GAO
Accountability * Integrity * Reliability

Comptroller General
of the United States

United States General Accounting Office
Washington, DC 20548

September 3, 2003

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Subject: Proposed Rules on Inspections of Registered Public Accounting Firms

This letter provides the U.S. General Accounting Office's (GAO) comments on the Public Company Accounting Oversight Board's (PCAOB) July 28, 2003, proposed rules on accounting firm inspections, as mandated by the Sarbanes-Oxley Act of 2002.

GAO supports improved transparency and accountability in the accounting profession, and we believe that the proposed inspection rules will help in this endeavor. In finalizing the rules on inspections, we urge the PCAOB to consider the important issue of coordination with the profession's self-regulatory peer review program in order to avoid duplication and to minimize the burden on CPA firms that are required to undergo both a PCAOB inspection and a peer review.

GAO envisions a system of coordination in which peer reviewers would place appropriate reliance on a firm's PCAOB inspection report such that peer reviewers could use this information to possibly reduce the scope of their peer review, as appropriate. In order to make such a system possible, peer reviewers would need specific information and access to documentation on the scope of the inspections or information from the PCAOB on the specific level of assurance and reliance that can be placed on the inspection reports for purposes of planning the scope of the peer review engagement.

Coordination of effort between PCAOB inspections and peer reviews is particularly important because many CPA firms are subject to the peer review requirements of *Government Auditing Standards* promulgated by the GAO under the statutory authority awarded to the Comptroller General of the United States. For example, the following laws and regulations require peer reviews as applicable under *Government Auditing Standards:*

- The Inspector General Act of 1978, as amended, 5 U.S.C. App. (2000), requires that federal inspectors general appointed under the IG Act comply with *Government Auditing Standards* for audits of federal establishments, organizations, programs, activities, and functions. The act further states that the inspectors general shall take appropriate steps to assure that any work performed by nonfederal auditors complies with *Government Auditing Standards*.

- The Chief Financial Officers Act of 1990 (Public Law 101-576), as expanded by the Government Management Reform Act of 1994 (Public Law 103-356), requires that *Government Auditing Standards* be followed in audits of certain executive branch departments' and agencies' financial statements.

- The Single Audit Act Amendments of 1996 (Public Law 104-156) require that *Government Auditing Standards* be followed in audits of state and local governments and nonprofit entities that expend federal awards. The Office of Management and Budget (OMB) Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations, which provides the government wide guidelines and policies on performing audits to comply with the Single Audit Act, also requires the use of *Government Auditing Standards*.

- The Federal Deposit Insurance Corporation (FDIC) requires peer reviews of firms that audit depository institutions as required by the FDIC Improvement Act of 1991.

- Other laws, regulations, and authoritative sources require the use of *Government Auditing Standards*. For example, some state and local laws and regulations require auditors at the state and local levels of government to follow *Government Auditing Standards*. Also, the terms of an agreement or contract may require auditors to comply with *Government Auditing Standards*. Federal audit guidelines pertaining to program requirements, such as those issued for Housing and Urban Development programs and Student Financial Aid programs, also require that *Government Auditing Standards* be followed.

Many PCAOB-registered public accounting firms, including all big four firms and numerous other CPA firms, are subject to the above peer review requirements and thus will be required to undergo both a PCAOB inspection as well as a peer review. Because the PCAOB's mandate only allows for inspections of a firm's public company audits, the PCAOB's inspections will not fully cover the requirements of the other peer reviews.

The American Institute of Certified Public Accountants (AICPA) recently released an exposure draft of proposed professional standards for performing and reporting on peer review engagements. Enclosed is a copy of GAO's letter commenting on the AICPA's proposed standards, in which we urge coordination of the peer review program with the PCAOB inspection program.

We believe that coordination between the relevant key stakeholders is called for before both the PCAOB's and the AICPA's standards are finalized. As a key stakeholder, we are happy to participate in any relevant coordination efforts.

We thank you for considering our comments on this very important issue.

