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1997 Annual Reviewers' Letter: Informational Update for Peer reviewers

American Institute of Certified Public Accountants (AICPA)

AICPA

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

1997 ANNUAL REVIEWERS' LETTER

INFORMATIONAL UPDATE FOR PEER REVIEWERS

AICPA

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Self Regulation and SECPS

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To Peer Reviewers:

A distinguishing hallmark of our profession is the public's reliance on many of the services we perform. Further, our objectivity and integrity are key attributes that our clients look for when selecting their CPAs. The AICPA Code of Professional Conduct provides that AICPA members should practice in firms that have internal quality control procedures in place to ensure that the public interest is served and that services are competently delivered and adequately supervised. Statement on Quality Control Standards No. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, issued by the Auditing Standards Board, requires that a CPA firm have a system of quality control for its accounting and auditing practice, and describes elements of quality control and other matters essential to the effective design, implementation, and maintenance of that system. The objective of the AICPA's peer review programs is to evaluate a firm's system of quality control and its compliance with its system—all in protection of the public interest.

As a result of peer review, quality control policies and procedures and work performed by AICPA members have steadily improved. Firms that receive a qualified or adverse report on their initial peer reviews are significantly less likely to receive such a report on subsequent peer reviews. This is due, in large part, to implementing the recommendations made during the initial review.

As we approach the twenty-first century, our profession faces many challenging issues. This annual reviewers' letter discusses many of those challenges as they relate to a firm's system of quality control and the performance and reporting on peer reviews under the AICPA peer review program and the SEC Practice Section (SECPS) peer review program.

We have organized this letter into the following sections—

- Audit Quality and Its Impact on the Public Interest
- Quality Control Standards Nos. 2 and 3
- Standards for Performing and Reporting on Peer Reviews
- Other Peer Review Issues
- New Accounting and Auditing Pronouncements
- Appendix A—AICPA Publications
- Appendix B—Quality Control Elements Conversion Chart

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I would like to thank peer reviewers, committee chairs, and committee members for their efforts on behalf of the AICPA peer review programs. The AICPA staff would also like to thank John Burzenski, past chair of the AICPA Peer Review Board, for his guidance, advice, and humor. John made a significant contribution to the program during his tenure. Also, we would like to welcome Walter Webb as the current chair of the Board and we look forward to working with him.

If you have any questions, comments, or concerns please feel free to contact me or Janet Luallen at 201/938-3037 with comments on AICPA peer review program matters, or Peter Quinn at 201/938-3064 for comments related to SECPS. Personally, thanks go to Elma Satterfield for her work in pulling together this letter along with the work of Janet Luallen, Karen Jones, and the entire AICPA Practice Monitoring Team.

Sincerely,

Arleen R. Thomas

Arleen R. Thomas

Audit Quality and Its Impact on the Public Interest

Audit Quality in Employee Benefit Plan Audits

When performing reviews of employee benefit plan audits, peer reviewers are expected to have current experience with such plans as well as current knowledge about the Employee Retirement Income Security Act of 1974 (ERISA) rules and regulations. The AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* is a comprehensive publication that includes the relevant accounting and auditing standards, the ERISA regulatory requirements, and examples of financial statements and auditor's reports to caution auditors about unusual problems associated with these audits. The AICPA Audit Risk Alert *Employee Benefit Plans Industry Developments - 1997* supplements the AICPA Audit and Accounting Guide. (See appendix A, "AICPA Publications," for information on ordering AICPA products.)

The AICPA and the U.S. Department of Labor (DOL) continue to be concerned about deficiencies noted on audits of employee benefit plans. In 1995, the DOL's Pension and Welfare Benefit Administration conducted a random sample of employee benefit plan audits. Of the plans reviewed, 19 percent did not comply with generally accepted auditing standards and 33 percent did not comply with ERISA reporting and disclosure requirements. The AICPA peer review programs' results confirm the high rates of noncompliance.

It is believed that these deficiencies resulted from the auditor's failure to understand the uniqueness of employee benefit plan audits and the risks associated with them. The DOL staff believes that auditors view these audits as ancillary to the sponsor's audits, have limited experience in performing employee benefit plan audits, and charge engagement fees that do not allow for completion of the applicable requirements.

Reviewers should caution firms that are performing ERISA engagements without considering their uniqueness or the special regulatory requirements associated with these audits. Firms face the possibility of being referred by the DOL to state licensing boards or to the AICPA Professional Ethics Division if the DOL identifies an engagement as substandard. As of December 31, 1995, there were 270 referrals made to the AICPA Professional Ethics Division. Of the resolved cases, 64 had been referred to the AICPA Trial Board or were settled without a Trial Board hearing, 109 resulted in letters recommending corrective action, 9 were found to contain no deficiencies, and 22 were closed for other reasons.

