

AICPA

PEER REVIEWER'S ALERT 07-01

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2007 AICPA Peer Review Program Conference

The 2007 AICPA Peer Review Program Conference will be held on September 30- October 2, 2007 in Atlanta, Georgia. This conference will include the latest developments, insights and training regarding the peer review process that peer reviewers, technical reviewers, administrators and committee members will encounter. Attendees will receive updated information that affects their role in the peer review process, participate in challenging mock cases and share recent peer review information, ideas and experiences.

Additional conference and registration information will be available at [CPA2Biz - Conferences](#) in the near future.

AICPA Standards for Performing and Reporting on Peer Reviews Exposure Draft Released

The AICPA Peer Review Board released an exposure draft on April 16 containing proposed revisions to the *AICPA Standards for Performing and Reporting on Peer Reviews (Standards)* and Interpretations to the *Standards*.

Many factors, most notably the need to be responsive to peer review users' needs, have influenced the need for a current reevaluation of the *Standards* and Interpretations.

Pivotal was the significant feedback on the AICPA Peer Review Program (Program) as a whole from an on-line poll of the Program's users. The feedback was considered by an AICPA Board of Directors (BOD) task force established in May 2005, which issued a report of recommendations (http://www.aicpa.org/download/transparency/BOD_TF_Report.pdf) to enhance the Program in February 2006.

In addition, since 2003, the Center for Public Company Audit Firms (CPCAF) Peer Review Program's (PRP) Peer Review Committee (PRC) and the Program's Peer Review Board (PRB) has been discussing various harmonization and merger issues. A Joint Peer Review Task Force was created in 2004 to evaluate whether and how the two related peer review programs could be harmonized and/or merged, as well as to consider other enhancements. The restructuring of the CPCAF such that it will no longer administer a peer review program has also given rise to the need to reevaluate the Program.

The most significant conclusions to come from the work of the above task forces were the (1) a recommendation to merge the two peer review programs and (2) a recommendation to reengineer the reporting process to be more understandable and usable in light of the growing mandate that the results of peer reviews be made more widely available.

In furtherance of those recommendations, the exposure draft proposes to create one set of *Standards* and Interpretations within the Program for all AICPA members subject to peer review. This includes those members' firms currently enrolled in the CPCAF Peer Review Program. Other proposals include a reengineered reporting process, changes to engagement and report

reviews, and more principles-based *Standards*. These revisions, as well as others, are expected to result in a more efficient, and effective peer review process.

The exposure draft contemplates that the revised *Standards* and Interpretations will be effective for peer reviews commencing on or after January 1, 2009. The exposure draft is available on the AICPA Peer Review Program and CPCAF Peer Review Programs' websites at www.aicpa.org/members/div/practmon/index.htm and <http://www.aicpa.org/centerprp/index.htm>, respectively.

All are encouraged to review the proposed changes and provide their feedback. The comment deadline is June 30, 2007.

New Statements on Auditing Standards and Statements on Standards for Attestation Engagements

The AICPA's Auditing Standards Board (ASB) has issued the following Statements on Auditing Standards (SAS) and Statements on Standards for Attestation Engagements:

SAS Nos. 104 – 111 are effective for audits of financial statements for periods beginning on or after December 15, 2006. However, early adoption is permitted.

- [SAS No. 104](#), Amendment to Statement on Auditing Standards No. 1, Codification of Auditing Standards and Procedures (“Due Professional Care in the Performance of Work”)
- [SAS No. 105](#), Amendment to Statement on Auditing Standards No. 95, Generally Accepted Auditing Standards
- [SAS No. 106](#), Audit Evidence
- [SAS No. 107](#), Audit Risk and Materiality in Conducting an Audit
- [SAS No. 108](#), Planning and Supervision
- [SAS No. 109](#), Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement
- [SAS No. 110](#), Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained
- [SAS No. 111](#), Amendment to Statement on Auditing Standards No. 39, Audit Sampling.

SAS No. 112 is effective for audits of financial statements for periods ending on or after December 15, 2006. However, early adoption is permitted.

- [SAS No. 112](#), *Communicating Internal Control Related Matters Identified in an Audit*

The following conference calls on SAS No. 112 have been archived:

- [Peer review conference call on SAS No. 112](#) – (available through August 3, 2007)
- [PCPS SAS No. 112 call](#) - open to the public
- [Governmental Audit Quality Center \(GAQC\) SAS No. 112 call](#) - open to the public

SAS No. 113 has two different effective dates. The amendments in paragraphs 1 through 5 of SAS No. 113 are effective for audits of financial statements for periods beginning on or after December 15, 2006. However, early adoption is permitted. The amendments in paragraphs 7 through 14 are effective for audits of financial statements for periods ending on or after December 15, 2006. Earlier adoption is also permitted.

- [SAS No. 113](#), *Omnibus 2006*

SSAE No. 14 is effective when the subject matter or assertion is as of or for a period ending on or after December 15, 2006.

- [SSAE No. 14](#), *SSAE Hierarchy*

Please click through the above links for summaries of each new SAS and SSAE.