Sincerely yours,

David M. Walker
Comptroller General
of the United States

Enclosure

cc: The Honorable William H. Donaldson, Chairman
Securities and Exchange Commission

The Honorable William J. McDonough, Chairman
Public Company Accounting Oversight Board

William F. Ezzell, Jr., Chair
American Institute of Certified Public Accountants

Barry C. Melancon, President and CEO
American Institute of Certified Public Accountants

Mr. Anthony Lynn
Chair, AICPA Peer Review Program

Mr. Gary Freundlich
Director, AICPA Peer Review Program

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Mr. Anthony Lynn
Chair, AICPA Peer Review Program

Mr. Gary Freundlich
Director, AICPA Peer Review Program
American Institute of Certified Public Accountants
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201 Plaza Three
Jersey City, NJ 07311-3881

Subject: Exposure Draft: Proposed Revisions to the AICPA *Standards for Performing and Reporting on Peer Reviews*

This letter provides the U. S. General Accounting Office's (GAO) comments on the AICPA's May 30, 2003, exposure draft of proposed revisions to the *AICPA Standards for Performing and Reporting on Peer Reviews (Standards)* and Interpretations to the *Standards.* We commend the AICPA's efforts to reevaluate the administration, performance, reporting objectives, and overall effectiveness of peer reviews conducted under the AICPA Standards. We support the AICPA's goal of designing, implementing, and maintaining a preeminent program that monitors the quality of an audit organization's accounting and auditing practice, and we are especially pleased that the proposed standards

- clearly identify audit organization and peer reviewer responsibilities during peer review, and
- require that individuals serving on peer review teams meet certain qualifications and conditions.

As presently structured, the peer review program is a critical element of the self-regulatory system used to maintain confidence and trust in our nation's capital markets. The peer review program is essential to maintaining and improving audit quality involving public companies, non-public companies, governmental, not-for-profit, and other types of entities. We are providing specific suggestions to further strengthen the peer review program in the following areas:

- coordination with PCAOB inspections,
- transparency of peer review results,
- a risk-based approach for peer review frequency, and
- a new name/title for "peer review".

In enclosures to this letter, we also provide specific recommendations for (1) modifying the peer review report wording to better reflect the work performed and to improve report clarity and transparency, (2) enhancing independence requirements, and (3) enhancing reviewer qualifications.

Coordination between peer reviews and PCAOB inspections

This is an especially opportune time to reevaluate peer review standards because the Public Company Accounting Oversight Board (PCAOB) has recently issued proposed rules for inspections of registered public accounting firms, as mandated by the Sarbanes-Oxley Act. The overlapping roles of the PCAOB inspectors and the peer reviewers pose challenges for the profession and should be carefully analyzed as the AICPA revises its standards. Critical issues to be resolved include information sharing and degree of reliance placed on each other's work. The AICPA should consider how the inspection and review functions of the PCAOB and the self-regulatory peer reviews could be jointly used to efficiently and effectively achieve their common objectives.

The PCAOB is developing procedures for inspections and enforcement of U.S. firms that audit publicly traded companies and plans to begin full inspections of these firms next year. In GAO's comment letter to the PCAOB on the proposed inspection rules, we urged the PCAOB to consider the issue of coordination with the profession's self-regulatory peer review program prior to finalizing any related requirements in order to avoid duplication and to minimize the burden on CPA firms that are required to undergo both a PCAOB inspection and a peer review. At the same time, we would also urge the AICPA to coordinate its peer review program with the PCAOB inspection program.

One possible coordination approach would involve peer reviewers placing appropriate reliance on a firm's PCAOB inspection report such that peer reviewers could use this information to possibly reduce the scope of their peer review as appropriate. In order to make such a system possible, peer reviewers would need specific information and access to documentation on the scope of the inspections or information from the PCAOB on the specific level of assurance and reliance that can be placed on the inspection reports for purposes of planning the scope of the peer review engagement. Other coordination approaches are also possible and should be considered, including determining the appropriate scope and targeting of peer review activities.

Coordination of effort between peer reviews and PCAOB inspections is particularly important because many CPA firms receiving PCAOB inspection are also subject to the peer review requirements of *Government Auditing Standards* promulgated by the GAO under the statutory authority awarded to the Comptroller General of the United States. For example, the following laws and regulations require peer reviews as applicable under *Government Auditing Standards:*

- o The Inspector General Act of 1978, as amended, 5 U.S.C. App. (2000), requires that federal inspectors general appointed under the IG Act comply with *Government Auditing Standards* for audits of federal establishments, organizations, programs, activities, and functions. The act further states that the inspectors general shall take appropriate steps to assure that any work performed by nonfederal auditors complies with *Government Auditing Standards.*

- o The Chief Financial Officers Act of 1990 (Public Law 101-576), as expanded by the Government Management Reform Act of 1994 (Public Law 103-356), requires that *Government Auditing Standards* be followed in audits of certain executive branch departments' and agencies' financial statements.

