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October 16, 2014

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Feedback Regarding the AICPA's Discussion Paper: Enhancing Audit Quality

The accompanying feedback represents a joint response by the Accounting Principles and Assurance Services Committee and the Peer Review Committee (collectively "we" or the "Committees") of the California Society of Certified Public Accountants ("CalCPA"). CalCPA has approximately 40,000 members.

The Accounting Principles and Assurance Services Committee (the "APAS Committee") is the senior technical committee of CalCPA. The APAS Committee consists of 53 members, of whom 47 percent are from local or regional CPA firms, 27 percent are from large multi-office CPA firms, 12 percent are sole practitioners in public practice, 10 percent are in academia and 4 percent are in international CPA firms. Members of the APAS Committee are with CPA firms serving a large number of public and nonpublic business entities, as well as many non-business entities such as not-for-profits, employee benefit plans and governmental organizations.

The Peer Review Committee (the "PR Committee") administers the AICPA Peer Review Program for firms who are not required to be registered with and inspected by the Public Company Accounting Oversight Board (the "PCAOB") and who have their main office in California, Arizona or Alaska. There are 20 PR Committee members who are with CPA firms ranging in size from sole practitioner to large multi-office firms. For the calendar year ended December 31, 2013, the PR Committee accepted over 600 system peer reviews and over 1300 engagement peer reviews.

Introduction

We recognize and support the AICPA's role in providing leadership regarding the self-regulation of the public accounting profession and the audit process of private entities. We also believe it appropriate to undertake a comprehensive assessment regarding the adequacy of the AICPA's ethics, auditing and quality control standards as set forth in the Discussion Paper (the "DP") in light of recent criticisms by the United State Department of Labor ("DOL") and others. No one argues that enhancing audit quality is not a laudable objective. However, it is not necessarily the case that every step that can be taken to enhance audit quality should be taken, nor does it mean that our profession should respond to that criticism along the path outlined in this DP.

Our basic role as auditors is to address the issue of financial statements containing material misstatements. Regulators often focus on compliance with regulations as opposed to compliance failures that can or do result in materially misstated financial statements. Of course, compliance with laws and regulations is a concern in every audit, but the profession's basic focus should be on non-compliance that can have a material effect on the financial statements. When CPAs take on audits of regulated industries, it should be the compliance supplements issued by the regulators that drive the auditor's procedures.

We should not let regulators drive our self-regulation process. Many federal agencies have the authority to debar auditors. Many federal agencies issue compliance requirements that drive the nature and extent of the audit procedures performed to evaluate compliance with relevant laws and regulations. This is the way to go for employee benefit plan audits.

The AICPA's self-regulatory process should be robust and effective, but it will never be sufficient in the eyes of a critic because there will always be shortcomings as no system can achieve perfection. Moreover, if we are to be responsive to the users of financial statements, a single user of a particular kind of audit should be able to just specify how that kind of audit is to be done.

Any changes ultimately adopted by the AICPA to our self-regulatory process should in fact be likely to enhance overall audit quality, and should be cost effective, i.e. the benefit should outweigh the cost. Perhaps the measures outlined in the DP will enhance audit quality, but we seriously question whether the second requirement is met.

Competence and Due Care

1. **How can the profession reinforce the importance of the Code and ensure that all CPAs performing private entity financial statement audits adhere to the due care and competence requirements?**

   To begin with we recommend expanding the CPA exam to include the AICPA Code of Professional Conduct (the "Code"). We also suggest the AICPA consider some form of mandatory periodic continuing professional education in the Code as a requirement for AICPA membership renewal. Those members who chose to perform audits of employee benefit plans should be required to join the AICPA's Employee Benefit Plan Quality Center (the "EBP Center"). The EBP Center leadership should evaluate the need to enhance their outreach activities with the DOL in light of the DOL's ongoing criticisms of employee benefit plan audits and the failure of many members who failed to correctly report such audits to their peer reviewers. Any proposed efforts on the part of the AICPA to enhance ethical behavior and enhance the peer review process of higher risk engagements should be coordinated with the National Association of State Boards of Accountancy ("NASBA") to insure that similar standards are in force at the various state boards for those who choose NOT to be a member of the AICPA. Remember, the AICPA can only regulate those who choose to join; a behavioral change must be implemented nationwide regardless of professional affiliation.