The following are common deficiencies related to generally accepted auditing standards and generally accepted accounting principles noted by the AICPA and the DOL:

- Inadequate or no audit program or planning documentation
- Inadequate or no documentation of the auditor's understanding of internal controls

- Inadequate or no documentation supporting the audit work performed
- Deficiencies in the auditor's report
- Deficiencies in the notes to the financial statements

Common ERISA reporting and disclosure deficiencies are as follows:

- The auditor's report failed to extend to one or more of the required supplemental schedules.
- The required supplemental schedules failed to include all the necessary information pursuant to ERISA and DOL regulations.
- The plan administrator inappropriately invoked the limited-scope audit exemption when the financial institution holding the plan's assets did not qualify for such exemption because it was neither a bank or similar institution nor an insurance company.
- The statement of net assets available for benefits was not presented in comparative form as required by DOL regulations.
- The notes to the plan's financial statements failed to include certain information required by DOL regulations (for example, a note reconciling financial statement amounts to amounts reported in the Form 5500 Series Annual Report).
- The audit was of the trust rather than of the plan.

In the spirit of protecting the public interest and in response to the high rate of noncompliance discussed above, both peer review programs have special criteria for selecting audits of employee benefit plans for review during a peer review. The SEC Practice Section (SECPS) peer review program requires that such audits be reviewed if the firm plans to continue performing these engagements. Effective for peer review years beginning on or after January 1, 1997, the AICPA peer review program will require reviewers to assess employee benefit plan audits at a higher level of peer review risk. (See "Standards for Performing and Reporting on Peer Reviews" herein for further discussion on peer review risk.) If the firm performs such audits, and at least one is not selected for review, the reviewer will be required to document his or her justification for such omission in the summary review memorandum.

Peer reviewers should be aware that legislation has recently been introduced that, if enacted, would repeal the limited-scope audit exemption and mandate both independent quality control reviews and specific continuing professional education (CPE) requirements, among other things. Peer reviewers should be alert for new developments in this area, as the proposed legislation, if enacted, would substantially change the way employee benefit plan audits are conducted.

Compliance Attestation Engagements

Auditors who perform student financial aid compliance attestation engagements under Statement on Standards for Attestation Engagements (SSAE) No. 3, *Compliance Attestation* (AICPA, *Professional Standards*, vol.1, AT sec. 500), should be aware that the Department of Education's Office of the Inspector General (OIG) has identified pervasive problems with auditors not complying with the requirement in SSAE No. 3 to obtain written representations from management. In particular, many auditors are failing to obtain written representation stating that management has performed an evaluation of the entity's compliance with specified requirements as called for by paragraph 70(c) of SSAE No. 3. Engagements with this deficiency should be considered substandard and the reviewer should inform the firm that the OIG expects to refer firms to the AICPA Professional Ethics Division for these deficiencies.

Quality Control Standards Nos. 2 and 3

In 1996, the AICPA Auditing Standards Board issued Statement on Quality Control Standards (SQCS) No. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, and (SQCS) No. 3, *Monitoring a CPA Firm's Accounting and Auditing Practice*. These Statements supersede SQCS No. 1, *System of Quality Control for a CPA Firm.* The provisions of SQCS Nos. 2 and 3 are applicable to a CPA firm's system of quality control for its accounting and auditing practice as of January 1, 1997, and thereafter.

SQCS No. 2 redefines a firm's accounting and auditing practice to include engagements performed under SSAEs issued by the Auditing Standards Board. SQCS No. 2 also combines the nine elements of quality control into five broad elements. The five elements and the significant changes are as follows:

1. *Independence, Integrity, and Objectivity*—Expands the *independence* element under SQCS No. 1 to include integrity and objectivity.

2. *Personnel Management*—Combines the SQCS No. 1 elements of *hiring, advancement, assigning personnel to engagements,* and *professional development*.

   Personnel management adds a requirement for firms to establish policies and procedures to ensure that firm personnel participate in general and industry-specific CPE and other professional development activities that enable them to fulfill responsibilities assigned and satisfy applicable CPE requirements of both the AICPA and regulatory agencies. *Personnel* refers to ***all*** individuals who perform professional services for which the firm is responsible—***whether or not they are CPAs.*** *Personnel* includes—

   - CPAs and individuals qualified to seek that status.

   - Part-time employees who work year-round on accounting and auditing engagements.

   - Individuals who provide client services on accounting and auditing engagements regardless of their education, depending on the type of duties performed.

   It is the firm's judgment, based on the above guidelines, as to whether an individual is a professional subject to the CPE requirements. However, reviewers should examine these decisions and question those that appear unreasonable.

   SQCS No. 2 does not change existing CPE requirements set by the AICPA and others, but makes it clear that firms must do more than just provide CPE hours. Firms are required to ensure that all personnel have both general and *industry specific* knowledge and skills that relate to the types of clients and services they perform. Rather than just counting CPE hours, firms must give careful thought about the subject matter of CPE courses taken by its people and how best to provide them with the necessary skills.

3. *Acceptance and Continuance of Clients and Engagements*—Adds a requirement that a firm establish policies and procedures that provide reasonable assurance that it will accept only engagements it can complete with due professional competence. (Professional pronouncements already required a CPA firm to accept only those engagements it can complete with professional competence.)