- o The Single Audit Act Amendments of 1996 (Public Law 104-156) require that *Government Auditing Standards* be followed in audits of state and local governments and nonprofit entities that expend federal awards. The Office of Management and Budget (OMB) Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations, which provides the government wide guidelines and policies on performing audits to comply with the Single Audit Act, also requires the use of *Government Auditing Standards.*

- o The Federal Deposit Insurance Corporation (FDIC) requires peer reviews of firms that audit depository institutions as required by the FDIC Improvement Act of 1991.

- o Other laws, regulations, and authoritative sources require the use of *Government Auditing Standards.* For example, some state and local laws and regulations require auditors at the state and local levels of government to follow *Government Auditing Standards.* Also, the terms of an agreement or contract may require auditors to comply with *Government Auditing Standards.* Federal audit guidelines pertaining to program requirements, such as those issued for Housing and Urban Development programs and Student Financial Aid programs, also require that *Government Auditing Standards* be followed.

PCAOB inspections will have two phases: (1) review of the firm's quality control policies and (2) review of engagements to determine if the firm's quality control policies are followed. After completing an inspection, the PCAOB will issue a confidential report on the engagement results to the firm, the SEC, and appropriate state regulators.

Communication and working relationship opportunities for efficiency and effectiveness exist between the peer review program and the PCAOB. Factors to consider include

- the level of assurance that peer reviewers can place on PCAOB inspection reports,
- whether the PCAOB will share with the AICPA or with peer reviewers information concerning the scope of its inspection,

- whether peer review reports should disclose the degree of reliance placed on PCAOB inspection reports, and
- whether peer reviewers should select sample engagements for review from the population of all engagements performed by the firm during the year under review or only from a population of audits excluding publicly traded companies.

Greater transparency of peer review results

GAO supports making peer review reports, letters of comment, and response letters generally available to parties contracting for audit services and others with a "need to know" or on a request basis. GAO also supports making the peer review reports publicly available (without the letters of comment and response letters). Increased availability of this information will improve transparency of the peer review process and help demonstrate the valuable services and quality products provided by the profession.

Government Auditing Standards currently require audit organizations to provide peer review reports and letters of comment to parties contracting for audit or attestation services as well as to auditors who rely on the audit organization's work. The standards also require government audit organizations to transmit their external peer review reports to appropriate oversight bodies. The standards also recommend making peer review reports and letters of comment available to the public upon request.

Risk-based approach for peer review frequency

The effectiveness of the peer review process can be improved by bringing greater scrutiny to those audit organizations that have experienced problems. The proposed standards call for an initial peer review within 18 months after a firm's first engagement requiring a peer review, and every 3 years and 6 months after the year-end of the previous review. We believe that specific provisions should be added to require firms to have more frequent peer reviews if the previous peer review has identified significant deficiencies or problems. The PCAOB has indicated it is adopting a risk-based approach for determining the frequency and scope of its inspections procedures. Similarly, when planning the frequency and scope of engagement procedures, peer review teams and administrators should consider the pattern and pervasiveness of deficiencies reported in past inspections and peer reviews.

New name/title for "peer review"

In its proposal, the Board also requested comments on whether the terms "peer review," "system review," "engagement review," and "report review" appropriately reflect the enhanced peer review program, as proposed. The three levels of engagements under the peer review program as presented in the current standards and in the exposure draft have significantly different levels of scope and assurance. As explained in the standards, the three levels of peer review are

- o system reviews – for audit organizations that perform audits, examination-level attestation engagements, or engagements in accordance with *Government Auditing Standards*. A system review is intended to provide a reasonable basis for the reviewer's opinion.

- o engagement reviews - for audit organizations that perform only compilations, reviews, and/or attestation engagements performed at the review or agreed-upon-procedures level. In an engagement review, the reviewer provides limited assurance that the review and attestation engagements submitted for review conform with the requirements of professional standards.

- o report reviews - for audit organizations that compile financial statements that omit substantially all disclosures. In a report review, the reviewer provides no opinion or assurances; however, the reviewer may provide comments and recommendations on conforming financial statements and accountant's reports with professional standards with the objective of enhancing the overall quality of compilation engagements.

