Managing an Accounting Practice:
Peer Review Preparation
November 10, 2017
Elon University
Victor W. Moran, M.B.A., C.P.A.

1. Highlights of <u>Avoid Potholes for a Smooth Ride to Peer Review</u> (AICPA Private Companies Practice Section, December 2016)
2. Prudent preparation for a practically painless peer review
3. Addressing documentation issues
4. Recent AICPA research on single audit quality factors

<u>TIERS OF CONCERN IN PERFORMING ACCOUNTING SERVICES</u>

(a reprise)

TIER 1

<u>Provide service that meets client needs</u>

Imposes commitment to excellence

TIER 2

<u>Litigation</u>

Imposes prudence

TIER 3

<u>Peer review</u>

Imposes discipline

---

1. **Highlights of <u>Avoid Potholes for a Smooth Ride to Peer Review</u>** (AICPA Private Companies Practice Section, December 2016)
    a. **AICPA's ongoing initiative on Enhancing Audit Quality to focus on**
        i. New industries
        ii. Industries with new or rising risks
        iii. Audit areas of increased risk
        iv. Areas with increased inspection matters
    b. **"areas your firm might need to take" a closer look at to ensure quality standards are being met** [targeting, hopefully, those most relevant to small firms – vwm]
        i. Reports
            1. Audits
                a. Not in conformity with clarified auditing standards
                b. Report date significantly earlier than the date of the review of the workpapers and the release date
                c. Failure to appropriately report on supplemental information by:
                    i. Not identifying all supplemental information
                    ii. Using outdated language [perhaps due to incorrectly copying and pasting from practice aids – vwm]
            2. Reviews
                a. Not updated for applicable professional standards [i.e., SSARS 23]
                b. Contained inappropriate titles
                c. No mention of responsibility taken on supplementary information
                d. Failed to cover all or correct periods in the financial statements
            3. Compilations
                a. Not updated for applicable professional standards [i.e., SSARS 23]
                b. Contained inappropriate titles or lacked titles
                c. Contained no explanation of the degree of responsibility the accountant is taking with respect to supplementary information
                d. Failed to:
                    i. Mention that substantially all disclosures are omitted
                    ii. Refer to the accountant's report on each page of the financial statements
                    iii. Label select disclosures as "Selected Information Substantially All Disclosures Required by [Applicable Financial Reporting Framework] Are Not Included"
                    iv. Cover all or correct periods in the financial statements

ii. Representation Letters
   1. Audits
      a. Did not conform with clarified auditing standards requirements
      b. Were dated incorrectly
      c. Did not cover all appropriate periods
      d. Missing required representations [perhaps due to incorrectly copying and pasting from practice aids – vwm]
   2. Reviews
      a. Did not include all representations by professional standards require
      b. Were dated incorrectly
      c. Did not cover the appropriate periods [perhaps due to incorrectly copying and pasting from practice aids or failing to update letters for the current period – vwm]

iii. Documentation and Performance [documentation issues discussed more specifically below – vwm]
   1. Audits
      a. Failure to appropriately document planning procedures, including:
         i. Risk assessment (and linkage of risks to procedures performed)
         ii. Planning analytics
         iii. Understanding of IT environment
         iv. Internal control testing
      b. Failure to:
         i. Address fraud considerations
         ii. Communicate and/or document required communications with those charged with governance
         iii. Address why accounts receivable not confirmed
         iv. Document sampling methodology
         v. Document consideration of the group audit standard when a component unit was audited by another auditor
      c. Audit documentation did not contain sufficient competent evidence to support the firm's opinion on the financial statements [see misconceptions below – vwm]
   2. Reviews—Lacking expectations or the comparison of expectations to actual for analytical procedures [Do peer reviewers have varying expectations for the documentation of expectations? Just asking – vwm]
   3. "Peer review areas of focus—The documentation should enable an experienced auditor, having no previous connection with the audit, to understand the nature, timing, extent and results of procedures, including significant findings or issues." [the standard]