   This element also adds a requirement for firms to establish policies and procedures that provide for obtaining an understanding with the client about the nature, scope, and limitations of the services to be performed.

4. *Engagement Performance*—Combines the elements of *supervision* and *consultation*.

5. *Monitoring*—Is an *ongoing* process of evaluating the firm's system of quality control which replaces the SQCS No. 1 element *inspection*, which is a measure of the system of quality control at a *point in time*. Monitoring procedures, which may or may not include inspection procedures, provide the firm with a means of identifying and communicating circumstances that may necessitate changes to its quality control system or the need for improvement in its level of compliance with the system. Monitoring is required by the Standards for a firm of any size.

   Inspection is a retroactive evaluation of whether the firm's policies and procedures, guidance materials, and practice aids continue to be appropriate; whether its professional development activities are effective; and the degree of the firm's compliance with its policies and procedures and professional standards. Inspection procedures are not required by SQCS Nos. 2 and 3 if other effective monitoring procedures exist.

Guidance on Implementing the New Quality Control Standards

In 1996, the AICPA issued the *Guide for Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice*. The guide provides examples of policies and procedures a firm should consider for each of the five elements of quality control, using four hypothetical firms ranging from a large national firm to a sole practitioner who performs no audits. SQCS No. 3 provides guidance on implementing the monitoring element and Section 10000 of the *AICPA Peer Review Program Manual* and section 18000 of the *SECPS Peer Review Manual* include guidance material on performing monitoring procedures. (See appendix A, "AICPA Publications," for information on ordering AICPA products.)

Firms will likely ask whether they should include inspection as one of their monitoring procedures. SQCS No. 3 identified several factors that a firm should consider.

- The nature, complexity, and diversity of the firm's practice, and the risks associated with the firm's practice.

- The firm's size, the number of offices, the degree of authority allowed personnel and offices, and the firm's organizational structure.

- The results of recent peer reviews and inspections.

- Appropriate cost-benefit considerations.

The results of such considerations can be seen in the examples shown in the *Guide for Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice* discussed above. The national and regional firms may include inspection procedures to evaluate compliance with its policies and procedures and professional standards at the engagement level while the sole practitioner with no audits uses post issuance review procedures. The greater diversity of the larger firm lends itself to the performance of inspection procedures because ongoing monitoring of engagements can be difficult and probably costly. Postissuance review procedures may fulfill the needs of the sole practitioner because generally, the procedures can be incorporated into the firm's day-to-day workflow. The local firm should evaluate the pros and cons of performing preissuance or postissuance reviews of engagements as a monitoring procedure to determine, on an ongoing basis, if it is complying with its quality control policies and procedures and professional standards, or of performing inspection to test compliance at a fixed point in time. The guide describes two scenarios for this size firm, one in which the firm performs inspection and one in which it performs preissuance or postissuance reviews of engagements.

For all firms, developing monitoring procedures will require considerable professional judgement. Each firm should focus on ensuring that it has policies and procedures to identify and communicate circumstances that may necessitate changes to the quality control system or the need for improvement in its level of compliance. There is flexibility in SQCS No. 2 to allow firms to meet that objective.

Impact of SQCS No. 2 on Reporting on Peer Reviews

It is expected that peer reviewers will encounter transitional issues associated with the January 1, 1997, effective date of SQCS No. 2. A firm that has a peer review year that includes January 1, 1997, will have a portion of its year encompassing engagements performed under the firm's old quality control system and a portion of the year encompassing engagements performed under the firm's new quality control system. Both peer review programs developed the following guidance for reporting on peer reviews performed during the transition period:

1. For peer review years ending on or before December 31, 1996, the peer review report and letter of comments should refer to the nine quality control elements listed in SQCS No. 1.

2. For peer review years ending after December 31, 1996, the peer review report and the letter of comments should refer to the five quality control elements listed in SQCS No. 2.

Reporting on the Untimely Implementation of SQCS Nos. 2 and 3
(AICPA Peer Review Program Only)

The AICPA peer review program wants to remind reviewers that although SQCS No. 2 became effective on January 1, 1997, some firms may not have updated their policies and procedures by that date. In those situations, a team captain performing a peer review on a firm with a system of quality control that straddles the transition from SQCS No. 1 to SQCS Nos. 2 and 3, should be flexible, realizing a firm needs time to revise all of its policies and procedures to conform with the new standards. A team captain should use professional judgment in deciding whether the failure to implement SQCS No. 2 and 3 timely should result in a comment at the exit conference, a letter of comment finding or a qualified report.

Standards for Performing and Reporting on Peer Reviews

SECPS and AICPA peer review program Standards have been revised to conform to the new quality control Standards and to establish other new provisions. The effective dates of the revised peer review Standards are as follows:

- The revised SECPS *Standards for Performing and Reporting on Peer Reviews* are effective for peer reviews for which field work has commenced on or after July 1, 1997.

- The revised AICPA *Standards for Performing and Reporting on Peer Reviews* are effective for peer review years beginning on or after January 1, 1997.

Reviewers should follow the guidance below to determine when a peer review should be performed under the old peer review Standards and when under the revised Standards, as well as the peer review forms and checklists that should be used to document the review.

