preparing for and undergoing a peer review, coupled with the

knowledge and expertise of a peer reviewer, firms can design and refine internal quality control systems to ensure work is performed in conformity with professional standards and enable them to develop and refine the technical skills of their employees. This will, in turn, allow firms and sole proprietors to deliver high quality services to their clients.

Increased Consumer Confidence and Protection

Paramount to a healthy economy, both on a state and national level, is consumer confidence. This is achieved when consumers feel that firms providing accounting services are doing so in accordance with the highest level of professional standards. By requiring mandatory peer review, the Board demonstrates its commitment to enhance the quality of the services provided by CPAs and accounting firms and contribute to the public's confidence in the profession.

In addition to increased consumer confidence, mandatory peer review also provides increased consumer protection. Two crucial areas where the Board has taken definitive steps to increase consumer protection within mandatory peer review are (1) adding an enforcement component and (2) expanding the types of services that result in firms requiring a peer review.

As noted in earlier sections of this report, the Board has recommended that enforcement actions be taken against firms receiving substandard peer reviews. To this end, the Board proposes that firms receiving substandard peer review ratings be required to submit the reports and additional peer review documents within 30 days of receipt. This will allow the Board to quickly begin investigations and take decisive actions as warranted. This also will ensure that only qualified licensees are practicing and providing services to consumers in this state.

The Board is also recommending that the services mandating peer review be expanded over the existing requirements of B&P Code Section 5076. Under existing law, B&P Code Section 5076 defines attest services to include an audit, a review of financial statements, or an examination of prospective financial information. It, however, does not include the issuance of compiled financial statements. The Board is recommending that firms providing compiled financial statements also be required to undergo mandatory peer review. This underscores the Board's intent to ensure that *all* accounting and auditing services provided to consumers are vetted for quality.

FINAL RECOMMENDATION

Since May 2007 the Board has evaluated the AICPA Peer Review Program and the associated *Standards*, and has deliberated on known policy issues related to implementing a mandatory peer review requirement in California. The Board believes that the new *Standards* adopted by the AICPA substantially address the previous uncertainties identified by the prior Task Force. Therefore, the Board believes that the AICPA Peer Review Program offers an effective peer review service which licensees can use to fulfill a peer review requirement. Further, the Board has recommended that

broad/generic standards be adopted in regulation that allow additional peer review programs to become authorized by the Board. Finally, the oversight provided by the PROC will provide the Board and consumers of California with appropriate safeguards for maintaining a high level of standards for peer review.

The Board also believes that its policy decisions related to participation and enforcement greatly enhance the existing peer review requirement prescribed by Business and Professions Code Section 5076. By recommending the removal of the exclusions from peer review for sole proprietors, small firms, and compilations, coupled with creating an enforcement component to mandatory peer review that will allow the Board to discipline firms found to have violated the California Accountancy Act, the Board believes the maximum consumer benefits related to a mandatory peer review requirement will be achieved.

In short, the California Board of Accountancy, therefore, recommends that a mandatory peer review requirement be instituted based on the following broad policy decisions reached by the Board:

- **Participation** – All California-licensed firms performing accounting and auditing services must complete a peer review. Only those firms, who as their highest level of service, perform work on non-disclosure financial statements where no report is issued, or any of a firm’s work subject to review as part of the PCAOB inspection program will be excluded.
- **Enforcement** – Based on guidelines developed by the Board, the Administrative Committee in concert with the Board’s Enforcement Division will review all peer reviews with a substandard rating to determine a course of action. Firms receiving a second consecutive substandard report or a first substandard report which shows high levels of incompetence, or are so egregious that disciplinary action is warranted, will be investigated by the Board’s Enforcement Division.
- **Transparency** – The Board will employ active measures to ensure that consumers are informed about firms’ peer review requirement. Using its Web site, the Board will encourage consumers to actively request peer review results and will identify and provide contact information for other resources, such as the AICPA and PCAOB, where consumers can obtain certain firms’ peer review and inspection reports. However, substandard reports received or requested by the Board shall be collected for the purposes of conducting an investigation and, therefore, are exempt from the public purview pursuant to Government Code Section 6254(f) of the Public Records Act.
- **Program Administration** – The Board will establish broad/generic standards in regulation, whereby organizations can apply for recognition by the Board to provide peer review services in California. In addition, through regulation the Board will establish that the AICPA Peer Review Program has met these

standards and is, therefore, recognized by the Board to begin performing peer reviews at the onset of the requirement.

- **Program Oversight** – The PROC will be charged with ensuring that all Board-approved administering organizations administer peer reviews in accordance with the standards adopted by the Board.
- **Document Submission Requirements** – Require all firms receiving a substandard peer review rating to submit the peer review reports, along with all requested documentation, within 30 days of receiving the report.

As noted in the Introduction, the Board is submitting this report at this time in order to support possible legislative action in the 2009-2010 legislative session. This will allow for the peer review requirement to become effective January 1, 2010, with firms required to report, and, if necessary, submit, their peer review reports beginning July 1, 2011. The Board will also begin the rulemaking process once legislation is introduced in order to have the necessary regulations in place should peer review legislation be passed.

The Board's recommendation to adopt a mandatory peer review requirement is in concert with its Legislative mandate and its stated mission to protect the public welfare, particularly consumers, by ensuring that only qualified persons and firms are licensed to practice public accountancy and that the appropriate standards of competency and practice, including ethics, objectivity, and independence are established and enforced. It is the Board's sincere desire that through the adoption of a mandatory peer review requirement, California will continue to lead the nation in consumer protection and promotion of the highest professional accountancy standards.