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4-1986

PCPS Reporter, Volume 7, Number 2, April 1986

American Institute of Certified Public Accountants. Private Companies Practice Section

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Published by and for the Members of the Private Companies Practice Section of the AICPA Division for CPA Firms

Editor: John R. Mitchell

AICPA Board Concurs With Division's Advertising Program

The AICPA's Board of Directors recently indicated its concurrence with the advertising program developed and paid for by the Division for CPA firms and recommended that the Division give consideration to concerns expressed by some Institute members if any future advertising program is to be developed.

The Division's current advertising program concludes in April. In May, the Joint Coordinating Committee will evaluate the results of the program.

There seems to be little question about whether the ads, and some related promotion activities, have been effective. From October 21, 1985 through February 14, 1986, the staff received 758 requests for information about the Division or its member firms, more than six times the 116 requests in the same period a year earlier. In 1986's first three months 111 membership applications were received, more than triple January-March 1985's 33. □

1985 Review Costs Down Slightly; Reviewers' Rates Unchanged for 1986

For four of the six firm size classifications, the average peer review cost declined somewhat in 1985. The cost increased in the other two categories.

According to Dale Rafal, Director of the AICPA's Quality Control Review Division, "We consider several relationships in estimating costs, and in evaluating them. The most important is the cost per accounting and auditing hour for firms of about the same size.

"On an A&A hour basis, costs were generally down in 1985. One reason was that many firms were being reviewed for the second time. When the reviewers arrived the firms were ready, their papers were in shape, and their procedures in place. In some cases the firms' internal inspection programs were also good enough to allow the reviewers to test them and reduce the scope of their work.

"Probably another factor was that each year our reviewers are more experienced. Still, I think a lot of the credit belongs to the Peer Review Committee, for its continuing efforts to streamline the guidelines, checklists and

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Peer Reviews Conducted By PCPS Committee-Appointed Review Teams Cost Summary—1985 Review Year

Firm Description	Number of Firms	Average Number of Professionals	Cost Per Review			Average Cost Per Review—1984
			Low	Average	High	
Sole Practitioner, No Professional Staff	4	1	\$ 957	\$1,154	\$ 1,398	\$ 1,303
2-5 Professionals:						
1 Partner	16	3	924	2,292	3,876	2,235
2 or more Partners	16	4	1,330	2,234	3,536	2,278
6-10 Professionals	33	8	1,643	3,448	5,938	3,059
11-20 Professionals	27	14	2,046	4,271	5,739	4,436
Over 20 Professionals	12	29	4,006	7,442	12,192	7,896

Notes:

1. Cost includes reviewers' time charges, AICPA's 10% administrative fee, and reviewers' expenses.
2. The 1985 reviews include all those conducted on site by PCPS committee-appointed review teams for which the costs were fully processed at the time of compilation. Cost information is not available for firm-on-firm reviews and those administered by state societies or associations.
3. Hourly billing rates for reviews of firms with less than 20 professionals and no SEC clients are \$60 for team captains, \$50 for team members who are partners or proprietors, and \$40 for other team members. For firms with 20 or more professionals and all firms with SEC clients, the rates are \$10 higher in each classification. (These rates are the same for 1986.)
4. PCPS member firms normally incur these costs once every three years.

New Dimensions in Peer Review

David E. Peeler, Chairman
PCPS Peer Review Committee

Good news for reviewers and reviewed firms. Scheduled for release this spring are revised standards and peer review program guidelines designed to simplify, clarify, and streamline the peer review process without sacrificing the program's quality. For several months, joint task forces composed of members from the PCPS and SECPS Peer Review Committees have worked diligently on improvements to existing peer review standards and guidelines which (a) simplify the development and implementation of a firm's quality control system, (b) simplify the firm's procedures for accumulating and organizing information about its quality control system and compliance with the membership requirements, (c) achieve greater efficiency and effectiveness in the conduct of peer reviews, (d) clarify circumstances under which various types of reports are issued, and (e) improve guidance in preparing letters of comments and firms' responses thereto.

