

Governance of an Assurance Practice In the United States

May 11, 2010

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Agenda

- Background
- AICPA Standards
- PCAOB Standards
- Concluding Thoughts

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Background

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Background

- High profile audit failures in the U.S. and internationally
- Public outcry to require oversight of the audit function
- As a result, we have more groups interested in the quality controls of the audit function – both state and federal

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AICPA Standards

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AICPA Requirements

- In October 2007, Statement on Quality Control Standard No. 7 (SQCS No. 7), *A Firm's System of Quality Control*, was issued by the Auditing Standards Board of the AICPA

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SQCS No. 7

- Effective as of January 1, 2009
- Replaced and superseded all previously existing SQCSs
- Comprehensively addresses the quality control processes over a firm's accounting and auditing practice
- ASB considered the requirements of the International Standard on Quality Control 1 (ISQC 1), *Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements*, which was effective in 2005

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SQCS No. 7, continued

- This standard places an unconditional obligation on the firm to establish a QC system designed to provide reasonable assurance that the firm complies with professional standards and legal and regulatory requirements, and that it issues reports that are appropriate in the circumstances
- Requires firms to adopt documented policies and procedures

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SQCS No. 7, continued

- Nature of policies and procedures depends on various factors, such as the following:
 - Size of firm
 - Type of services provided
 - Type of industries served
 - Number of partners
 - Number of professional personnel
 - Number of offices

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Documentation Requirements

- SQCS No. 7 requires the firm to document its policies and procedures
- It does not require the firm to have a formal quality control document; it allows for flexibility and latitude in determining the documentation method that best suits the firm
- How do your firms document their QC policies and procedures?

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Communication Requirements

- SQCS No. 7 - the firm should communicate its QC policies and procedures to firm personnel.
- It does not require the communication in writing, although this is preferable.
- How do your firms communicate their QC policies and procedures?

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Effective Communication

- Includes the following elements:
 - Description of policies and procedures
 - The objectives they are trying to achieve
 - Message that each person is responsible for maintaining quality, as well as being familiar with the policies and procedures and complying with them
 - Comments stressing the importance of receiving feedback and encouraging staff to communicate their concerns on QC issues

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Benefits of Effective QC System

- Improved quality of work
 - Reduced risk of error
 - Reduced noncompliance with professional standards
- Improved staff morale – focus on matters that are important to them
 - Professional development
 - Career counseling
 - Advancement
 - Technical proficiency

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Benefits of Effective QC System, continued

- Reduced risk of litigation
 - Less potential for error
 - Increases quality of documentation
 - Less insurance costs?
- Increased efficiency in delivering services
 - Over time, better QC leads to efficiencies
 - Standardization and consistency improve
 - Particularly important in periods of growth; otherwise, lack of structure and order can cause a firm to lose its competitive edge
- What benefits have you seen in your firms?

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Elements of a Quality Control System

- Leadership responsibilities (tone at the top)
- Relevant ethical requirements (i.e., independence/objectivity rules)
- Acceptance and continuance of clients/engagements
- Human resources
- Engagement performance
- Monitoring

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Effective Leadership Over QC

- Essential ingredient for QC success
- Management must have an expectation of, and insistence on, quality
- Must come from the top (partner group) down
- Partner actions, not words, need to reflect the appropriate tone at the top

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Firm Culture

- Culture = shared beliefs, assumptions, and behaviors of firm personnel
- What we do is determined by our culture
- Cooperative attitude (no passive resistance) among partner group is essential, as is an unwavering belief in the importance of quality and adaptability
- Adaptability = willingness to change and support change
- Must maintain QC system current

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Communication to Employees

- Message must be clear – commitment to quality will not be compromised, regardless of the engagement or the circumstances. No compilation, review, audit, or other attestation service can be considered too insignificant or too rushed to dispense with QC-required policies and procedures.
- What's your experience in this area?

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Other Attributes of Tone at the Top

- Management accountability for quality
- Management structure does not create a conflict between quality and profitability
- The way a firm evaluates, compensates, and promotes its personnel should reflect the objectives of a system of quality control
- Management needs to allocate sufficient resources to the QC initiative
- Those charged with QC operational responsibility should have sufficient and appropriate experience, ability, and authority to identify, develop, and implement the necessary QC policies and procedures
- Audit engagement partner should assume responsibility for overall quality on each engagement

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Relevant Ethical Requirements

- Defined as ethical requirements to which the firm and its personnel are subject, which consist of the AICPA *Code of Professional Conduct* together with rules of state boards of accountancy and applicable regulatory agencies, which may be more restrictive

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Relevant Ethical Requirements, continued

- The firm and its personnel should maintain independence. If applicable, independence of another firm that performs part of the engagement should be confirmed.
- The firm should be notified of breaches of independence requirements and take appropriate actions to resolve such situations.
- The firm should obtain annual written confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent.

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Relevant Ethical Requirements, continued

- The firm's policies and procedures should address requirements, if any, for the rotation of personnel.
- The firm should withdraw from specific engagements if threats to independence cannot be mitigated through the application of effective safeguards.
- Any experiences to share?

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Acceptance/Continuance of Clients

- Policies and procedures should be designed to provide the firm with reasonable assurance that it will only undertake or continue relationships and engagements where the firm:
 - Has considered the integrity of the client, including the identity and reputation of the client's owners, key management, related parties, and those charged with its governance.
 - Has considered the risks associated with providing professional services in the particular circumstances.
 - Is competent to perform the engagement and has the capabilities and resources to do so.
 - Can comply with legal and ethical requirements.
 - Reaches an understanding with the client regarding the services to be performed.

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Acceptance/Continuance of Clients, continued

- Factors to consider:
 - Timing and scope of clients and engagements subject to the policy.
 - Conflicts of interest.
 - Significant issues discovered after the engagement begins.
 - Withdrawing from an engagement or ending a client relationship.
- Any experiences to share in this area?