SECPS Peer Review Program

SECPS reviewers should use the 1996 team captain checklists and program guidelines (sections PRM 12000 - 13600 of the *SEC Practice Section Peer Review Program Manual*) if fieldwork begins before July 1, 1997. The 1997 team captain checklists and program guidelines should be used if fieldwork begins on or after July 1, 1997. In all cases, the 1997 engagement checklists should be used.

AICPA Peer Review Program

For peer review years beginning on or before January 1, 1996, the peer review should be conducted under the old peer review program Standards and documented using the 1996 peer review forms and checklists (sections 4200 - 4800 and 8100 - 8600) of the *AICPA Peer Review Program Manual.*

For peer review years beginning on or after January 1, 1997, the peer review should be conducted under the revised peer review program Standards using the revised forms and checklists that refer to the new quality control Standards and the new peer review program Standards.

It is the peer review years that fall between these two periods that will present the most problems for peer reviewers. If a peer review year begins after January 1, 1996 but before January 1, 1997, the firm's system of quality control will most likely be based on SQCS No. 1 at the beginning of its peer review year, changing during the year to a system based on SQCS No. 2. Since the revised peer review program standards will not be in effect, reviewers should document the peer review using the 1996 team captain checklist and summary review memorandum (PRP Section 4800). However, since the revised quality control standards are in effect, sections that relate to those standards (PRP sections 4200-4700) should be used as soon as they are updated to reflect SQCS No. 2.

Engagement Checklists

Notwithstanding any of the above, 1997 engagement checklists should be used on all engagements for all SECPS and AICPA peer review program reviews performed in 1997 to ensure that current professional standards are taken into consideration.

Major Changes

The major changes to the provisions in the SECPS and AICPA peer review program Standards are listed below. This letter does not provide a complete list of all the changes to the Standards. The new Standards of both programs should be studied carefully and, if necessary, appropriate training courses attended to ensure a thorough understanding.

Definition of an Accounting and Auditing Practice

SQCS No. 2 requires that a firm have a system of quality control for its accounting and auditing practice that includes all audit, attest, accounting, review, and other services for which Standards have been established by the ASB or the AICPA Accounting and Review Services Committee. For purposes of performing and reporting on peer reviews, the SECPS peer review program will require that the reviewer consider all such engagements in determining the scope of the peer review. In comparison, the AICPA peer review program Standards will include all engagements covered by Statements on Auditing Standards, Statements on Standards for Accounting and Review Services, the Statement on Standards for Attestation Engagements *Financial Forecasts and Projections* (AICPA, *Professional Standards*, vol. 1, AT sec. 200) and attest services on financial information only when the firm audits, reviews, or compiles the historical financial statements of the client.

Change in Qualifications for Review Team Members

The revised Standards of both programs will require that review team *members* be associated with a firm that has had an unqualified report on its most recent peer review.

Changes to Only the AICPA Peer Review Program

Audits of SEC Registrants —Effective for peer review years beginning on or after January 1, 1997, the AICPA peer review program will require reviewers to assess audits of SEC registrants (where the firm no longer has the client) at a higher level of peer review risk. If the firm performs such audits, and at least one is not selected for review, the reviewer must document the justification for the omission in the summary review memorandum. This provision also applies to audits of employee benefit plans discussed on page 2 of this document.

On-Site Peer Reviews—The revised AICPA peer review program Standards will require that a firm that performs agreed-upon procedures engagements under Statement on Auditing Standards (SAS) No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement*, have an on-site peer review. Because of the public interest element of these engagements and the importance to the profession of maintaining the quality of these services, for peer review years beginning January 1, 1997, firms that perform engagements under SAS No. 75 should have an on-site review.

This is a significant change. Under the current AICPA peer review program Standards, firms with SAS No. 75 engagements and no audits were not required to have on-site peer reviews. We encourage reviewers to discuss this change with firms as soon as possible to make sure appropriate reviews are scheduled.

Change in Selection Criteria for Off-Site Peer Reviews—Currently, engagements selected on off-site peer reviews are those for which accountants' reports were *issued* during the review year. Engagements selected for on-site peer reviews are those with years ending during the review year regardless of when the auditors' or accountants' reports were issued. Under the revised Standards, engagements selected for both on-site and off-site peer reviews will be those with periods ending during the review year as long as the reports have been issued prior to the peer review.

The AICPA Peer Review Board also revised the guidelines for selecting the number of engagements for off-site peer reviews. Under the new guidelines the selection must meet the following three criteria:

1. One engagement for each area of services performed by the firm:
    - Reviews
    - Compilations with disclosures
    - Compilations without disclosures
    - Attestation engagements

2. One engagement for each owner of the firm responsible for the issuance of compilation or review reports

3. A minimum of at least two engagements for the firm

The above three criteria are not mutually exclusive. For example, one of every type of engagement that an owner performs does not have to be reviewed as long as, for the firm as a whole, all types of engagements noted above performed by the firm are covered. Additionally, the attestation engagement selected for review can be on either prospective financial statements or assertions on financial statements.