The task forces have been overwhelmingly successful. Standards have been revised, peer review programs and engagement checklists redesigned, and instructional materials clarified. The new guidelines have been field tested, receiving high marks from both reviewers and reviewed firms. Comments on the new program include . . . "effective" . . . "more efficient than predecessor programs" . . . "helped us organize and prepare for peer reviews" . . . "new direction assisted us in modifying our quality control document and in developing a system which meets our practice requirements."

The following paragraphs outline the highlights of the program's major changes.

NEW PEER REVIEW PROGRAM GUIDELINES

The compliance review program guidelines for initial and subsequent systems-oriented reviews and for engagement-oriented reviews have been merged into one program, the Peer Review Program Guidelines, which incorporates and improves upon many of the good features of the prior guidelines. The new guidelines are designed to assist a reviewed firm in (a) developing a relevant quality control system and (b) accumulating and organizing information about its quality control system and compliance with membership requirements. The new guidelines also assist reviewers in evaluating a firm's system of quality control, utilizing compliance and engagement checklists designed to efficiently and effectively test and document findings and formulate conclusions.

IMPROVED GUIDANCE FOR ISSUING UNQUALIFIED OR MODIFIED REPORTS

The revised reporting standards continue to focus on the adequate design and functioning of a firm's quality control system, but deal with previous misunderstandings and stress the individuality of a firm's system.

The new standards also provide expanded guidance on assessing the significance of design deficiencies in a firm's system of quality control and the degree of noncompliance

with its policies and procedures and with the membership requirements. The program, including engagement checklists, is designed to assist reviewers in formulating conclusions on the effectiveness of a firm's system of quality control and the significance of related deficiencies.

IMPROVED GUIDANCE FOR PREPARING LETTERS OF COMMENT

Determining what to include in a letter of comments and properly communicating those matters has been the most difficult task reviewers face in concluding a peer review engagement. The revised standards offer expanded guidance to assist reviewers in writing better letters of comments, emphasizing concise letters that focus only on items that create a condition in which there is more than a remote possibility that the firm will not conform with professional standards on accounting and auditing engagements. These materials are being released this spring. In addition a joint task force is now compiling numerous examples of letter of comment items, addressing a variety of matters in all functional areas, that will assist reviewers in preparing better letters of comment. Release of the new material is scheduled for this fall.

The Peer Review Committee believes that the program functions best in an environment of free exchange of ideas between peers. The emphasis on concise letter of comment items is not intended in any way to inhibit this interaction. Rather, the Committee believes the process will, in fact, improve as a result of this shift in emphasis. The PRC anticipates an increase in the number of firms receiving letters of *suggestions*, which will address isolated instances of noncompliance and other matters aimed at helping a firm achieve greater efficiencies in conducting its accounting and auditing practice. Of course, all matters included in the letters of comments and of suggestions should have been discussed at the exit conference.

COMMENT LETTERS TO BE IN THE PUBLIC FILE

The Division's advertising and public information programs have increased the public interest in peer review results. The PRC has concluded that placement of the letter of comments and the firm's letter of response in the Division's public files is in the best interest of the peer review program. This will be effective for all reviews on which reports are dated on or after April 1, 1987.

Anticipating concerns from firms and questions from users of peer review reports, the Committee is developing a brochure that explains the significance of the report, letter of comments, and letter of response. Drafts of the new brochure will hopefully be available at next month's PCPS Conference.

EXPANDED GUIDELINES FOR ENGAGEMENT SELECTION

In response to public interest in audits conducted pursuant to the Single Audit Act of 1984, reviewers will now be required to include one or more such engagements in their engagement selection process. To assist reviewers in

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Special Report

Hearing Criticizes Governmental Audits; Recommended Improvements Focus on Peer Review, Enforcement and Education

Stephen H. Collins

Editor's Note: Mr. Collins is the *Journal Of Accountancy's* associate editor-special projects, and is the former editor of *The CPA Letter*. At your *Reporter's* request he prepared this article on testimony at a recent Congressional hearing.