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Human Resources

- The firm should establish policies and procedures designed to provide reasonable assurance that the firm has sufficient personnel with the capabilities, competence, and commitment to ethical principles.

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Human Resources, continued

- Policies and procedures established over personnel issues should address
 - Recruitment and hiring
 - Determining capabilities and competencies
 - Assignment of engagement teams
 - Professional development
 - Performance evaluation, compensation, and advancement
- Any war stories to share here?

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Engagement Performance

- The firm should establish policies and procedures designed to provide it with reasonable assurance that engagements are ***consistently performed*** in accordance with professional standards and regulatory and legal requirements, and that the firm or the engagement partner ***issues reports that are appropriate*** in the circumstances.

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Engagement Performance, continued

- The primary goal is to design a **standardized engagement approach** that provides reasonable assurance that **each engagement** conforms to professional standards and regulatory and legal requirements.
- A standardized engagement approach is not intended to be a substitute for the exercise of professional judgment.
- An engagement performance QC system encompasses the unique planning, performing, supervising, reviewing, documenting, and communicating decisions that occur on each engagement.

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Engagement Performance, continued

- There is no differentiation of service level in SQCS No. 7 regarding the requirements for engagement quality control review, documentation, consultation, and resolution of differences, so those requirements are relevant for compilation and review engagements as well as audit and attestation engagements. Accordingly, the engagement performance quality control system needs to be flexible enough to address all of those different types of engagements.
- Includes the following elements:
 - Engagement documentation
 - Retention of engagement documentation
 - Consultations with others
 - Engagement quality control review
 - Rotation of partner/other engagement members
- Any insights/war stories to share?

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Monitoring

- The firm is required to monitor the operating effectiveness of its quality control system
- Implicit in the monitoring concept is
 - the firm's quality control system is kept up-to-date for changes in professional standards
 - appropriate changes are made to keep the system current with changes in the nature of the firm's practice and its personnel
- Those changes serve to improve the quality of the firm's accounting and auditing services and to increase its efficiency in delivering those services

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Monitoring, continued

- Includes annual office inspections of engagements and functional areas of the firm
- Includes discussions of the results of the inspections to learn from deficiencies in the operations of the QC system
- Any insights/stories to share?

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Practice Monitoring and Peer Review

- Any person engaged in the practice of public accounting who is licensed as a CPA in a CPA firm is required to be enrolled in an AICPA-approved practice monitoring program if services performed by the firm are within the scope of the AICPA practice monitoring standards and the firm issues reports purporting to be in accordance with the AICPA professional standards.
- Firms with no accounting and auditing practice need not participate in a practice monitoring program.

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Practice Monitoring and Peer Review, continued

- Most states have also adopted or will adopt some form of quality control review as a requirement of state licensing
- Peer reviews are conducted every three years, focusing on the professional aspects of the reviewed firm's accounting and auditing practice, not the business aspects
- Designed to provide constructive (not punitive) results for the benefit of the reviewed firm

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Practice Monitoring and Peer Review, continued

- Performed by independent CPAs with experience and expertise in similar practice areas
- Reviewers are required to receive training and have certain other qualifications
- Peer review reports are *pass*, *pass with deficiencies*, and *fail*.
- Reports are publicly available at aicpa.org

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Peer Review – Personal Observations

- Not overly difficult or stressful
- More a collegial atmosphere with peer reviewer; willing to be “flexible” in findings and results
- Maybe not achieving its intended result because of the nature of the process and the relationship with the reviewer/reviewer firm
- Other observations/comments?

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PCAOB Standards

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PCAOB

- Created by the Sarbanes-Oxley Act of 2002
- Oversees audits of U.S. public companies in order to protect interests of investors
- All accounting firms that issue audit reports of U.S. public companies or play a substantial role in the audit of a U.S. public company are required to register with the PCAOB
- The Act mandates the PCAOB to conduct a continuing program of inspections of public accounting firms registered with the PCAOB to assess the degree of compliance of such firms with the Act, PCAOB rules, SEC rules, and professional standards

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PCAOB Inspections

- Except for the largest firms (“accelerated firms”), all firms are inspected at least once every three years; inspections can be more frequent
- Performed by PCAOB inspectors
- Similar in structure to an AICPA peer review
- Inspection reports are available at pcaobus.org

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PCAOB Inspections, continued

- Reports address specific deficiencies in selected audit engagements, but they do not identify the clients
- Specific quality control deficiencies are omitted from the public portion of the inspection report and remain confidential unless the firm fails to satisfactorily address those deficiencies within 12 months

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Types of Deficiencies Found by PCAOB Inspections

- Revenue
- Related-party transactions
- Equity transactions
- Business combinations and impairment of assets
- Going concern considerations
- Loans and accounts receivable
- Service organizations
- Use of other auditors
- Use of the work of specialists
- Independence
- Concurring partner review

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PCAOB Inspections – Personal Observations

- Definitely **NOT** a peer review
- Strenuous and stressful in preparing the firm for the review
- Inspectors are not flexible in their findings and resolution
- Process seems to be slow and cumbersome
- However, process seems to be improving as inspectors become more experienced
- Seems to be generating the intended result – better audits and better documentation of audits
- Any observations?

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Concluding Thoughts

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Concluding Thoughts

- Peer reviews/inspections are here to stay
- As leaders in our firms, we need to take these efforts seriously and devote adequate time and resources to continually ensure our firm's quality initiatives are updated and operating effectively
- We can have the most influence for good by the tone we set every day in our offices among our people – as we demand quality and diligence in our own work, and demand the same of our staff, we will get quality and diligent effort from our staff

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Questions/Comments?

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