Reviewer Rotation—The revised AICPA peer review program Standards will no longer restrict the number of successive reviews a team captain or off-site reviewer can perform on the same firm. The responsibility for determining when to rotate reviewers should rest with the reviewed firm. (Caution: SECPS Standards were not revised. Those Standards prohibit an individual who serves as team captain for three successive reviews of the same firm from serving in that capacity for the firm's next peer review.)

Risk-Based Approach to the Selection of Offices and Engagements—The revised AICPA peer review program Standards will require a risk-based approach to selecting offices and engagements for review. This approach requires the reviewer to assess the levels of inherent and control risk as the key considerations in deciding on the number and characteristics of offices to visit and engagements to review. See paragraph 41 of the revised Standards for a discussion of the risk-based approach. The SECPS peer review program has required this approach for several years.

Regardless of the assessed levels of inherent and control risk, both programs require that a reasonable cross section of the firm's accounting and auditing practice must have been reviewed (or inspected for SECPS reviews), with greater emphasis on those engagements with higher assessed levels of peer review risk. After selecting engagements to be reviewed based on the risk assessment, reviewers should make sure the scope includes the specific types of engagements required to be selected by the applicable peer review program Standards.

Other Peer Review Issues

SECPS — Reporting to the Quality Control Inquiry Committee (QCIC)

The SECPS membership requirements state that member firms must report to the Quality Control Inquiry Committee (QCIC), *within 30 days of being served*, any litigation (including criminal indictments) against the firm or its personnel or any proceeding or investigation publicly announced by a regulatory agency that alleges deficiencies in the conduct of an audit of the financial statements or reporting thereon of a present or former SEC client. Currently, many member firms are not reporting to the QCIC on a timely basis. Reviewers should review a firm's compliance with this membership requirement, discuss any delayed filings with the firm, and consider whether the delays should be discussed in the letter of comments.

Systemic Approach to Peer Reviews

The AICPA self-regulatory team has found instances in which reviewers appear to focus on selected engagements and fail to appropriately evaluate the firm's system of quality control—the primary objective of a peer review and the basis for the peer review report. For example, after discovering a substandard engagement, some reviewers begin considering whether the peer review report should be qualified before the underlying cause of the engagement deficiency has been identified.

Reviewers must think of engagement deficiencies as symptoms of deficiencies in the firm's system of quality control. A good way to determine the systemic cause of engagement deficiencies is to ask the firm to provide complete answers on the Matters for Further Consideration (MFC) form instead of just checking "yes we agree", and then talking to individuals in the firm about what they believe to be the cause of engagement deficiencies.

We believe that the failure to understand root causes of engagement deficiencies has led some reviewers to overemphasize the use of standard forms and checklists as recommendations for improving firms' systems of quality control. Although forms and checklists are helpful in many circumstances, their use will not cure all deficiencies. For example, checklists will not help firms that lack overall knowledge of accounting and auditing matters or knowledge in the specific area in which the deficiency arose. Checklists will not help firms in which policies and procedures for the review of engagements are routinely overridden. The exact same engagement deficiencies may stem from completely different causes. Without understanding the underlying cause, a reviewer cannot make recommendations to the firm that will reduce the likelihood of the engagement deficiencies recurring. Guidance for determining the underlying cause of engagement deficiencies can be found in the case studies in the guidelines for writing letters of comments. This guidance is in section 3400 of the *AICPA Peer Review Program Manual* and section 2200 of the *SEC Practice Section Reference Manual*.

Considering the Adequacy of Audit Procedures Performed in Key Areas

We continue to hear from regulators and others that reviewers are focusing their reviews of engagements on disclosures and other generally accepted accounting principles issues and not spending enough time on issues related to generally accepted auditing standards. Some CPA firms are placing too much reliance on client representations. Reviewers should challenge the work performed in key areas to make sure enough was done to support the report issued.

Review Acceptance

The fundamental tenet of both programs is that reviews are to be performed by *peers* and that practitioners should have experience in the type of industries in which the reviewed firm's clients operate. A reviewer must be a peer in order to—

1. Obtain an understanding of the reviewed firm's practice and its system of quality control.

2. Detect deficiencies, if any, in the design or compliance with the system.

3. Review a reasonable cross section of the reviewed firm's accounting and auditing engagements and detect deficiencies, if any, in those engagements.

4. Determine the underlying systemic cause of engagement deficiencies.

5. Make effective recommendations for strengthening the system or compliance with the system.

Before accepting a peer review engagement, reviewers should seriously consider the nature of the firm's practice, their own knowledge of systems of quality control and the peer review process, and their ability to detect deficiencies in the industries the firm serves. Reviewers must remember that a peer review is not just something for the firm to get through—a peer review should help the firm improve its practice. When a reviewed firm opens its practice for an objective review of its system of quality control and the work it produces under that system, and pays for that review, it is entitled to have its review performed by a peer that will make the firm aware of any conditions in the firm that should be improved. The failure to do this can put a firm in a vulnerable position if uncorrected deficiencies in its quality control system result in errors that are found by third parties. The failure of reviewers to alert firms to deficiencies in their practices also discredits the peer review programs.