"Congress simply will not tolerate continued sloppy, unprofessional, substandard CPA audits of federal grant funds. Decisive corrective actions are needed to dramatically improve the quality of these audits. Failure to achieve such improvements would force the Federal government to reconsider its policy of relying on audits performed by CPA firms." With these words, Congressman Jack Brooks (D-Tex.), Chairman of the Legislation and National Security Subcommittee of the Committee on Government Operations, opened its second hearing to review the quality of audits of Federal grant recipients performed by CPA firms.

Testifying were Charles A. Bowsher, U.S. Comptroller General, and representatives of the General Accounting Office; Herman J. Lowe, AICPA Board Chairman, accompanied by AICPA President Philip B. Chenok, AICPA Vice President Thomas P. Kelley and Harold I. Steinberg, Chairman of the Institute's Task Force on Quality of Audits of Governmental Units; and Thomas Iino, President of the National Association of State Boards of Accountancy.

Last November, the subcommittee held a hearing on the first phase of the GAO's study of the quality of CPA audits of Federal grant funds. That study, said Brooks, "documented serious and widespread deficiencies in CPA audits of grant funds." The hearing on March 19 focused on the second phase of the study, zeroing in particularly on the GAO's detailed reviews of CPA audits.

According to Bowsher, the GAO's report "clearly shows that there are problems with audit quality and these problems require significant reforms within the accounting profession." In part, the study indicates that CPAs did not satisfactorily comply with standards on 34 percent of governmental audits performed. Also, more than half of the unsatisfactory audits had "severe standards violations."

AICPA PLAN INCLUDES MANDATORY PEER REVIEWS

Mr. Lowe of the AICPA presented a three part plan, adopted in February by the Institute's Board of Directors, that reinforces the GAO recommendations. The plan would require CPAs performing such audits to participate in an approved peer review program, similar to the requirement recently adopted by the REA. (See story on page 2.)

The AICPA plan would also require these CPAs to take special CPE courses in governmental auditing, and to waive their right to confidentiality in ethics proceedings triggered by an inspector general. Lowe also mentioned that in February the AICPA issued a state and local government audit guide, and is currently conducting related training courses across the country.

NASBA's Iino spoke of the various efforts being taken by that group, including positive enforcement programs. All in all, the three groups testifying demonstrated a joint effort of taking positive steps to improve audit quality. Questions from the Congressmen were relatively few, although a number were provided in writing for subsequent written responses. Committee members voiced some interest in whether the practice of awarding audits to the lowest bidder affects audit quality.

In closing, Brooks noted that the number of substandard audits was "unacceptably high" and "dramatic improvements are needed if the Federal government is to continue its reliance on the work of CPA firms." □

1987 Conference Set for Phoenix Resort; Mark Your Calendar Now

The luxurious new Pointe at South Mountain will be the site of the 1987 PCPS Conference, scheduled for May 3-5. This will be the ninth annual PCPS Conference, but only the second held in a resort environment.

Billed as "the largest resort in the Southwest," the Pointe also features championship golf, indoor and outdoor racquet sports, seven heated swimming pools (most of them open around the clock), horseback riding and a fitness center. The resort's literature invites you to "experience the ambiance of a Spanish/Mediterranean hideaway. Majestic mountains provide a breathtaking backdrop for the lush courtyards, hand-carved stone fountains, tiled walks and graceful archways . . ."

The standard sleeping accommodation is a two-room suite with a private balcony. Not all the details are in place, but the Section's meeting planners promise that all this will be available to Conference registrants and their families at a very attractive room rate—\$90, single or double. □

1985 Review Costs Down

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review procedures. A lot of progress was made in time for the 1985 review year, and we've made even bigger strides since then.

"Firms that perform no audits may also meet the peer review requirement by having a report review, which does not involve a trip to the firm's office. In 1985, the average total cost of the seven such reviews was \$999. These firms averaged three professionals each.