Verification of Reviewer Resumes– What to Expect

During 2005, the AICPA Peer Review Board issued a variety of enhanced oversight procedures. One of the key enhancements relates to the administering entity verifying peer reviewers' experience, including the accuracy of the information on reviewers' resumes. Ensuring that reviewers' resumes are updated annually and are accurate, not only facilitates the timeliness of the scheduling process, but is one critical element in determining if the reviewer/review team has the appropriate knowledge and experience (including current engagement responsibilities) to perform a specific peer review.

As a reviewer, you either have been asked or will be asked to verify certain information listed on your resume. Verification procedures may include sending copies of the following to the administering entity:

- License to practice as a certified public accountant in the state in which you are practicing
- CPE certificate from qualified reviewer training course
- CPE certificates to meet requirements under Interpretation No. 4
 - 48 CPE credits related to accounting and auditing to be obtained every three years with at least 8 hours in one year
 - Reporting period to be the same as the reviewer maintains for the AICPA.
- CPE records that qualify to perform Yellow Book audits, if applicable

It is important to comply with the administering entity's request for information in a timely manner.

Incomplete Engagements

In certain instances, a firm may not have all engagements that fall in its peer review year completed and issued at the time of its peer review. If there is a comparable engagement, thereby providing an adequate cross section of engagements despite the incomplete engagements, the peer review should proceed as planned, substituting the comparable engagement. However in accordance with paragraph 3100.46 of Standards for Performing and Reporting on Peer Reviews, if the current year's engagement has not been completed and issued, and a comparable engagement within the peer review year is not available, the prior year's engagement should be reviewed.

However, if there is an incomplete engagement (which is an initial engagement) and there is no comparable engagement, the firm should request an extension from the administering entity. Although the administering entity will likely grant the extension, the firm needs to consider if it will be meeting the requirements of its state board or other regulatory bodies. If an extension is not possible, the peer review should be performed and the report should be modified due to a scope limitation. For example, a firm is performing an initial Yellow Book audit that falls in its peer review year. The Yellow Book audit is not complete and there is no comparable audit. The firm can request an extension from the administering entity. However, if the GAO will not grant an extension, the firm will have to proceed with its peer review and receive a modified report due to a scope limitation. A waiver of a scope limitation is not generally appropriate in this situation.

If the situation arose due to a permanent change in the nature of the firm's business, the firm should consider requesting a change in its peer review year-end date. If there is any uncertainty as to how the situation should be handled, the administering entity should be contacted.

Reviewer Checklists – Ensure Consistency

Reviewers should be diligent in completing Question No.2 on the Reviewers / Team Captain Checklists.

Question No. 2 is the following:

Obtain the firm's background and scheduling information from the firm, and review and compare such information with that furnished by the firm. If the information provided to the administering entity differs significantly from the information provided by the firm to you, please reconcile and notify the administering entity.

In order to fully address this question, the reviewer should obtain the firm's background and scheduling information from the firm and review and compare such information to the engagement statistics that the firm provides to the reviewer.

Reviewers should also ensure that the engagements provided on the List of Accounting and Auditing Engagements or on the Engagement Summary Form are engagements with periods ending during the year under review. The date of the report and the date the financial statements were issued should not be considered when completing these forms. However, the date of the report would be appropriate for attestation engagements, including financial forecasts and projections. In addition, engagements selected for review should be made from those listed on the List of Accounting and Auditing Engagements or on the Engagement Summary Form and therefore have period end dates that fall in the firm's peer review year (with the exception of attestation engagements).

Documenting Risk Assessment

Note: This article is from the Peer Review Course: AICPA Peer Review Program Standards: Practical Guidance for Selected Topics

Components of Risk Assessment and Definition of Peer Review Risk

Reviewers must assess peer review risk and use a risk-based approach in the selection of engagements and offices for review (*Standards*, par. 55-56).

.55 In planning the review, the review team should use the understanding it has obtained of the reviewed firm's accounting and auditing practice and its system of quality control to assess the peer review risk associated with those areas. The higher the assessed levels of peer review risk, the greater the number of offices or engagements that need to be reviewed. The assessed level of peer review risk may be affected by circumstances arising within the firm (for example, individual partners have engagements in numerous specialized industries or the firm has a few engagements constituting a significant portion of the firm's accounting and auditing practice) or outside the firm (for example, new professional standards being applied for the first time or adverse economic developments in an industry).

.56 When assessing risk, the review team should evaluate the reviewed firm's quality control policies and procedures over its accounting and auditing practice in relation to the requirements contained in SQCS No. 2. This evaluation provides a basis for the review team to determine whether the reviewed firm has adopted appropriately comprehensive and suitably designed policies and procedures that are relevant to the size and nature of its practice.

Generally accepted auditing standards require audit risk assessment during audit planning, and peer review risk is likewise assessed in planning a system review. Some reviewers have developed the habit of formalizing the risk assessment after arriving on-site in the reviewed firm's office or after selecting one or more engagements for review. Ineffectiveness and, at the very least, inefficiency should be expected when using this approach. Based on the assessed peer review risk, a risk-based approach is used in the selection of engagements for review (and, for firms with multiple offices, in the selection of offices to visit during the review).