2. **What are CPAs' challenges and obstacles in exercising due care?**

   The principal challenge is the inherent conflict of self-interest and independence in a profession in which the client pays the fee, and the need to be competitive, which drives down audit cost at the expense of audit quality. The initiatives we suggested in our response to Question 1. may drive substandard auditors out of the profession, which would be a beneficial outcome.

3. **(a) Should the AICPA provide additional (specific) guidance on what it means to be competent? If so, in what areas? (b) What suggestions do you have to define competence?**

   (a) The Committees do not believe additional guidance is needed.
   (b) N/A

4. **What methods, other than existing ones, should the profession consider to facilitate the right match of competency with an audit engagement?**

   From time to time, we all need doctors and lawyers. How do we choose? Word of mouth? Inquiry about appropriate experience? Board certification? We can't speak authoritatively, but we suspect Board Certification is at the bottom of the list.

   The AICPA should establish a program of enhancing public awareness. Not all CPAs are auditors. CPA licenses allow, more or less, CPAs to perform any audit, but audits require different competencies and no CPA possesses all competencies, and the public should understand this. Of course, the profession could be changed so that additional licensing is required for audits in general, or for specific audits.

   We note that many states, including California, have adopted multiple licensing options in light of the fact many licensees never intend to perform audits. Therefore, the Committees suggest the AICPA and NASBA jointly consider the need for a uniform nationwide "auditor" designation similar to PFS, CFE, etc., and further refine the need for specialized CPE and testing.

Auditing and Quality Control Standards

5. **Do you believe revisions should be made to the ASB's auditing or firm quality control standards to improve audit quality in the near term? If so, what specific revisions would you propose and why do you believe they would improve audit quality?**

   The Committees do not believe any revisions are needed.

6. **Are revisions needed to the auditing or quality control standards to address specific industries or regulated areas? If so, what revisions are needed and what industries or areas should be addressed?**

   The Committees do not believe that any major changes are needed. (Please see our comments in the Introduction)

   But, a couple of suggestions for improvement are –

   - Must belong to the relevant AICPA quality centers if you do that kind of work.
   - Issue more AICPA Accounting and Auditing Guides to handle nuances in specific industries.

7. **What other guidance is needed to help practitioners apply the auditing and quality control standards to improve audit performance and quality?**

   Requiring all AICPA member CPAs auditing employee benefit plans to belong to the EBP Center is a start.

   State boards of accountancy already impose specific CPE requirements for auditors, and even more specific requirements for auditors that sign particular kinds of audit reports. We recommend that NASBA consider expanding these requirements to cover EBP audits and other peer review "must select" audits.

Guidance, Tools, Learning and Resources

8. **(a) Based on your use of audit engagement training tools and resources, what additional authoritative publications or non-authoritative guidance, tools or training could be developed for audits of financial statements that would enhance competencies and drive quality engagement performance? (b) For which industries or specialized topics is it difficult to obtain educational and professional resources?**

   (a) The AICPA has published many audit and accounting guides (the "Guides") which are helpful in identifying industry specific "rules of the road" but lack practical guidance. Several of our Committee members have suggested the Guides should consistently contain sample financial statements for the industry and sample audit work papers covering audit areas unique to that industry. Second, the AICPA/NASBA should consider developing a list of high risk industries for which specialized CPE is required that would be enacted into the individual state board regulations.
   (b) At this time there are sufficient training courses and state and national level conferences available in many specialized industries to satisfy the needs of knowledgeable professionals.

Practice Monitoring

9. What advantages and challenges do these changes present? How could potential challenges or unintended consequences be minimized or avoided?

Competent peer reviewers are required for the system to work. Peer reviewers must be compensated at a rate normally received for other work or competent professionals will not be encouraged to participate in such programs.

10. (a) Will removal of poor performing peer reviewers and (b) the suggested training programs increase reviewer quality? Why or why not?

(a) Yes, removing poor performing peer reviewers increases reviewer quality and should be the first step the AICPA's Peer Review Board ("PRB") should undertake in enhancing the effectiveness of the existing peer review program.
(b) Yes, the suggested training programs will enhance the quality of the existing peer review program.

11. (a) What effect do you expect these requirements will have on the peer review program's ability to maintain a sufficient number of qualified peer reviewers? (b)If you expect them to have an adverse impact on the peer reviewer pool, what implementation steps could mitigate the impact?

(a) Not all CPAs are qualified to be peer reviewers. Adding CPE and testing requirements will shrink the population further. If reviewers were adequately compensated the population would increase.
(b) Expand the pool of eligible Team Captains to include audit managers; modify the peer review qualifications to focus on competence, not things like how recently one signed an audit report.