"In general, the cost of a report review is approximately one half or just a little more than half what the same firm would pay for an on-site review. Some firms that are eligible for a report review have, however, elected an on-site review, since they believe that they will get more value in the form of solid suggestions from face to face contact with a qualified reviewer."

The Peer Review Committee recently agreed to keep the reviewers' hourly billing rates unchanged for 1986. These rates will continue at the levels shown in Note 3 to the accompanying cost summary. □

New Dimensions in Peer Review

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evaluating this type of engagement, a joint task force developed an audit review checklist for state and local government entities, including those receiving Federal assistance.

From time to time, the engagement selection guidance may be expanded to require including engagements in other areas of public interest. Currently, in addition to governmental engagements, greater weight is given to selecting those involving publicly held clients, financial and lending institutions, and brokers and dealers in securities.

NEW QUALIFICATION FOR SERVICE AS A REVIEWER

Because of the magnitude of these changes, the PRC has concluded that effective implementation cannot be accomplished without mandatory attendance at reviewers' training courses. Therefore, reviewers wishing to serve as team captains must attend a training course using the 1986 AICPA materials. *This is a requirement for all reviews on which the report is dated on or after August 1, 1986.* To handle the anticipated increased demand for training, sessions have been scheduled throughout the country. (See related article.)

EFFECTIVE DATE

The revised standards, guidelines, checklists and forms will be effective for all reviews on which reports are dated on or after August 1, 1986, with earlier application encouraged.

When the task forces embarked on carrying out their assigned tasks, no one realized the magnitude of the changes that would result. The PRC believes that a more effective and efficient peer review program will result, with better integrated standards, programs, and checklists. However, the Committee anticipates that some delays will be experienced in accepting peer review documents due to requested revisions to conform with the new guidelines. The Committee is totally committed to assuring a smooth transition and will do whatever is necessary to achieve this.

REA Adopts Peer Review Requirement; Other Agencies Urged To Follow Suit

The Rural Electrification Administration recently became the first Federal agency to require that CPA firms participate in an approved peer review program. As detailed in the January 21 *Federal Register*, each REA borrower must have its financial statements audited. Financials dated after December 31, 1987 must be audited by a CPA who belongs to and participates in an approved peer review program like the Division's. An earlier REA release indicated that 104 of the 538 CPAs auditing the agency's borrowers already participate in such a program.

The PCPS and SECPS chairmen had strongly endorsed the REA's original peer review proposal, which was published in January of 1985. Their letter pointed out that "those who engage CPA firms to perform accounting and

auditing services and those who rely on financial statements audited by CPAs have a right to request objective evidence of that quality."

A number of local government units have either required reviews or given preference to reviewed firms. Other Federal agencies have sometimes formally recognized peer review in their proposal evaluation formulas. However, REA is believed to be the first Federal agency to establish peer review participation as a requirement.

As reported elsewhere in this issue, the AICPA recommended March 19 that CPAs who perform certain other government-related audits be subject to a peer review requirement similar to the REA's.

MSC Asks Special Committee to Consider Legal Liability to Clients as Well as Third Parties

Late last year the Institute announced the establishment of a Special Committee on Accountants' Legal Liability, chaired by Ray J. Groves, AICPA's immediate past chairman. Early this year, the Member Services Committee focused on the various approaches that the Special Committee might take.

The MSC members recognized that claims by third party plaintiffs could be a major problem for all CPA firms, and especially those that audit public companies. They noted, however, that claims by *clients* far outnumber those by third parties.

In a letter to the Special Committee, MSC Chairman Thomas L. Aman pointed out that clients' claims typically target tax service, management service, investment advice and fiduciary activities. "We believe that developing and publicizing protective boilerplate for these types of engagements," the letter continued, "is a major service that your committee could readily provide." PCPS Chairman John T. Schiffman also signed the letter.

The Special Committee considered the PCPS letter, and directed its staff and counsel to move in the direction suggested by the PCPS.