Peer review risk consists of three *components*:

1. *Inherent risk* – The likelihood that a firm's accounting or auditing engagements will fail to comply with professional standards, assuming the firm does not have a system of quality control.
2. *Control risk* – The risk that a firm's system of quality control will not prevent the performance of an engagement that does not comply with professional standards. Control risk is further broken down into two parts:
 - a. *The firm's control environment* – The collective effects of various factors that establish, enhance, or mitigate the effectiveness of specific quality control policies and procedures. A firm's control environment reflects the overall attitude, awareness, and actions of firm management and the message management sends to employees concerning the importance of quality work and its emphasis in the firm.
 - b. *The firm's quality control policies and procedures* – Every firm has quality control policies and procedures, even where they are informally documented or not documented at all and/or are not well understood throughout the firm. Sometimes, however, the quality control policies and procedures are so immature or incomplete that the firm effectively has none beyond the owners asserting the firm complies with relevant professional standards – the understanding of which may be shallow or very outdated.
3. *Detection risk* – The risk that the reviewer (or review team) will fail to detect design or compliance deficiencies in the reviewed firm's system of quality control that either
 - a. Result in the firm having less than reasonable assurance of conforming with professional standards in all material respects or
 - b. Constitute conditions whereby there is more than a remote possibility that the firm will not conform with professional standards on accounting and auditing engagements in all material respects.

The above outlines the *components* of peer review risk. A more practical *definition* of peer review risk is, however, needed in order to fully understand its significance in achieving the objectives of peer review. Peer review risk is the risk that the reviewer will

- Fail to identify significant weaknesses in the reviewed firm's system of quality control or the degree of compliance therewith, and as a result
- Issue an inappropriate report on the reviewed firm's system of quality control for its accounting and auditing practice or the firm's compliance with that system or both, or
- Reach an inappropriate conclusion about whether or not to issue a letter of comments and/or about the comments to be included in or excluded from the letter of comments.

The lower the inherent and control risk, the higher the detection risk that can be tolerated and vice versa. This is explained in the text that follows.

Inherent Risk Factors

In assessing inherent risk factors, the reviewer should consider

- Circumstances arising within the firm (for example, the firm or individual partners have engagements in several specialized industries);
- Circumstances outside the firm that impact the firm's clients (for example, new professional standards or those being applied initially for one or more clients, changes in regulatory requirements, adverse economic developments in an industry in which one or more of the firm's clients operate, or significant developments in the client's organization).
- Variances that may occur from year to year, engagement to engagement or, perhaps, from partner to partner, within the firm. For example, inherent risk will always be higher for an audit of a company or organization operating in a high-risk industry than for a compilation of financial statements without disclosure for a company operating in a non-complex industry; and there are many situations between these two extremes.

Control Risk Factors

Assessing control risk requires reviewers to evaluate the effectiveness of the reviewed firm's quality control policies and procedures in preventing the performance of engagements that do not comply with professional standards. When assessing control risk, the review team should evaluate the reviewed firm's quality control policies and procedures and discuss with the firm if it considered the guidance in the AICPA's *Establishing and Maintaining A System of Quality Control for a CPA Firm's Accounting and Auditing Practice*. The reviewer should evaluate whether the reviewed firm has adopted appropriately comprehensive and suitably designed policies and procedures for each of the elements of quality control in the context of the firm's overall control environment and the inherent risk embodied in its accounting and auditing practice.

The assessed levels of risk are the key considerations in deciding the number and types of engagements to review and, where necessary, offices to visit. Through the assessment of risk, the reviewer determines the coverage of the firm's accounting and auditing practice that will result in an acceptably low peer review risk. Engagements selected should provide a reasonable cross-section of the firm's accounting and auditing practice, with a greater emphasis on those engagements in the practice with higher assessed levels of peer review risk.

Reviewers must document, as part of the Summary Review Memorandum (SRM), the risk assessment of the firm's accounting and auditing practice and its system of quality control, the number of offices and engagements selected for review, and the basis for that selection in relation to the risk assessment. To effectively assess risk of the firm's accounting and auditing practice and its quality control policies, risk assessment documentation should not only address

the engagements selected and the reasoning behind that selection, but also the environment of the firm and its system of quality controls. Some factors that should be considered in assessing risk include the following:

- The relationship of the firm's audit hours to total accounting and auditing hours
- Size of the firm's major engagement(s), relative to the firm's practice as a whole
- Initial engagements and their impact on the firm's practice
- The industries in which the firm's clients operate, especially the firm's industry concentrations
- The results of the prior peer review
- Owners' continuing professional education (CPE) policies and the firm's philosophy toward continuing education – Accumulate the necessary hours or maintain the needed skills and improve delivery of professional services?
- The firm's monitoring policies
- Adequacy of the firm's professional library
- Risk level of the engagements performed – Does the firm perform audits of employee benefit plans, entities subject to A-133 and others under *Government Auditing Standards*, HUD-regulated entities, and other with high-risk features or complex accounting or auditing applications?
- Have there been any major changes in the firm's structure or personnel since the prior peer review?

Detection Risk

Inherent risk and control risk directly relate to the firm's accounting and auditing practice and its system of quality control, respectively, and should be assessed in planning the review. Based on the combined assessment, the reviewer selects engagements for review and determines the scope of other procedures to reduce the peer review risk to an acceptable level. The lower the combined inherent and control risk, the higher the detection risk that can be tolerated. Conversely, a high combined inherent and control risk assessment results in a low detection risk and the resulting increase in the scope of review procedures.