Because the three levels of peer review are so significantly different in terms of scope and level of assurance provided, we believe that the generic use of the term "peer review" when referring to a specific engagement is confusing and creates an expectation gap when referring to an engagement review or a report review. Therefore, we propose using the term "peer review" only for system reviews, and we recommend that the Board rename the three different levels of engagements as follows:

1. Peer Review of CPA Firm's Quality Control System for Audit and Attest Engagements
2. Independent Review of CPA Firm's Documentation for Compilation and Review Engagements
3. Independent Assessment or Review of CPA Firm's Compilation Reports.

We also recommend using the above descriptions as the titles of the three reviewer's reports.

Other Matters

We also offer in enclosures 1 to 3 the following recommendations along with specific wording changes. The nature of our suggested changes is as follows:

- Modify the peer review report language concerning firm competencies to perform accounting and auditing engagements in accordance with professional standards to more accurately reflect the work performed by the reviewer.

- Strengthen independence requirements by precluding firms related through joint participation in associations that provide marketing services to members from performing peer reviews of other firms that are members of the same association.

- Broaden reviewer qualifications to allow participation on peer review teams by qualified CPAs—such as academics, retired government auditors, and retired CPA firm auditors—who are employed as consultants or contractors by a CPA firm.

We believe that coordination between the relevant key stakeholders is called for before both the AICPA's and the PCAOB's standards are finalized. As a key stakeholder, we are happy to participate in any relevant coordination efforts.

Thank you for considering our comments on these very important issues.

Sincerely yours,

David M. Walker
Comptroller General
of the United States

Enclosures – 3

cc: William F. Ezzell, Jr., Chair
American Institute of Certified Public Accountants

Barry C. Melancon, President and CEO
American Institute of Certified Public Accountants

William H. Donaldson, Chairman
Securities and Exchange Commission

William J. McDonough, Chairman
Public Company Accounting Oversight Board

Office of the Secretary
Public Company Accounting Oversight Board

Simplifying Report Wording

GAO Proposed Change:

The peer review report language should cover the firm's compliance with professional standards rather than the firm's competencies demonstrated to perform accounting and auditing engagements in accordance with professional standards.

The wording in the illustrated reports also should convey more concisely the work performed and the conclusions reached as a result of the engagement.

Rationale for and Benefits of Proposed Change:

In a peer review engagement, the reviewer tests a firm's quality control system and the output from the system. This testing and the resulting evidence gathered do not provide sufficient basis for expressing an opinion on the firm's collective competencies (knowledge, skills, and abilities) demonstrated to perform accounting and auditing engagements. Modification to the report language is needed to better reflect the work performed and reduce the likelihood of creating an expectations gap with report users.

In addition, we are also making specific changes to write the report in an active voice to improve clarity and transparency in the profession's self-regulatory structure.

Suggested Wording of Proposed Change:

Page 39 Paragraph 135 Appendix D: Illustration of an Unmodified Report on a System Review

<u>Title: Peer Review of Audit Firm's Quality Control System</u>

We have reviewed the accounting and auditing practice of [Name of firm] (the firm) for the year ended June 30, 20XX. Firm management is responsible for assuring that the firm's accounting and auditing practice is conducted in conformity with applicable professional standards. In addition, the firm is responsible for designing a system of quality control and complying with it in order to provide reasonable assurance that the firm complies with professional standards in all material respects. We are responsible for expressing our opinion on 1) the firm's compliance with professional standards in all material respects and 2) the firm's design of and compliance with its system of quality control. Our opinion is based on our examination of firm records and documentation during our review.

We performed our review under the American Institute of Certified Public Accountants' (AICPA) peer review program, and we complied with standards established by the Peer Review Board of the AICPA. During our review, we read required representations from the firm, interviewed firm personnel and obtained an understanding of the nature of the firm's accounting and auditing practice, and the design of the firm's system of quality control sufficient to assess the risks implicit in the firm's practice. Based on our assessments, we selected engagements to test audit documentation for conformity with professional standards and compliance with the firm's system of quality control. The engagements we selected represented a cross-section of the firm's accounting and auditing practice with emphasis on higher-risk engagements. (The engagements selected included, among others, audits of Employee Benefit Plans, engagements performed under Governmental Auditing Standards, and audits of Depository Institutions with more than $500 million in assets.)[19] Our review of engagements included examining the firm's engagement documentation on significant risk areas and interviews of engagement personnel.