4. [I have observed some conflict between the level of documentation recommended by certain practice aids, which counsel minimum documentation, and peer reviewers who expect more documentation or certain kinds of documentation (memos, additional language on workpapers that the firm considers self-explanatory, e.g., tick marks considered by the practitioner to be "standard"). vwm]

iv. Engagement Letters
1. Reviews
    a. Failure to obtain an engagement letter
    b. [Failure to] include all required elements in the letter" [perhaps due to incorrectly copying and pasting from practice aids – vwm]
2. Compilations—failure to:
    a. Obtain an engagement letter
    b. Include all required elements in the letter [perhaps due to incorrectly copying and pasting from practice aids – vwm]
3. Letter referred to GAAP on an engagement performed in accordance with a special purpose framework" [perhaps due to incorrectly copying and pasting from practice aids – vwm]

v. Disclosures
1. Missing or insufficient fair value disclosures related to:
    a. Fair value hierarchy of investments
    b. Description of the levels
    c. Descriptions of the methods used
    d. Tabular presentation of amounts
2. Long-term debt not segregated into current and long-term portions
3. Missing or insufficient disclosures for related-party transactions, debt maturation schedules and significant estimates
4. No disclosure of the date through which subsequent events were evaluated

vi. Quality Control
1. Relevant ethical requirements—failure to obtain written confirmation on independence for all personnel
2. Acceptance and continuance—failure to:
    a. Obtain a license in all states where engagements were accepted
    b. Evaluate risk of performing an engagement in a specialized industry and/or to obtain the necessary knowledge of current standards in specialized areas prior to performance of the audit
3. Monitoring
    a. Failure to design policies and procedures for the completion of monitoring
    b. Monitoring procedures did not include review of all elements of quality control

c. Results of monitoring and inspections were not documented

4. Engagement performance
    a. Practice aids for performing and documenting engagements were not completed
    b. Criteria for Engagement Quality Control Review (EQCR) not established
    c. EQCR not performed on engagements that meet the firm's criteria
    d. Current quality control materials for the performance of engagements not maintained
    e. No established policy for the retention of engagement documentation
5. Human resources
    a. Policies not sufficient to ensure partners and staff obtain appropriate CPE
    b. Policies not set to require relevant CPE for levels of service and industries of engagements performed
    c. Current licenses within all jurisdictions the firm practices not maintained
6. Leadership responsibilities for quality within the firm
    a. Failure to have a written quality control document in accordance with SQCS 8
    b. [Failure to] communicate quality control policies and procedures with staff
    c. [In the early years of peer review, staff were—more often than they should have been—put in the awkward position of reviewing partners' work in the inspection process. vwm]
7. [Failure to] devote sufficient resources for the support of quality control policies and procedures

vii. Code of Professional Conduct
1. Failure to establish and document in writing the firm's understanding with the client with regard to non-attest services provided
2. [Failure to] address management's responsibilities to oversee and evaluate the results of services performed
3. [Failure to] collect fees for professional services provided more than one year prior to the date of the current report
4. [Failure to] communicate and/or document required communications with those charged with governance

viii. Independence [selected issues from report]
1. Multiple nonattest services provided to a client can increase the significance of threats to independence.

2. One key safeguard to reduce the threat of management participation is that the client must designate an individual with suitable skill, knowledge, and/or experience to:
    a. Assume the management responsibilities
    b. Oversee the nonattest service
    c. Evaluate the adequacy/results of the services performed
    d. Accept responsibility for the results of the services
3. CPAs are expected to use their professional judgment and experience to determine whether the individual designated by the client can fulfill these responsibilities.

ix. Not-for-Profit Organizations
1. Necessary knowledge of current standards and obtain the proper training for NFP engagements not obtained
2. Auditors' report did not refer to the Statement of Functional Expenses [perhaps due to incorrectly copying and pasting from practice aids – vwm]
3. Net assets not properly classified as unrestricted, temporarily restricted and permanently restricted
4. Improper expense classifications on the Statement of Functional Expenses
5. Inadequate disclosure of the nature, amounts and types of net asset restrictions
6. Policies regarding donated goods and services not disclosed

x. Governmental, A-133 and HUD [the longest section of this report, so I will highlight just a few of these items]
1. Failure to include all of the required elements of professional standards in the Independent Auditor's Report
2. Failure to include all of the required elements of professional standards in the Auditor's Report on Internal Control over Financial Reporting and on Compliance and Other Matters
3. Failure to present the financial statements in accordance with professional standards
4. Failure to properly document independence considerations required by Yellow Book
5. Failure to meet the Yellow Book CPE requirements including 80 hours of A&A and 24 hours of Yellow Book specific courses
6. Failure to document required communications with those charged with governance including proper communication of internal control findings
7. Failure to ensure that the written representations from the audited entity contained all applicable elements
8. Failure to identify and test sufficient and appropriate major programs

xi. Employee Benefit Plans [selected items; see NC State Board newsletter items below]