Below is an example of an appropriately documented risk assessment in the SRM:

4A. Describe your assessment of the inherent and control risk related to the reviewed firm's accounting and auditing practice and its system of quality control. The assessment of these risks is qualitative and not quantitative. (Attach a memorandum if more space is needed.)

Inherent and Control Risk Factors – Firm’s practice has a few high- or moderate-risk clients, nine audits subject to YB (cities or local school districts, most subject to A-133), two other audits (a major construction company + a text book distributor), a few reviews (retail trade or medical practices), and the usual compilations for a rural-area firm.

One firm owner has significant experience in YB audits and is a respected “expert” on GASB 34. The other firm owner also has YB experience and recently served as a CPE discussion leader on 101-3 implementation in “small” firms. Each owner each serves as partner-in-charge on audits and a cross-review system is in place. The five other professionals are each CPAs and the practice has been very stable for 20+ years. Firm owners make all decisions relative to the QC functional elements. Most of the firm’s CPE is group discussion, including an annual in-house (joint venture with a regional firm) A&A update with an outside speaker. The firm’s second office is a satellite office only used in tax season.

Based on review of completed QC questionnaire, system in place is common to that found in firms with similar characteristics that have experienced successful peer reviews. The firm owners appear very conscious of QC matters. The firm uses an outside party to assist in its monitoring in year two of the three-year cycle, and internal monitoring procedures are strong and acceptably documented for each year (including the year covered by the review). The firm’s review history is very favorable and there are no known factors that suggest the level of QC has dropped.

Conclusion: Inherent risk = moderate, due to YB/A-133 and construction audits; Control risk = low, due to QC system features; Detection risk = low due to cross-section selected

4B. Based on the above assessment describe how you arrived at the office(s) and engagement(s) selected for review.

Because of the concentration, selected two governmental audits (one A-133 and one new client, representing both owners); one construction audit (high-risk industry is not firm’s strength); the retail trade review, and 3 compilations representing 3 industries (one w/ & two w/o disclosures). This covers each owner, all types of engagements, the “must select” requirement, and results in an acceptably low level of detection risk.

Guidance for Peer Reviewers and Others - AICPA Peer Review Program
Implications of Interpretation 101-3 – Performance of Nonattest Services

Note: This guidance was previously issued in April 2005 via email.

At its January 2005 meeting the AICPA Professional Ethics Executive Committee (PEEC), adopted revisions to Interpretation 101-3 – *Performance of Nonattest Services* (“101-3”) to provide clarification on the applicability and intent of the rule and ensure its continued effectiveness in promoting independence when a member renders nonattest services to an attest client. The revisions do not relax the rule or change its meaning. PEEC believed these changes were necessary and appropriate after it became evident, based on feedback from a significant

number of members, that a number of 101-3's requirements warranted further clarification regarding client competency, documentation of understanding, and routine activities.

One of the revisions PEEC has adopted relates to general requirement no. 3, which requires that a member document his or her understanding with the client regarding key aspects of the nonattest services engagement. 101-3 has been revised to reflect that a failure to document the understanding with the client would **not** be considered to impair a member's independence provided such understanding had been established; but rather, would be considered a failure to comply with an Ethics standard under Rule 202.

According to 101-3, before a member or his or her firm ("member") performs nonattest services for an attest client, the member should determine that the requirements described in 101-3 have been met. In cases where the requirements have not been met during the period of the professional engagement or the period covered by the financial statements, the member's independence would be impaired. However, PEEC acknowledged that a failure to **document** the understanding, when in fact the understanding with the client had been established, should **not** result in an impairment of independence.

The AICPA Peer Review Board (Board) guidance has and continues to be that when a firm performs an engagement when it lacks independence, the engagement would be deemed substandard (except on compilation engagements where the accountants report has appropriately noted the lack of independence). Therefore, if a firm fails to meet the documentation requirements of 101-3 (general requirement no. 3) that alone does not cause an impairment of independence and therefore does not automatically result in the engagement being deemed substandard. When a firm fails to meet any of the other requirements of 101-3 (general requirement no. 2), independence has been impaired and therefore would result in the engagement being deemed substandard.

Guidance on AICPA Interpretation 101-3, Performance of Nonattest Services can be found on the AICPA web site as well as guidance related to the revisions adopted by PEEC related to Understanding General Requirement No. 2: Client Responsibilities <http://www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/Resources+and+Tools>.

The Board has also considered the impact of 101-3 on each type of peer review. The guidance details three specific areas for reviewers to consider:

- What procedures should peer reviewers perform to determine if firms are performing non-attest services and if the firm is in compliance with the requirements of 101-3 where applicable?
- What documentation should peer reviewers be discussing with the firm and/or physically be reviewing?
- How should peer reviewers treat the firm's failure to comply with Interpretation 101-3?

System Reviews

Review teams should first evaluate the firm's policies and procedures and compliance therewith for identifying all services performed for all clients. The peer review quality control policies and procedures questionnaires completed by the reviewed firm requests the firm to identify whether the firm performs nonattest services (The firm's own quality control documents may contain this information as well). In addition, the peer review engagement checklist profile information completed by the reviewed firm on all engagements selected for review asks the firm if it performs nonattest services for the client. The questionnaires and profile information also serve as representations made by the reviewed firm for the review team to follow when completing the team captain and engagement checklists.