12. What effect do you expect these requirements will have on peer review stakeholders and on the peer review program as a whole? What should the PRB require of new peer reviewers to give reasonable assurance that they will develop and maintain the experience and expertise to perform high-quality peer reviews?

If enhanced CPE with exams, and/or increased compensation, improves the quality of the peer reviewer pool (and this should by no means be taken for granted), the quality of peer review should get better. Improved monitoring (if it occurs) is likely to improve audit quality by identifying more issues with practitioners' competence. However, the Committees strongly believe it is better to focus attention on improving the overall quality of the audits performed (i.e. prevention) rather than after the fact practice monitoring.

The Committees suggest the PRB consider adding a requirement that peer review Team Captains must serve as Team Members for 3-5 peer reviews BEFORE being eligible to be a Team Captain.

Address Risks Posed by Low-Volume Auditors of High-Risk Engagements

13. What are the advantages and disadvantages of these changes? Are there potential unintended consequences? How could they be avoided or minimized?

The Committees support the suggestion that a mandatory remedial step for a failed peer review of a practice with 5 or fewer "must select" reports be the engagement of a third-party to perform a pre- or post-issuance review of future audits in that industry. However, why limit this remedial step to firms with a low volume of audits? The Committees recommend this mandatory remedial step should be applied whenever a peer review is failed regardless of the number of audit engagements the firm performs.

14. Should these requirements extend to firms that audit five or fewer engagements in any one industry (not just must-select industries)?

The Committees could not reach a consensus on this point; we were evenly divided.

Deepen Review of High-Risk Industries and Areas of Concern

15. What are the advantages and disadvantages of this initiative? If there are potential disadvantages or unintended consequences, how can they be avoided or minimized?

The Committees believe these are reasonable steps to undertake.

16. Peer reviewers currently review complete sets of engagement working papers in order to cover a reasonable cross section of the engagements performed by each firm. The PRB is considering a new approach where reviewers would still obtain a reasonable cross section but would only review those sections of engagements that represent particularly high risk. Which approach do you support and why?

The Committees support a change to focus the peer review process on areas of high risk, consistent with the application of the risk based approach to audits in general.

17. Are the targeted risk areas that the AICPA has identified for initial focus appropriate? What other high risk areas should the PRB consider?

The Committees believe the four areas of initial focus (independence, sufficiency of audit evidence, employee benefit plan audits and municipalities that issue securities) are too broad, i.e. listing employee benefit plan and municipality audits without further specificity suggests that every aspect of these audits is high risk. The first step in any peer review would be to become sufficiently familiar with the audit to identify the areas of high risk.

Improve Engagement and Firm Tracking

18. Recent changes were made to peer review practice aids to bring more attention to the completeness of the peer review population. These changes include revisions to the firm representation letter and additional questions in the Team Captain Checklist (System Reviews) and Review Captain Summary (Engagement Reviews). What other measures could ensure that peer reviewers receive complete information on the engagement population and that firms understand their responsibility to accurately report data?

The Committees believe that firms found to be falsely representing their practice for the purpose of avoiding peer review should be banned from performing audits and referred to the applicable state board of accountancy for disciplinary action.

The Committees believe that the list of engagements submitted by the firm to the peer reviewer should be signed as being "under the penalty of perjury". The PRB should modify the underlying peer review requirements to support such an assertion.

The Committees also suggest the engagement letter for undertaking a peer review should contain language about the information submitted by the firm to the peer reviewer being complete and accurate. The PRB should modify the available engagement letter templates accordingly.

19. How could the information provided be verified? What databases could be leveraged?

Consider reviewing the peer reviewed firm's marketing material, listings provided to insurance carriers, and internal quality control databases.

Make DOL and other regulatory databases available and searchable by auditor name/ID.

Create a National Group of Technical Experts Reporting Directly to the PRB

20. What are the advantages and challenges presented by these changes? How could related potential challenges or unintended consequences be minimized or avoided?

The users of audited financial statements want and expect CPAs to be competent at the work they choose to do. However, subjecting the work to the scrutiny of "nationally recognized experts" takes us out of the realm of "peer" review. Being reviewed by a nationally recognized expert is not peer review. If the PRB needs to hire help, it should be competent practitioners. Of course this does not exclude "national experts", but it is broader, and our profession does not allow the designation "expert". Competence and nationally recognized expertise are not the same thing.

