



**G A O**

Accountability \* Integrity \* Reliability

**Comptroller General  
of the United States**

**United States Government Accountability Office  
Washington, DC 20548**

June 29, 2007

Ms. Susan Rowley, Senior Technical Manager  
AICPA Peer Review Program  
American Institute of Certified Public Accountants  
220 Leigh Farm Road  
Durham, NC 22707-8110

Dear Ms. Rowley:

This letter provides the U.S. Government Accountability Office's (GAO) comments on the Proposed Revisions to the American Institute of Certified Public Accountants (AICPA) Standards for Performing and Reporting on Peer Reviews.

We support the objectives of this proposal, particularly the goals of

- creating standards that are more principles based, and
- creating a more understandable and easier to use peer review reporting model.

The proposed revisions, however, appear to involve mostly administrative procedures and reporting format and do not address the effectiveness of the peer review process in promoting or improving audit quality. The proposed revisions also contain extensive process-oriented guidance and would benefit from editing to separate the standards from guidance. The guidance could be separately labeled or included in a separate peer review manual.

We are particularly concerned about the problem of ineffective peer reviews, which underlie two recent issues that appear to be widespread but, to our knowledge, have not been detected or addressed by the peer review program. Our first concern is the alarming increase in the number of financial statements that have been restated in recent years. Frequent restatements to correct material misstatements can undermine public trust and confidence in both the audited entities and the auditors. Our second concern involves the National Single Audit Sampling Project's June 2007 report on its quality control reviews of 208 randomly selected single audits. The report estimates that 35.5 percent of all single audits were substandard or contained material reporting errors that resulted in the audits being considered unacceptable. Another 16 percent had significant deficiencies and thus were considered to be of limited reliability.

We believe that the Peer Review Board should review the peer program design, operation, and results to determine if the problems noted above result from ineffective standards or from flawed implementation of those standards and evaluate

how the peer review program can be designed to improve audit quality. Also, consideration should be given to increasing the qualifications and training required of peer review team members.

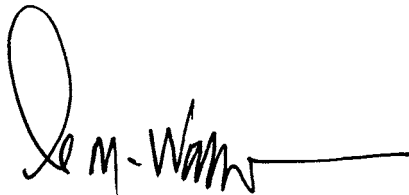
We also have serious concerns about the proposal to eliminate the “letter of comment” used for communicating findings in peer reviews. We believe that the proposal reduces transparency. It also eliminates information used by government audit organizations when contracting with or using the work of CPA firms. The letter of comment is prepared under current peer review standards when a matter exists that creates conditions in which there was more than a remote possibility that the firm would not conform with professional standards on accounting and auditing engagements in all material respects but were not of such significance to cause the report to be modified or adverse. The letters of comment are used by government organizations when contracting for CPA firm services<sup>1</sup> and for making judgments in using the work of CPA firms.<sup>2</sup> We understand that the AICPA is proposing a “Matter for Further Consideration” (MFC) form for communication with the firm about matters not impacting the peer review opinion. We support the use of MFCs during the course of the peer review, but we disagree with eliminating the letter of comment as a result of implementing the new MFC procedures.

We are also providing comments on the following matters in the enclosure to this letter:

- Terms and Definitions to Communicate Weaknesses
- Clarifying Scope in the Peer Review Report
- Revisions to Revised Report Wording
- Conforming Guidance with Report Wording
- Other Suggestions

We appreciate the opportunity to work with the AICPA on these important matters.

Sincerely yours,

A handwritten signature in black ink, appearing to read "D M Walker", with a long horizontal line extending to the right.

David M. Walker  
Comptroller General  
of the United States

Enclosure

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<sup>1</sup> GAO, *Government Auditing Standards, January 2007 Revision*, GAO-07-162G, Sections 3.56 through 3.57.