Review teams should then determine whether the firm has complied with the requirements of 101-3, including the firm's documentation of the understanding with the client. Review teams should consider the pattern and pervasiveness of any 101-3 deficiencies as well as their systemic cause. These deficiencies along with the other deficiencies noted during the peer review must be considered when determining their affects on the peer review report and/or letter of comments.

Summary of Key Points:

- Failure to meet the documentation requirements of 101-3 alone does not cause an impairment of independence and therefore does not automatically result in the engagement being deemed substandard.
- Failure to meet any of the other requirements of 101-3 (general requirement no. 2), creates an impairment of independence and therefore would result in the engagement being deemed substandard.
- Procedures and Consideration on System Reviews
 - o Evaluate the firm's policies and procedures and review the firm's compliance with 101-3 when they are performing nonattest services for attest clients
 - o Review the firm's related documentation to determine compliance with 101-3
 - o Consider the pattern and pervasiveness of 101-3 and other deficiencies to determine the affects on the peer review report and/or letter of comments.
 - o If the firm fails to comply with the documentation requirements of 101-3 **AND** has numerous other deficiencies on an engagement (not related to 101-3), consideration should be given as to whether the engagement is substandard (similar to consideration on any engagement that has numerous deficiencies).

Engagement Reviews

Review teams should first evaluate the engagement checklist profile information completed by the reviewed firm on all engagements submitted for review. This document asks the firm if it performs non-attest services for the client along with specific questions regarding documentation required by 101-3. The profile information also serves as representations made by the reviewed

firm for the reviewer to follow when completing the reviewer's checklist and the engagement checklists. The profile information also provides common examples of non-attest services to assist the reviewed firm.

Engagement reviews include the review of documentation required by the Statements on Standards for Accounting and Review Services and the Statements on Standards for Attestation Engagements, which encompass the AICPA Code of Conduct, therefore, reviewers should review the firm's documentation of the understanding with the client to determine if the firm is in compliance with 101-3.

The firm's failure to comply with documentation requirements of 101-3 alone would not result in an engagement being deemed a substandard engagement or result in the issuance of a modified report, but would be included as a finding in the letter of comments. When a reviewer determines that the engagement is substandard for the failure to comply with any of the other requirements of 101-3, the reviewer should follow the guidance outlined in Appendix O of the Standards for Performing and Reporting on Peer Reviews (*Standards*) in determining whether to issue a modified or adverse report. Appendix O states that the identification of at least one substandard engagement automatically results in the issuance of a modified peer review report unless only one engagement was reviewed (an adverse report would be issued). The reviewer would issue an adverse report when all of the engagements submitted for review were deemed substandard.

Summary of Key Points:

- Failure to meet the documentation requirements of 101-3 alone does not cause an impairment of independence and therefore does not automatically result in the engagement being deemed substandard.
- Failure to meet any of the other requirements of 101-3 (general requirement no. 2), creates an impairment of independence and therefore would result in the engagement being deemed substandard.
- Procedures and Consideration on Engagement Reviews
 - Review the firm's representations regarding the performance of nonattest services and its compliance with 101-3 when they are performing nonattest services for attest clients.
 - Review the firm's related documentation to determine compliance with 101-3.
 - Failure to meet the documentation requirements of 101-3 would be included in the letter of comments, and would not by itself cause the report to be modified or adverse (or the engagement to be deemed substandard).
 - Paragraph 147-1e (Appendix O of the *Standards*) indicates that departures from professional standards, noted in a significant number of areas *on one engagement*, that individually may not be considered a significant departure from professional standards, may be considered substandard when the departures are considered in aggregate.
 - Failure to meet any of the other requirements of 101-3 creates an impairment of independence and therefore would result in the engagement

being deemed substandard and the issuance of a modified report (or an adverse report if all engagements reviewed are deemed substandard).

Report Reviews

Review teams should first evaluate the engagement checklist profile information completed by the reviewed firm on all engagements submitted for review. This document asks the firm if it performs nonattest services for the client along with specific questions regarding documentation required by 101-3. The firm is also asked to describe the documentation of the understanding with the client required by 101-3. This profile information also serves as representations made by the reviewed firm for the reviewer to follow when completing the reviewer's checklist and the engagement checklists. The profile also provides common examples of nonattest services to assist the reviewed firm.

Report reviews do not specifically include the review of engagement documentation required by professional standards, therefore, reviewers should not review any 101-3 engagement documentation to determine if the firm is in compliance with 101-3. Reviewers will determine 101-3 related documentation deficiencies based on the representations of the firm on the engagement profile and should not include them in the peer review report. However, such deficiencies should be communicated to the reviewed firm in a manner deemed appropriate by the reviewer. The peer reviewer's focus is first, where applicable, that the reviewed firm has the understanding with the client on all matters required by 101-3 (general requirement no. 2), and that the reviewed firm understands the documentation requirements (general requirement no. 3).