We also examined selected administrative files to assess the firm's compliance with Quality Control Standards issued by the AICPA. Prior to concluding the review, we reassessed the adequacy of our procedures and conducted an exit conference with firm management to discuss the results of our review. We believe that the procedures we performed provide a reasonable basis for our opinion.

In our opinion, [Name of Firm] complied with professional standards in all material respects on the engagements we reviewed that were performed during the year ended June 30, 20XX. In addition, the firm's system of quality control is designed to meet the requirements of the quality control standards established by the AICPA for an accounting and auditing practice and the firm complied with its quality control system during the year ended June 30, 20XX . For the engagements we reviewed, the firm's quality control system provided the firm with reasonable assurance of complying with professional standards in all material respects during the year ended June 30, 20xx.

(As is customary in a system review, we have issued a letter dated xx-xx-xx that details matters we detected during our review that were not of sufficient significance to affect the opinion expressed in this report [20])

page 43, paragraph 138. Appendix G: Illustrations of a Modified Report on a SystemReview

Paragraphs 1 – 3 of this report are the same as in the Unmodified report

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19 If the firm performs audits of Employee Benefit Plans, engagements performed under *Governmental Auditing Standards*, audits of Depository Institutions with more than $500 million in assets, or other engagements required to be selected by the Board in Interpretations, the engagements selected for review should be identified in the report.

20 To be included if the review team issues a letter of comments with an unmodified or modified report.

During our review, we detected deficiencies, which are described below, that were significant enough to cause us to modify our opinion on the effectiveness of the firm's quality control system during the year ended June 30, 20xx. However, the pattern and pervasiveness of the deficiencies were not significant enough to cause us to issue a negative opinion on the firm's quality control system during the year ended June 30, 20xx. In our opinion, because of these deficiencies, [Name of Firm] complied with some but not all professional standards during the year ended June 30, 20XX. In addition, the firm's system of quality control is designed in a way that meets some but not all of the requirements of the quality control standards for an accounting and auditing practice established by the AICPA and the firm complied with some but not all of the requirements of its system of quality control during the year.

Page 52, Paragraph 144. Appendix M: Illustrations of an Adverse Report on a System Review

Paragraphs 1 – 3 of this report are the same as in the Unmodified report

In our opinion, [Name of Firm] did not comply with all professional standards in all material respects during the year ended June 30, 20_. In addition, the firm's system of quality control is not designed to meet the requirements of the quality control standards for an accounting and auditing practice established by the AICPA, and the firm did not comply with its quality control system during the year. As a result of these deficiencies, the firm's quality control system did not provide the firm with reasonable assurance of complying with professional standards during the year ended June 30, 20xx. Our opinion is based on deficiencies we detected during our review, which are described below.

Enclosure 2

Strengthening Independence Requirements

GAO Proposed Change:

Firms that are related through joint participation in associations that provide marketing services to members should be precluded from performing peer reviews of other firms that are members of the association.

Rationale for and Benefits of Proposed Change:

GAO's recommended change would demonstrate that the peer reviewers are independent in fact and in appearance and thus improve public confidence in the peer review system. We believe that members of these associations have economic incentives to help other members. This causes lack of independence in fact. Even if there are no explicit profit sharing arrangements, if a member firm receives less than an unqualified peer review report, the stigma affects all the firms in the association. Thus peer reviewers who are members of the same association do not appear independent.

Suggested Wording of Proposed Change:

Page 35, *new paragraph* 131.6. If the reviewed firm and the reviewing firm are both members of an association that jointly markets member qualifications and services, independence is impaired.

Broadening Reviewer Qualifications.

GAO Proposed Change:

Qualification for service as a reviewer should allow participation on peer review teams by qualified CPAs who are employed as consultants for peer review engagements by a CPA firm and who satisfy all other qualifications for service as a reviewer.

Rationale for and Benefits of Proposed Change:

The proposed change would permit otherwise qualified CPAs, such as academics, retired government auditors, and retired CPA firm auditors, to participate on peer review engagements as consultants or contractors to the firm engaged to perform the review. This, in turn, would broaden the base of potential reviewers, would bring diverse perspectives to the peer review process, and would help assure an adequate supply of qualified reviewers.

Suggested Wording of Proposed Change:

Page 7, paragraph 31d. [an individual serving as a reviewer should–] have acquired appropriate knowledge and skills from current or recent management-level experience in accounting or auditing practice or from other sources such as experience with regulators (PCAOB, GAO, AICPA, or SEC).