<sup>2</sup> GAO/PCIE *Financial Audit Manual*, GAO-01-765G, Section 650.26 through 650.28.

cc:

Mr. David Jentho, Chair  
AICPA Peer Review Board

Gary Freundlich, Director  
AICPA Peer Review Program

### Terms and Definitions for Communicating Weaknesses

Paragraph 70 of the proposed revisions provides terms and definitions used to communicate weaknesses in the design or operation of an audit entity's system of quality control. In this paragraph, the term "significant deficiency" is given a definition that is notably different in concept from the definition used in Attestation Standard (AT) 501, *Reporting on an Entity's Internal Control over Financial Reporting* and in Statement of Auditing Standards (SAS) 112, *Communicating Internal Control Related Matters Identified in an Audit*. The definition of "significant deficiency" in paragraph 70 appears to be more consistent with the concept of "material weakness" in AT 501 and SAS 112. Also, the definition of "deficiency" in paragraph 70 appears to be more consistent with the concept of "significant deficiency" in AT 501 and SAS 112. For example, an adverse opinion on internal control under AT 501, which is similar to a "fail" under these draft peer review standards, results from one or more "material weaknesses."

In order to prevent confusion, we suggest revising the terms and definitions used to communicate quality control weaknesses. Specifically, the Program should either use new terms to communicate quality control weaknesses or should replace the term "significant deficiency" with "material weakness" and replace the term "deficiency" with "significant deficiency."

### Clarifying Scope in the Peer Review Report

The illustrated reports for engagement reviews (appendices J-M) and for peer reviews of quality control materials or CPE programs (appendices O-Q) do not adequately alert readers of the limited scope of work performed and the limited assurances provided in these engagements. Instead, the report language used to communicate the differences between these engagements and a systems review is so subtle that the distinction is likely to be missed by most readers. In order to clearly communicate the extent of work performed and the assurances provided, we recommend including language in the reports indicating that the peer reviewers only reviewed selected engagements (or the quality control materials or CPE programs) and did not review the system of quality control for the accounting and auditing practices of the audited entity. The report also should state that the engagement does not provide the same level of assurance as a system review.

### Revisions to Revised Report Wording

The revised language for rating peer review results as "pass," "pass with deficiencies" and "fail" is not integrated into the report opinion paragraph, but instead is attached to the end of the paragraph where it appears out of place. In order to improve the flow of the report wording, we recommend revising this language. A reworded opinion paragraph for the illustrated system review report with a "pass" rating (Appendix C) could read as follows:

In our opinion, the system of quality control for the accounting and auditing practice of XYZ & Co. in effect for the year ended June 30, 20XX has been suitably designed and complied with to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects. **Accordingly, in our opinion, the firm's system of quality control for the accounting and auditing practice in effect for the year ended June 30, 20XX has earned a rating of pass.** ~~Firms can receive a rating of pass, pass with deficiency(ies) or fail. The firm has received a peer review rating of pass.~~

#### Conforming Guidance with Report Wording

The description in paragraph 5.a. of the proposed revisions indicates firms have a responsibility to “Establish and maintain appropriate quality control policies and procedures, and comply with them to ensure the quality of their practices.” We recommend conforming this guidance with the report language used in the first paragraph of Appendix C, which states that “The firm is responsible for designing a system of quality control and complying with it to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects.”

#### Other Suggestions

- The term “significant failure” is used in paragraph 68 but is not defined in the proposed revisions. We recommend defining this term in the document in order to promote consistency of implementation.
- In the illustrative reports with ratings of “pass with deficiencies” (Appendices D, F, K, and P) and “fail” (Appendices H, M, and Q), the opinion paragraph should precede the listing of deficiencies noted during the review in order to provide a more logical flow to the report.
- 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 same association. We are concerned that members of these associations may have economic incentives to help other members. This change would support the principle that peer reviewers should be independent in fact and in appearance and thus help improve public confidence in the peer review system.
- The provisions on documentation retention in paragraphs 24-25 state that peer review documentation should not be retained, except for certain documents, for an extended period of time after the peer review is completed. This extended period of time is generally defined in

Interpretation 11 as 120 days after the peer review is completed. The standard should include the reasoning as to why certain documentation should not be retained.

- The illustrative representation letter in Appendix B, page 55, should use wording that is consistent with the peer review report. Specifically, the second paragraph of the representation letter should be revised as follows:

“We understand that we are responsible for **designing a system of quality control and complying with it to provide reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects.**  
~~complying with the rules and regulations of state boards of accountancy and regulators.~~”