The reviewer should include a significant comment in the report when the engagement is substandard for failure to comply with any of the other requirements of 101-3 resulting in the impairment of independence.

Summary of Key Points:

- Procedures and Consideration on Report Reviews
 - Review the firm's representations regarding the performance of nonattest services and its compliance with 101-3, including representations regarding documentation, when they are performing nonattest services for attest clients
 - DO NOT review the firm's 101-3 engagement documentation
 - Failure to meet the documentation requirements of 101-3 should NOT be included in the report since report reviews do not specifically cover the firm's engagement documentation. However, any documentation deficiencies should be communicated to the reviewed firm in a manner deemed appropriate by the reviewer.
 - Failure to meet any of the other requirements of 101-3 (general requirement no. 2), creates an impairment of independence and therefore would result in the engagement being deemed substandard and the issuance of a report with significant comments

Engagement Review Report

Ethics Interpretation 101-3 – *Performance of Nonattest Services* (“101-3”), indicates that before a member or his or her firm ("member") performs nonattest services for an attest client, the member should determine that the requirements described in 101-3 have been met. In cases where the requirements have not been met during the period of the professional engagement or the period covered by the financial statements, the member's independence would be impaired. However, a failure to **document** the understanding (general requirement no. 3), when in fact the understanding with the client had been established, should **not** result in an impairment of independence. However, it is considered a failure to comply with the AICPA Code of Professional Conduct.

The AICPA Peer Review Board (Board) guidance has and continues to be that when a firm performs an engagement when it lacks independence, the engagement would be deemed substandard (except on compilation engagements where the accountants report has appropriately noted the lack of independence). Therefore, if a firm fails to meet the documentation requirements of 101-3 (general requirement no. 3) that alone does not cause an impairment of independence and therefore does not automatically result in the engagement being deemed substandard. When a firm fails to meet any of the other requirements of 101-3 (general requirement no. 2), independence has been impaired and therefore would result in the engagement being deemed substandard.

The third paragraph of the unmodified Engagement Review Report should be tailored, depending upon the situation, in accordance with the footnotes 23 and 24 in Appendix P of the *Standards for Performing and Reporting on Peer Reviews*. The following are various scenarios that can occur and how the paragraph should be tailored.

Scenario 1

A firm submits reviews and compilations with various types of documentation required by Professional Standards, including 101-3. The firm documented everything in accordance with Professional Standards.

The third paragraph of the report should be the following:

In connection with our engagement review, nothing came to our attention that caused us to believe that the financial statements or information and the related accountant's reports submitted for review by [*Name of firm*] for the year ended June 30, 20XX, did not conform with the requirements of professional standards in all material respects or that the documentation on those engagements did not conform with the requirements of professional standards in all material respects.

Scenario 2

A firm submits reviews and compilations with various types of documentation required by Professional Standards, including 101-3. All of the firm's documentation is in accordance with Professional Standards, except that the firm did not document its understanding with the client, as required by general requirement no. 3 of 101-3. However, the firm is in accordance with general requirement no. 2 of 101-3 and therefore independence is not impaired.

The third paragraph of the report should be the following:

In connection with our engagement review, nothing came to our attention that caused us to believe that the financial statements or information and the related accountant's reports submitted for review by [*Name of firm*] for the year ended June 30, 20XX, did not conform with the requirements of professional standards in all material respects or that the documentation on those engagements did not conform with the requirements of professional standards in all material respects.

As is evident from this scenario, the Peer Review report is not modified if the firm has complied with all documentation requirements, except for 101-3. This is true provided that the firm has established an understanding with the client and therefore independence has not been impaired.

Scenario 3

The firm submits compilations and the only documentation requirement is 101-3. The firm did not document its understanding with the client, as required by general requirement no. 3 of 101-3. However, the firm is accordance with general requirement no. 2 of 101-3 and therefore independence is not impaired.

The third paragraph of the report should be the following:

In connection with our engagement review, nothing came to our attention that caused us to believe that the financial statements or information and the related accountant's reports submitted for review by [*Name of firm*] for the year ended June 30, 20XX, did not conform with the requirements of professional standards in all material respects or that the documentation on those engagements did not conform with the requirements of professional standards in all material respects.

As is evident from this scenario, the Peer Review report is not modified even if the only documentation required is 101-3 and the firm does not have any such documentation, provided the firm has established an understanding with the client and therefore independence has not been impaired.

Scenario 4

The firm has no engagements with documentation requirements. This is true in one of the following instances:

1. The firm does not perform any non-attest services for its attest clients (including compilation clients).
2. The firm only performs compilations and the reports have appropriately disclosed the lack of independence.

The third paragraph of the report should be the following:

In connection with our engagement review, nothing came to our attention that caused us to believe that the financial statements or information and the related accountant's reports submitted for review by *[Name of firm]* for the year ended June 30, 20XX, did not conform with the requirements of professional standards in all material respects and there was no documentation required for the engagements submitted for review.

Considerations Related to Accepting an Audit Engagement

Reviewers can discuss the following with reviewed firms, when applicable, as an opportunity to add value.