21. (a) What effect do you expect these requirements will have on the peer review program's ability to maintain the current pool of peer reviewers and attract new ones? (b) If you expect them to have an adverse impact, what implementation steps could mitigate the impact?

(a) The more onerous the process, the fewer that will be interested in participating, at all levels. Practitioners will get out of the business of auditing the "must select" industries, and fewer practitioners will choose to be peer reviewers.
(b) See the Committees' suggestions in our responses to Questions 10, 11, 12 and 18 that would likely broaden the pool of peer reviewers.

22. What effect do you expect these requirements will have on other peer review stakeholders and on the peer review program as a whole?

Please see the Committees' response to Question 21. Peer reviewers that do peer reviews as a loss leader, just like firms that do audits as a loss leader, are generally less likely to adhere to professional standards and maintain competency. Until adequate compensation is paid to these parties there will be little progress in the quality of either.

Make Peer Review Results More Informative

23. Are the current report rating grades (pass, pass with deficiencies, fail) clear and meaningful? Do you find these categories useful? If not, how would you change the report rating grades? (The peer review reporting model is discussed briefly starting on page 21 of the Peer Review Q&A and in more detail starting in paragraph .94 of the Peer Review Standards; links to these materials appear below.)

The Committees believe the current report rating grades are adequate.

24. What actions, if any, does your organization take when a firm receives a pass, pass with deficiencies or fail report? What actions do you think should be taken by others?

Peer review reports with a pass with deficiencies and failed system reviews result in required corrective action, e.g. post-release reviews. If engagement review problems are identified, typically additional CPE is mandated.

All failed peer reviews are referred to the applicable state boards of accountancy.

25. What information about a firm would be useful in better understanding, evaluating and using its peer review report? How should it be made available?

The Committees generally believe the current peer review report is adequate and easily understood. All a user has to do is ask for it. However, certain enhancements should be considered:

- The AICPA should consider amending the requirements for firm membership to include making all peer review reports available on the AICPA's website, similar to the PCAOB's requirement for registered auditing firms. An alternative is NASBA evaluating whether to recommend that peer review reports be made available on the various state boards of accountancy websites to facilitate ease of access by clients and prospective clients.

- The AICPA should consider modifying the existing peer review report format to include relevant metrics about the peer reviewed firm's assurance practice. For example, metrics regarding firm size, composition of the assurance practice (such as types of industries served) and the location of multiple offices could be included to enhance a reader's use of the report.

26. Which model do you find more helpful: the peer review reporting model (opinion on the overall system of quality control) or the reporting model used by many regulatory bodies (a list of engagements and topics of deficiencies)? Could a hybrid model better meet your needs? If so, what would that model look like?

The Committees believe the current AICPA peer review reporting model is adequate. Presenting too much detail is counterproductive in that it undermines the overall conclusion.

27. Please share any other suggestions for enhancing the transparency and usability of peer review reporting. Explain how your suggestions would be helpful to you and what you will be able to do with the improved reporting.

The Committees believe that peer review results should be publicly available as discussed in our response to Question 25.

The Committees also recommend the AICPA undertake a targeted public awareness campaign to enhance awareness of the peer review process.

28. How would your suggestions for improvement enhance audit quality? How will they be more beneficial for the users of the report?

The Committees believe that the threat of being evaluated as doing poorly will result in doing better work. The empirical data provided by the PCAOB since the inception of their inspection efforts indicates a general improvement in overall audit quality of public company audits over the past eleven years (with substantial room for additional improvements). In addition, The Arizona Board of Accountancy required mandatory peer review in 2006. We saw a substantial overall improvement in the types of peer review reports received by firms in their second and third peer reviews. The California Board of Accountancy required mandatory peer review in 2010 and we are starting to see similar results.

29. Beyond what is mentioned throughout the "Practice Monitoring" section of this paper, what other requirements should the AICPA Peer Review Program consider that would meaningfully impact audit quality?

The Committees recommend the following additional requirements be considered:

- Incorporate an element of surprise in the peer review process so firms don't know what engagements might be selected. This could be implemented by including all reports issued since the last peer review within the scope of the following peer review, instead of the current model of selecting engagements only from the twelve-month period immediately preceding the close of the peer review year. This change in scope could prevent a firm from backsliding in internal monitoring activities during the two intervening years.

- Reward competence by creating a designation for a peer reviewed firm's successful completion of a series of peer reviews, or some other positive reinforcement for good results.

We would be glad to discuss our comments with the AICPA further should the organization have any questions or require additional information.

Sincerely,

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