Reviewers who agree to perform a peer review of a firm with engagements in high-risk or complex industries must have current experience in those industries. Reviewers without such experience will be called upon to justify why they should be permitted to review those engagements. The entity administering the peer review has the authority to decide whether a reviewer has sufficient experience to review engagements in a particular industry. A reviewing firm may consider obtaining the services of an individual from another CPA firm to review a specific engagement if the needed expertise is not available in its own firm.

Reviewer Résumé Form

The AICPA Peer Review Board and the SECPS Peer Review Committee continue to be concerned about ensuring that reviewers have the industry expertise needed to identify engagement deficiencies, if they exist, in the engagements reviewed. This is especially important in high-risk or complex industries or in industries in which the reviewed firm has a concentration. The reviewer résumé form requires reviewers who list governmental audit expertise to also indicate whether they meet *Government Auditing Standards* (Yellow Book) CPE requirements and helps reviewers consider the level of experience they have in each industry. For each industry indicated, the reviewer is asked to show how experience was obtained by checking one or more of the following:

- Currently supervising or performing an engagement
- Supervised or performed an engagement in the last five years
- Supervised or performed preissuance engagement reviews within the last three years
- CPE courses and training in the last three years
- Other

Reviewers are sent forms for updating their résumés each year. Reviewers whose résumés are not updated at least every two years will be considered inactive.

Enhancing the Value of Peer Reviews

Peer reviewers have a unique opportunity to communicate on other matters helpful to the firm during the peer review. During on-site peer reviews, reviewers often become aware of inefficiencies in audit engagements. Such instances may involve the firm's use of excessive sample sizes for testing, the detail testing of insignificant accounts, rewriting numbers that do not change, or preparing schedules for accounts with immaterial amounts. A peer reviewer can add value to the peer review by discussing the implementation of new pronouncements that affect the firm's practice, or by explaining how additional up-front hours, spent effectively planning an engagement and identifying the key audit areas and the audit risks in those areas, can eliminate unnecessary procedures and actually reduce the total audit hours required.

Disagreements Over Technical Issues

On on-site reviews, the reviewed firm should be informed of all deficiencies before the reviewer leaves its office. If possible, the reviewer should provide this information as the review progresses so that the firm is fully prepared to respond to all issues by the exit conference. All findings— including the draft letter of comments, if any, and the firm's response — should be discussed at the exit conference. A reviewed firm should not be surprised by any finding in the report or letter of comments since it should have had an opportunity to respond to MFCs which should have been presented as the review progressed.

Nevertheless, because peer review is a subjective process and professional standards require the use of professional judgement, there may be differences of opinion between the reviewed firm and the reviewer as to whether an engagement deficiency exists. Most disagreements can and should be resolved before the exit conference or, for off-site peer reviews, before the peer review report and letter of comments are issued. If there is a disagreement over a technical issue—

- The reviewer should explain his or her position by citing the applicable section of professional standards and current practice experience that supports that position. This gives the reviewed firm the opportunity to research the issue and thereby broaden its knowledge of the Standards. It also gives the reviewed firm the opportunity to provide a possible alternative position on the matter. If necessary, the reviewer and the firm should consult with the entity administering the peer review, a knowledgeable outsider, or the AICPA Technical or Ethics hotline.

- AICPA Peer Review Program only—In an off-site peer review, engagement deficiencies may be communicated to the reviewed firm by telephone or in writing on the MFC form. In most cases, the communication is by telephone. Firms having off-site peer reviews should be given written MFCs, especially if the findings are significant enough to affect the peer review report, to make sure they clearly understand the nature of the deficiency and to give the firm the opportunity to research the issue and prepare a well-thought-out response.

Natural Peer Review Year End

The review normally covers a one-year period mutually agreed upon by the reviewer and the reviewed firm. SECPS and AICPA peer review program Standards anticipate that a firm will keep the same peer review year end from review to review. However, for PCPS firms and firms enrolled in the AICPA peer review program, if the previous peer review year end was not the most convenient for firm personnel or the natural year end for the reviewed firm, the firm should write to the state CPA society administering its peer review to request a permanent change to a year end that is more natural for the firm. An SECPS firm may change its review year without the peer review committee's prior approval, provided that the new review year is not beyond three months of the previous review year end and provided that the peer review is completed by the end of the third calendar year that included the previous year end. In deciding on a natural review year, the firm should consider the year ends of the majority of its engagements, the year ends of its largest engagements, engagements with high public interest (SEC, ERISA, governmental), and its normal yearly work cycle. If the firm wants to change its peer review year end and has not requested such a change from the administering entity, the reviewer should consult with the administering entity before performing the peer review.

AICPA World Wide WEB Site

The AICPA recently established a home page on the World Wide Web. The AICPA Web site *AICPA Online* (www.aicpa.org) provides members with immediate access to many Institute publications, membership information, state and federal legislative updates, hot professional news, and AICPA press releases, speeches, and exposure drafts. There is also a *Talk to Us* section where members can send E-mail messages directly to AICPA representatives or teams. During 1997, both the Private Companies and SEC Practice Sections expect to establish their home pages within the AICPA Web site.