1. Failure to report significant plan information, such as related party (party in interest) transactions and prohibited transactions between a plan and a party in interest
2. Failure to present a complete Schedule of Assets (Held at End of Year)
3. Insufficient participant testing related to demographic data and payroll
4. Insufficient procedures and documentation for reliance on SOC 1 reports

2. Prudent preparation for a practically painless peer review

a. Peer review: punitive or remedial

i. https://www.aicpa.org/InterestAreas/PeerReview/Resources/Transparency/DownloadableDocuments/TransparencyPositionPaper.pdf
Members' acceptance of mandatory peer review, demonstrated both through their votes and through their membership renewals, was predicated on two fundamental principles:
- Peer review would be remedial rather than punitive in nature, and
- The results of the peer review would be confidential except to those administering the program (and to third parties to whom reviewed firms chose to make the information available). [page 5]

Confidentiality: Peer review was originally designed as an educational and remedial program to strengthen quality control, to prevent recurrences of problems and to correct deficiencies in the practices of member firms. It was not intended to duplicate or facilitate state or federal enforcement responsibilities. From the very beginning, its role was corrective, rather than punitive. Members expected, and the AICPA delivered, confidentiality throughout the process. In today's environment, however, this kind of confidentiality is becoming increasingly difficult to support. [page 10]

ii. I have observed that, in practical terms, peer review can indeed be punitive, can even be humiliating, depending on the demeanor and conduct of the reviewer. The result: an adversarial relationship between the firm and the reviewer.

iii. As for peer review being educational and remedial, I more-than-suspect that some firms adopt audit, review and compilation procedures based not on professional standards (or in my tiers of concern, not based on the pursuit of excellence in client service, or even on the prudence imposed by the possibility of litigation), but based on what they believe their peer reviewer expects, particularly in that most troublesome area—documentation. There appears to be a wide spectrum of levels and types of documentation expected by peer reviewers.

b. Preparing for peer review

i. PPC's Guide to Quality Control has a chapter on peer review

1. Section on choosing a peer reviewer – not surprisingly, PPC has a checklist for choosing a reviewer
2. Recommends conducting in-house training in preparation for the peer review
3. Section on what to expect in a system review
4. Section on reducing the cost of the review – emphasizes importance of the annual inspection

ii. The Board's input

1. June 2017 Newsletter, "Tips for Avoiding a Complaint and Responding to a Complaint" [some peer review/quality related items]
    a. Know your professional limits – either acquire the necessary knowledge or do not accept the engagement
    b. Take relevant CPE
2. A cursory review of disciplinary actions in the Board's 2016-2017 newsletters
    a. The "should have known" cases
        i. Firm renewals indicated performed audits, reviews, compilations; applications submitted to participate in the peer review program, but never followed up to obtain a review
        ii. A firm performed only one compilation, another firm performed a "small number of audits," but neither firm knew these engagements made them subject to peer review
    b. The "failed" cases
        i. Due to GAAS, GAGAS, SSARS, yellow book, etc. nonconformity
        ii. Insufficient monitoring procedures
        iii. Failed after previous fail and a pass with deficiency
        iv. Peer review obtained, but ERISA audit not disclosed; review report recalled, subsequently received pass with deficiencies due to ERISA audit issues

iii. From a small firm partner's/sole practitioner's experience

1. The importance of the inspection
    a. Scheduling
    b. Resolving issues noted, in a timely manner
2. Keep the QC document updated
3. CPE related to practice areas
    a. Accounting/GAAP
    b. Standards (GAAS, SSARS, etc.)
4. Follow up on previous review results and recommendations

iv. AICPA weighs in—<u>AICPA Peer Review Program: Questions and Answers about the AICPA Peer Review Program</u>

1. A source for:

a. Enrollment requirements
b. Choosing a peer reviewer
c. Preparing for the review
d. System review versus engagement review
e. Peer review reports: pass, pass with deficiencies (pass with deficiencies with a scope limitation), fail
f. Other information on peer review