Accepting an Audit Engagement

There are many considerations a practitioner should evaluate when accepting either an initial audit or an initial audit in a specialized area (e.g. Governmental) or an audit in another state. The practitioner should consider the following:

- Peer Review requirements (i.e. step-up system review)
- Board of Accountancy Licensure Requirement for both
 - Firm License
 - Individual License
- Board of Accountancy rules and regulations
- GAO rules and regulations

Only after evaluating the ramifications of these consideration as well as other possible considerations should a practitioner accept such an audit engagement.

Employee Benefit Plans

Employee Benefit Plan Audit Quality Center

The AICPA established the Employee Benefit Plan Audit Quality Center (EBPAQC) (www.aicpa.org/ebpaqc) as a voluntary firm membership to enhance the quality of audits of employee benefit plans subject to the Employee Retirement Income Security Act (ERISA). The Center provides a centralized place for firms to find information about ERISA audits. Center resources include periodic EAlerts, a dedicated Center website, an online Member Discussion Forum for sharing best practices and discussing audit issues and teleconference updates on a variety of technical, legislative, regulatory, and practice management subjects. The Center has over 1,200 CPA firm members. A list of Center members is available on the Center website at <http://ebpaqc.aicpa.org/Memberships> .

EBPAQC firm members have agreed, as a condition of membership, to have employees of an EBPAQC member firm review the ERISA engagements selected for its peer review. Although it

is not a requirement of the Standards for Performing and Reporting on Peer Reviews, to avoid a misunderstanding with your client, it is advisable that team captains include a member that will allow the firm to comply with this membership requirement as part of the review team. Of course, if the team captain's firm is a member of the EBPAQC, ordinarily there will be no problem.

Also, as a condition of membership, EBPAQC firms' quality control policies and procedures must require an annual inspection that includes a review of the firms' ERISA employee benefit plan audit practice by individuals possessing current experience and knowledge of accounting and auditing practices specific to ERISA employee benefit plan audits. Note that pre- or post-issuance reviews may not serve as a substitute for this inspection requirement and inspections are required even during the peer review year. Since this membership requirement is more stringent than the requirements of professional standards, team captains should be aware of the possibility that EBPAQC member firms may fail to comply with firm quality control policies and procedures even if there is no departure from professional standards. There is no requirement to test for compliance with EBPAQC membership during a peer review. However, should it come to the attention of the reviewer that the firm has not modified its quality control policies and procedures in such a way as to meet the EBPAQC membership requirements, the team captain may wish to point this out to the firm.

To learn more about the EBPAQC benefits and membership requirements, visit the Center website or contact Cynthia Dillon, Center Administrator, at cdillon@aicpa.org or 202-434-9207.

DOL's ERISA Audit Quality Enforcement Initiative

The DOL's Employee Benefits Security Administration (EBSA) has an ongoing enforcement initiative to monitor the quality of ERISA audits. The audit quality program is administered by the EBSA's Office of the Chief Accountant (OCA). The EBSA will reject the Form 5500 filing where it has been determined that an audit failure has occurred. In addition, the EBSA will refer the substandard work to the AICPA's Professional Ethics Division or the appropriate State Board(s) of Accountancy. For firms that perform a limited number of employee benefit plan audits, the OCA will send letters to the plan administrator requesting copies of the audit workpapers. The OCA will perform an in-house review of the Form 5500, the independent auditor's report, and selected workpapers for each of those engagements. Those reviews will be expanded to include additional workpaper reviews, discussions with firm representatives, and any additional procedures deemed necessary based on the findings of the initial reviews.

Common ERISA Audit Deficiencies

Note: Based upon DOL reviews and AICPA peer review findings, the Employee Benefit Quality Center compiled this listing of deficiencies.

- Planning:
 - Inadequate audit planning
 - Failure to assess the risk of material misstatement due to fraud
- Internal Controls

- Failure to document an understanding of internal controls - most often when a substantive audit is going to be performed.
 - Inadequate use of SAS 70 reports; lack of testing when SAS 70 report is obtained
- Contributions
 - No audit work performed
 - Particularly multi-employer plans, failure to obtain adequate audit evidence for contributions back to contributing employers (multi-employer plans). Reliance on contribution reports is not enough.
- Insufficient payroll audit procedures
 - Failure to test elective deferrals
- Investments
 - No work performed
 - Failure to test end of year values
 - Failure to properly value hard-to-value- assets
 - Improper use of limited scope certifications
- Benefit payments
 - No audit work performed
 - Inadequate auditing regarding eligibility of claims to be covered by the plan
- Participant data
 - Insufficient testing of payroll data
 - Failure to test eligibility, forfeitures and allocations
 - In defined contribution plans with limited scope audits, failure of auditors to test the allocation earnings and gains/losses to participant accounts.
 - Sample sizes too low
 - Some firms have reduced their sample sizes selected for compliance and substantive testing to unacceptably low levels.
- Workpaper documentation
 - adequacy of audit documentation continues to be an issue
 - only evidence of audit work having been performed is a sign off on an audit step without any supporting documentation

Government Auditing Standards

AICPA Governmental Audit Quality Center

CPA firms perform thousands of audit and attestation engagements of governments, not-for-profit organizations, and certain for-profit organizations under *Government Auditing Standards* each year (also referred to as Yellow Book audits). These organizations receive billions of dollars in governmental financial assistance and, as a result, are subject to a myriad of unique and complex audit requirements. “*Governmental audits*” represent a critical portion of the many

audits performed by CPAs annually and include single audits, program-specific audits, and other compliance audits. To help CPAs meet the challenges of this unique and complex area, the AICPA launched the firm-based, voluntary membership, [Governmental Audit Quality Center \(GAQC\)](#) in October 2004. To date the Center has more than 625 member firms. Those firms audit over 80% of the federal dollars covered in single audits performed by CPA firms each year. For a complete list of member firms, sorted by firm name and by state, visit the Center's Web site at: www.aicpa.org/GAQC under the [Membership Tab](#).