New Accounting and Auditing Pronouncements

Reviewers should be aware of the following pronouncements that firms may be implementing for the first time or for which the effective date is near enough so that firms should be preparing to implement. During the planning phase of a peer review, reviewers should consider discussing with the reviewed firm how the requirements for new Standards are communicated to the appropriate personnel.

Statement of Position 94-6

In December 1994, the Accounting Standards Executive Committee (AcSEC) issued Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. SOP 94-6 is effective for financial statements issued for fiscal years ending after December 15, 1995, and for financial statements for interim periods in fiscal years subsequent to the year for which the SOP is first applied. The SOP applies to financial statements prepared in conformity with generally accepted accounting principles applicable to nongovernmental entities. The SOP requires disclosure of the following information:

1. Nature of operations
2. Use of estimates in the preparation of financial statements
3. Certain significant estimates
4. Current vulnerability due to certain concentrations

SOP 94-6 introduced several new terms to the accounting literature. It also relies heavily on some terms defined in Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies*. Reviewers should be familiar with the definitions and the need to apply professional judgment. For example, when assessing an entity's vulnerability to certain concentrations, the SOP uses *severe impact* as the threshold. That threshold is defined as a significant financially disruptive effect on the normal functioning of the entity. Thus, severe impact is a higher threshold than materiality. SOP 94-6 establishes a spectrum of judgments concerning materiality ranges. These are new terms and concepts and firms will need to use professional judgment in deciding on their meaning. Peer reviewers will to have to pay attention to SOP 94-6 as they perform peer reviews. Appendix A of SOP 94-6 contains several illustrative scenarios and disclosures that will help reviewers understand the meaning of the terms.

FASB Statement Nos. 116 and 117

Some firms may be implementing FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, and FASB Statement No. 117, *Financial Statements of Not-for-Profit*

Organizations, for the first time in 1997. Both pronouncements were effective for fiscal years beginning after December 15, 1994, except for not-for-profit organizations with less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the pronouncements became effective for fiscal years beginning after December 15, 1995.

Statement on Auditing Standards No. 82

In January 1997, the ASB issued SAS No. 82, *Consideration of Fraud in a Financial Statement Audit,* which supersedes SAS No. 53, *The Auditor's Responsibility for the Detection of Errors and Irregularities.* SAS No. 82 is effective for audits of financial statements for periods ending on or after December 15, 1997. SAS No. 82 does not change the auditor's detection responsibility but strengthens performance requirements. SAS No. 82 clearly articulates the auditor's responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. The new Standard provides helpful guidance to auditors in fulfilling their responsibility for detecting material misstatements resulting from fraud.

Statement of Position 96-1

In October 1996, AcSEC issued SOP 96-1, *Environmental Remediation Liabilities*, which provides accounting guidance for the recognition, measurement, display, and disclosure of environmental remediation liabilities. The provisions of the SOP are effective for fiscal years beginning after December 15, 1996. SOP 96-1 requires that environmental remediation liabilities be accrued when the criteria in FASB Statement No. 5 are met, and includes benchmarks to aid in the determination of when environmental remediation liabilities should be recognized in accordance with FASB Statement No. 5. Examples of such benchmarks are the identification of an entity as a potentially responsible party and the completion of a feasibility study. SOP 96-1 also requires that the accrual for environmental remediation liabilities include the incremental direct costs of the remediation effort and the costs of compensation and benefits for employees who are expected to devote a significant amount of time directly to the remediation effort, to the extent of the time expected to be spent directly on the remediation effort.

It is believed that many small practitioners think environmental liabilities affect only very large companies and not their clients. However, environmental liability is an issue for small local businesses such as dry cleaners or gas stations.

OMB Circular A-133

Office of Management and Budget (OMB) Circular A-133, *Audits of Institutions of Higher Education and Other Non-Profit Institutions*, has been revised. The revised Circular raises the dollar threshold for a single audit coverage to $300,000, implements a risk-based approach to selecting major programs, revises the definition of nonprofit organizations to include hospitals, reduces the audit report due date to nine months, and requires auditors to include a summary of audit results in the Schedule of Findings and Questioned Costs. The revised Circular is effective for audits of fiscal years ending on or after June 30, 1997.

Appendix A—AICPA Publications

Peer Review Program Manuals

Having the appropriate current program manual for conducting peer reviews is a key tool to the successful completion of a peer review. The Standards that govern the review and the guidance on selecting engagements and writing letters of comments and reports are found in the program manuals, which are listed in this appendix.

AICPA Peer Review Program

The Standards and all the forms and checklists needed to perform a peer review are included in the *AICPA Peer Review Program Manual*. The manual is available through a subscription service that is updated as changes are made. This manual may be ordered from the AICPA Order Department at 800/862-4272. The product no. is G01017; prices are $130 for renewals and $160 for new subscribers.