MAP Conference Schedule Set

This year the AICPA's Management of an Accounting Practice Committee has scheduled two three-day conferences. The first is July 14-16, in Nashville's Opryland Hotel. The second is November 10-12, at The Pointe at Tapatio Cliffs, in Phoenix. Each conference will address a variety of practice management topics.

This is the thirteenth year that the MAP Committee has presented conferences such as these. Each conference offers 22 hours of CPE credit. The registration fee is \$370.

The PCPS will host an information suite at each of the conferences, for registrants who want information about the benefits and requirements of Section membership.

For more information about the MAP Conferences, call David McThomas, (212) 575-6439.

Reviewers' Training to Be Mandatory For Team Captains; Seven Presentations Scheduled

Because of the significant recent changes in the peer review process, the Peer Review Committee will require team captains on reviews for which the reports are dated August 1 or later to have attended a 1986 (or later) training course using AICPA materials.

AICPA's first presentation of the 1986 course, "A Guide for Conducting Peer Reviews," will be on May 7, in Orlando, immediately following the PCPS Conference. Subsequent presentations, sponsored by various CPA societies, are as follows:

- May 23, San Francisco
- June 6, Philadelphia
- June 9, Atlanta
- June 26, Columbus, OH
- June 30, Denver
- July 14, St. Louis

For information about the course contact the Quality Control Review Division, 212/575-6658. To register for a state society presentation contact the sponsoring society. □

Membership Profile

The Section's membership profile continues to develop in a direction that has become familiar. In the past year the number of member firms declined a little more than 1%. By itself, however, this can be misleading, for while there were 17 fewer firms in March 1986 than a year earlier, during that period 32 member firms disappeared through mergers, usually with other members.

By most measures, the Section has grown. In the last year, the number of professionals in member firms increased more than 8%, while the number of CPAs grew 1½% to 59,502.

While some of those CPAs have not yet joined the Institute—we have no way of determining how many—it is interesting to note that the AICPA's July 31 annual report shows that the total number of Institute members in public practice was 117,850. It seems reasonable to conclude that almost half of the AICPA members in practice are with PCPS firms. This reinforces the concept that the Section, with its emphasis on quality practice backed up by the peer review requirement, is having an effect on a substantial number of practitioners, on their clients, and on those who rely on their clients' financial statements.

Member firms are growing in size. This trend has been uninterrupted since your *Reporter* first published relevant statistics. In late 1978, more than 84% of the firms had 5 or fewer partners. Currently, 73% do. The contrast is even more marked in the number of professionals. In late 1978, almost 55% had 5 or fewer professionals. Currently, less than 23% do.

One reason might be that the firms that are inclined to join the Division, with its emphasis on quality and its rigorous membership requirements, are the ones that tend to prosper and grow. Another probable factor, unfortunately, is that the Section has been unable to attract and retain as many smaller firms as its leaders would like, despite inducements such as the consulting review program, the Member Consultation Service, and the off-site report reviews for firms with no audit clients. □

PCPS Membership Statistics

	<u>March 1986</u>	<u>March 1985</u>	<u>March 1984</u>
TOTALS			
Number of Member Firms	1,555	1,572	1,691
Number of CPAs in Member Firms	59,502	58,586	57,838
Number of Professionals in Member Firms	112,691	104,068	100,356
RATIOS			
Number of Partners			
1	12.0%	13.8%	14.2%
2-5	61.2	59.8	61.0
6-10	19.0	18.8	17.8
11 or more	7.8	7.6	7.0
	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>
Number of Professionals			
1	3.9%	5.3%	5.4%
2-5	18.8	17.2	19.6
6-10	23.0	24.3	24.0
11-20	26.0	27.2	26.9
21-50	20.8	19.8	18.3
51 or more	7.5	6.2	5.8
	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>
Number of Offices			
1	68.6%	69.8%	70.6%
2-5	28.2	27.0	26.7
6 or more	3.2	3.2	2.7
	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>
Number of SEC Clients			
None	81.4%	81.7%	81.5%
1-4	15.3	15.0	15.6
5 or more	3.3	3.3	2.9
	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>

PCPS Reporter

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