The Center's focus is to promote the highest quality governmental audits. It also creates a community for CPA firms that practice in this important area. Member firms receive newsletters and alerts with the latest information, have access to a member discussion forum where they can ask other practitioners questions, and are able to participate in regularly scheduled conference calls on important governmental audit quality topics. The GAQC also provides a single access point via a [Center Web site](#) where members can learn about the latest developments in Yellow Book and single audits and communicate with other member firms. The Web site also includes membership information and instructions on how to join.

GAQC member firms must adhere to [membership requirements](#) including requirements relating to the firms' selection of its peer reviewer and performance of internal inspection of its governmental audit practice. These membership requirements are similar to those of the Employee Benefit Plan Audit Quality Center (EBPAQC) noted earlier in this *Alert*. However, GAQC member firms may allow its peer review to substitute for its annual inspection for the year under review.

To learn more about the GAQC benefits and membership requirements, visit the Center website or contact Cynthia Dillon, Center Administrator, at cdillon@aicpa.org or 202-434-9207.

Governmental Audit Quality Continues to Be a Concern

Federal Offices of Inspectors General (OIGs) continue to be very active in reviewing the quality of auditors' work and this is not expected to change. From the standpoint of the federal user, audits conducted under OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (also referred to as single audits), are a key accountability mechanism for the expenditure of taxpayer dollars. Consequently, audit quality continues to be an area of utmost importance. Both peer reviews and AICPA Professional Ethics Division (PED) investigations of audit organizations continue to indicate that there are problems in audits performed under *Government Auditing Standards* (GAS) and Circular A-133. Federal OIGs have also found similar problems based on their ongoing quality control reviews (QCRs) of single audits. As a result, the OIGs are nearing the completion of a coordinated and comprehensive review of single audit quality. Their effort included a review of more than 200 single audits and was designed to identify how extensive the audit quality problems may be. The OIGs plan to publicly report on their findings in March 2007 and to continue performing normal QCRs on an ongoing basis.

AICPA Ethics Interpretation No. 501-3 “Failure to Follow Standards and/or Procedures or Other Requirements in Governmental Audit,” of Rule 501, *Acts Discreditable*, of the AICPA Professional Code of Conduct states that when an auditor undertakes an audit of government grants, government units, or other recipients of government monies and agrees to follow specified government audit standards, guides, procedures, statutes, rules, and regulations, the auditor is obligated to follow those standards or guidelines in addition to generally accepted auditing standards. An auditor’s violation to do so is an act discreditable to the profession and a violation of Rule 501. OIGs take these violations very seriously and are likely to refer any firm performing substandard work to the AICPA PED and/or the appropriate state board of accountancy.

Common Deficiencies

The following are some of the more common deficiencies noted in QCRs and AICPA peer reviews of audits performed under GAS and Circular A-133.

- Audit documentation lacking (this one area is the root of many other quality problems).
- Failure to audit as major programs Type A programs not qualifying as low-risk.
- Failure to audit Type A programs as major because of errors made in determining the Type A/Type B program dollar threshold.
- Failure to audit all programs included in a cluster of programs.
- Failure to meet the percentage-of-coverage requirement in Circular A-133, section 520(f).
- Using inadequate or outdated reference material.
- Problems with compliance and internal control work, particularly a lack of attention to internal control.
- Problems with the schedule of expenditures of federal awards that goes unnoticed by the auditor.
- Extremely small samples, inadequate sampling techniques, and a general lack of documentation about samples and their selection.
- Inadequate GAS, Circular A-133, and Data Collection Form reporting.
- Auditor finding write-ups that do not include all of the required elements.
- Noncompliance with GAS Continuing Professional Education and audit documentation requirements.

Going Forward—Challenges to Continue

There are a number of developments on the horizon that will continue to provide challenges for auditors that perform these audits. First, there are a number of new AICPA auditing standards (for example, SAS Nos. 103 – 113) that will need to be implemented this year as well as over the next few years. Second, there are currently ongoing AICPA technical projects to determine the effect of new AICPA auditing standards on single audits and other compliance audits that will likely result in new guidance. (For example, looking at how SAS No. 112, *Communicating Internal Control Related Matters in an Audit*, will be implemented in a single audit or compliance auditing environment). Third, the U.S. Government Accountability Office is issuing a comprehensive revision to *Government Auditing Standards* in early 2007 that auditors will need to understand. Finally, the results of the federal single audit quality study may ultimately result in other changes in standards, guidance, and possibly law and/or regulation. Even if your

firm is not a member of the GAQC, you should consider bookmarking the [GAQC Web site](#) to stay on top of the latest developments in these areas.