A decision on whether to publish a 1997 paperback edition of the *AICPA Peer Review Program Manual* has not yet been made. A limited number of copies of the 1996 paperback edition, which includes all updates through March 1, 1996, are available. However, the engagement checklists have been revised and the 1996 engagement checklists included in the 1996 paperback edition may not be used. Reviewers who do not have the subscription service may obtain the latest peer review forms and checklists by ordering team captain packages from the AICPA Order Department. Team captain packages do not contain the Standards or the guidance on selecting engagements and writing letters of comments and reports. On-site team captain packages are $8; off-site packages are $4. The 1996 paperback is product no. 019007; price, $75.

SECPS Peer Review Program

The program and reference manuals for the SECPS peer review program includes the programs, forms, and checklists needed to perform an SECPS peer review. Manuals and updates are automatically sent to all SECPS member firms. (Additional copies may be ordered from the AICPA Order Department. The *SEC Practice Section Reference Manual* is product no. 018021GA; price, $68.75. The *SEC Practice Section Peer Review Program Manual* is product no. 017980GA; price, $125.)

Quality Control Standards

The *Guide for Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice*. The guide presents the recommendations of the AICPA Joint Task Force on Quality Control Standards on the application of SQCS Nos 2 and 3. The guide is discussed more fully on page 5 of this letter. The guide is available from the AICPA Order Department (product no. 067020; price, $25 to AICPA members, $27.50 to nonmembers.)

Statement on Quality Control Standards (SQCS) No. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, and (SQCS) No. 3, *Monitoring a CPA Firm's Accounting and Auditing Practice* (AICPA, Professional Standards, vol. 2, QC secs. 20 and 30), are available separately form the AICPA Order Department (product codes 067018 and 067019; price, $5 to AICPA members, $5.50 to non-members).

Reviewer Training

The AICPA and SECPS peer review programs have initial and continuing education requirements for team captains and, for the AICPA peer review program only, off-site reviewers. Peer review team captains and off-site reviewers must have completed a reviewer's training course, meeting the requirements established by the respective programs, within the five years preceding the commencement of a review. Peer review committees monitor compliance with this requirement, using information in the AICPA reviewer database. Reviewers who need to update their information in the database may call AICPA Practice Monitoring at 201/938-3030.

State CPA societies are offering a new two-hour course for peer reviews and a new two-hour course for CPA firms that will focus on the changes in the quality control Standards and in the AICPA peer review program Standards. Reviewers should contact their state CPA society for more information on these courses.

Keeping Current on Professional and Industry Developments

Annually, the AICPA publishes a general Audit Risk Alert plus Audit Risk Alerts for various industries to advise auditors of current economic, industry, and professional developments they should be aware of as they perform audits in the current period. Audit Risk Alerts have been issued covering a variety of practice areas and industries.

The AICPA also publishes a Compilation and Review Alert that provides valuable information that can be used during the review of compilation and review engagements. The Alert clarifies certain existing professional standards, suggests ways of implementing Statements on Standards for Accounting and Review Services (SSARSs) in special circumstances, points out pitfalls that frequently occur in compilation and review engagements, and summarizes new professional pronouncements.

Copies of Audit Risk Alerts can be purchased by calling the AICPA Order Department at 800/862-4272.

The SECPS Professional Issues Task Force (PITF) identifies and considers practice issues that appear to present audit concerns for practitioners. Information that may help auditors improve the efficiency and effectiveness of audits is published by the PITF in Practice Alerts that appear in the *CPA Letter*. The PITF issued three Practice Alerts in 1996 *(Complex Derivatives, Auditing Related Parties and Related-Party Transactions,* and *The Private Securities Litigation Reform Act of 1995)* and so far has issued one in 1997 *(Financial Statements on the Internet).* Although Practice Alerts are not authoritative and have not been acted upon by any committee of the AICPA, the PITF may refer practice issues to the standard-setting bodies for their consideration of the need for authoritative guidance.

New Not-For-Profit Guide

In August 1996, the AICPA Not-for-Profit Organizations Committee issued the Audit and Accounting Guide *Not-for-Profit Organizations*. The new Guide incorporates certain provisions of FASB Statement Nos. 116 and 117 and is directed at not-for-profit organizations in general rather than at specific kinds of organizations such as voluntary health and welfare organizations or private colleges and universities.

Appendix B

Quality Control Elements Conversion Chart

<table>
<tr><th>SQCS No. 1</th><th>SQCS No. 2</th></tr>
<tr><td>Independence</td><td>Independence, Integrity, and Objectivity</td></tr>
<tr><td>Consultation</td><td rowspan="2">Engagement Performance</td></tr>
<tr><td>Supervision</td></tr>
<tr><td>Assigning Personnel to Engagements</td><td rowspan="4">Personnel Management</td></tr>
<tr><td>Hiring</td></tr>
<tr><td>Professional Development</td></tr>
<tr><td>Advancement</td></tr>
<tr><td>Acceptance and Continuance of Clients</td><td>Acceptance and Continuance of Clients and Engagements</td></tr>
<tr><td>Inspection</td><td>Monitoring</td></tr>
</table>

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