2. Items of note under Preparing for the Review:
    a. establish and maintain appropriate quality control policies and procedures ***and comply*** with those policies and procedures (SQCS No. 8) [emphasis vwm]
    b. preparing for the next review
    c. make sure proposed actions from the previous review have been taken
    d. perform monitoring procedures to make sure previous deficiencies have been corrected
    e. review quality control document to make sure it is up-to-date and appropriate for the firm's size, structure, and nature
3. Resources of note:
    a. AICPA Peer Review Program Manual http://www.aicpa.org/InterestAreas/PeerReview/Resources/PeerReviewProgramManual/Pages/default.aspx
    b. Information regarding the AICPA Peer Review Program http://www.aicpa.org/InterestAreas/PeerReview/Pages/PeerReviewHome.aspx
    c. http://www.aicpa.org/InterestAreas/PrivateCompaniesPracticeSection/QualityServicesDelivery/KeepingUp/Pages/invigorate-the-focus.aspx#tone

3. Addressing documentation issues

a. Journal of Accountancy June 2017 page 38 "Audit Documentation: Tips for Getting It Right"

i. AICPA Peer Review Program "enhanced oversights"

ii. High levels of material nonconformity—most common cause: noncompliance with standards on Audit Documentation. One out of four engagements subject to enhanced oversights was materially nonconforming due to inadequate documentation.

iii. Three common misconceptions driving nonconformity:

1. **Auditors can meet their overall audit objectives without documenting their work.** Example: on a single-audit engagement, no documentation of tests of controls over compliance. Audit partner felt that because the tests had been done, enough had been done to support the audit opinion.
2. **A sign-off on an audit program is sufficient documentation of a detail test.** Example: on an audit of a defined contribution plan, the auditor believed requirements had been met for documenting

test of participant eligibility by simply signing off on the program that the test had been performed, no other documentation of evidence obtained.

3. **Oral explanation can substitute for written documentation.** Oral explanation may be used to provide clarification of documentation. Example: on a single audit the firm failed to document consideration of compliance requirements. If a procedure provides audit evidence, and there is not sufficient documentation of that evidence, no amount of oral explanation can substitute.

iv. How to raise quality:

1. Train personnel on audit documentation standard
2. Make sure consideration of documentation is part of the firm's internal inspection
3. Provide personnel with sample working papers from AICPA
4. Use practice aids from Governmental and Employee Benefit Plan Audit Quality Centers

4. **Recent AICPA research on single audit quality factors**
   a. **A sort of morality tale—even if your firm does not perform single audits, the quality factors discovered in this research may have practical application to your practice.**
   b. **Journal of Accountancy October 2017 page 9 "Key Factors Correlate with Quality in Single Audits" [see also the document at this link:** http://www.aicpa.org/advocacy/state/pages/aicpa-study-identifies-three-factors-driving-audit-quality.aspx**]**

i. "A new study by the Peer Review Program revealed a set of factors that had a strong correlation with quality in single audits. In the study, the Peer Review team randomly selected a sample of 87 single audits from its Enhanced Oversight Program. The engagements selected had year ends of Nov. 30, 2015, or earlier."

ii. Three factors had a strong correlation to quality performance in the sample:

1. **Size of single audit practice—**Firms that performed 11 or more single audits annually, regardless of firm size, had a non-conformity rate of 15%, compared with 49% for firms that performed 2 to 10 single audits each year and 62% for firms that performed one single audit annually.
2. **Membership in the Governmental Audit Quality Center (GAQC)**—Firms that were GAQC members were two times as likely to conform to standards compared to non-members. Additionally, GAQC member firms that performed 11 or more single audits annually had a 0% non-conformity rate.

3. **Qualifications of the engagement partner**—Engagement partners who performed more single audits annually had fewer instances of nonconformity in the study. A nonconformity rate of 25% was observed in audits performed by an engagement partner who reviewed and signed 11 or more single audits annually. Nonconformity rose to 44% for engagement partners who perform 2 to 10 single audits each year, and to 68% for engagement partners who perform just one single audit annually.

iii. [Practical application to firms that do not perform single audits:

1. Having only one, or a very few, engagements in a particular area does not a specialty/niche make. On the contrary, there may be a greater risk of nonconformity to standards.
2. Participation in professional groups relating to the specialty may significantly decrease the risk of nonconformity to standards.
3. Someone in the firm, namely a partner, simply must develop an expertise in the specialty area in order to decrease the risk of nonconformity to standards.]