

Quality Control Systems and Engagement Files Monitoring and Inspections – the Protocol

Executive Summary

A firm must establish and maintain a system of quality control for all services offered (APES 320 *Quality Control for Firms* and ASQC 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Reports and Other Financial Information, and Other Assurance Engagements*).

The policies and procedures include *engagement performance and monitoring*. Monitoring is a process comprising an *ongoing* consideration and evaluation of the firm's system of quality control, including a *periodic inspection* of a selection of completed engagements, designed to provide the firm with *reasonable assurance* that its system of quality control is operating effectively.

The frequency of inspections of quality control systems and engagements files must be articulated in policies and procedures to comply with APES 320 and ASQC 1.

A firm must communicate to relevant engagement partners and other appropriate personnel deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action.

A firm must communicate at *least annually* the results of monitoring its system of quality control to engagement partners and other appropriate individuals within the firm, including the firm's chief executive officer or, if appropriate, its managing board of partners.

The reviews performed by accounting bodies and regulators provide a useful insight into the areas where a firm's compliance needs to be benchmarked.

A failure to adequately address systems and engagement file shortcomings, and in a timely manner, may expose the public practitioner to reputational, legal and professional risks.

GAAP Consulting provides following services: Level 1: Quality control systems inspection under APES 320 and/or ASQC 1; Level 2: Engagement file inspection for specified services under auditing and/or ethical standards; Level 3: Agreed-upon procedures for specified services under auditing and/or ethical standards; and Level 4: Quality control related consulting engagements.

Introduction

1. Accounting firms can often struggle with the design and upkeep of quality control systems as evident from the results of the inspection programs of the accounting bodies and regulators. Practice risks are increased by a lack of attention to ongoing consideration and evaluation of the system of quality control, and appropriate engagement file inspection. A failure to adequately address systems and engagement file shortcomings, and in a timely manner, may expose the public practitioner to reputational, legal and professional risks. The misapplication of technical and professional standards may also result in practice inefficiencies.

2. The purpose of this protocol is to:

- describe the responsibilities of an accounting firm to establish and maintain a system of quality control, and to monitor compliance with professional standards (including the inspection of engagement files)
- highlight the deficiencies in quality control systems and engagement performance identified by the accounting bodies and regulators
- provide information about how to access *GAAP Consulting* (www.gaap.com.au) for independent inspections and assistance.

3. Under APES 320 *Quality Control for Firms*, a firm must *establish and maintain a system of quality control* designed to provide it with *reasonable assurance* that the firm and its personnel *comply with professional standards and applicable legal and regulatory requirements* and that *reports* issued by the firm are *appropriate* in the circumstances (APES 320.3). The same principle is reflected in relation to audit practices in ASQC 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Reports and Other Financial Information, and Other Assurance Engagements* (ASQC 1.16). Such policies and procedures must be documented and communicated to the firm's personnel (APES 320.11 and ASQC 1.17).

4. A firm must *establish and maintain a system of quality control* that includes policies and procedures that address each of the following elements:

1. leadership responsibilities for ensuring quality within the firm
2. relevant ethical requirements
3. acceptance and continuance of client relationships and specific engagements
4. human resources
5. *engagement performance*
6. *monitoring* (a process comprising an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements, designed to provide the firm with *reasonable assurance* that its system of quality control is operating effectively).

This protocol addresses two of these six elements: engagement performance and the monitoring elements of the system of internal control.

5. Professional standards are those issued by the Accounting Professional and Ethical Standards Board which include:

- APES 110 *Code of Ethics for Professional Accountants*
- APES 205 *Conformity with Accounting Standards* (AASBs)
- APES 210 *Conformity with Auditing and Assurance Standards* (ASAs)
- APES 215 *Forensic Accounting Services*
- APES 220 *Taxation Services*
- APES 225 *Valuation Services*
- APES 305 *Terms of Engagement*
- APES 310 *Dealing with Client Monies*
- APES 315 *Compilation of Financial Information*
- APES 320 *Quality Control for Firms*
- APES 330 *Insolvency Services*
- APES 345 *Reporting on Prospective Financial Information Prepared in Connection with a Disclosure Document*
- APES 350 *Participation by Members in Public Practice in Due Diligence Committees in connection with a Public Document.*

Professional standards also include all professional and ethical requirements of the accounting bodies, e.g., continuing professional development.

6. Reasonable assurance means a high, but not absolute, level of assurance (APES 320.2f). APES 320 does not provide any further elaboration of the term 'reasonable assurance'; however, it is well understood in an audit context.

7. The recently issued auditing standard ASQC 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Reports and Other Financial Information, and Other Assurance Engagements* reflects APES 320 in purely an audit context. ASQC 1:

- sets out the firm's responsibilities for applying, and complying, with relevant requirements
- establishes elements of a system of internal control and leadership responsibilities for quality within the firm

- describes relevant ethical requirements
- clarifies the policies and procedures required for the acceptance and continuance of client relationships and specific engagements
- sets out the policies and procedures concerning the firm's allocation of human resources to engagements
- describes the policies and procedures required for the firm's engagement performance, including consultation, quality review processes, resolution of any differences of opinion within the firm concerning the engagement; and the management of and retention of engagement documentation
- requires monitoring processes over the firm's system of quality control, including dealing with any deficiencies identified or any complaints or allegations made
- sets out the policies and procedures regarding appropriate documentation that provides evidence of the operation of the system of quality control.

8. Under the quality controls standards, there are seven key requirements:
1. Establish and maintain policies and procedures regarding consistency of quality of engagement performance, supervision and review (engagement performance).
 2. Establish and maintain policies and procedures relating to the system of quality control, including consideration and evaluation of the firm's quality control system, such as inspection of completed files and appointment of a quality control partner (monitoring).
 3. Evaluate the effect of deficiencies noted as result of monitoring.
 4. Communicate the deficiencies to the governance of the firm.
 5. Make recommendations for remedial action.
 6. Communicate at least annually the results of monitoring to the governance of the firm.
 7. Where a firm operates as part of a Network, determine the extent to which monitoring procedures are to be conducted on a network basis.

Quality assurance reviews by the accounting bodies and ASIC

9. The reviews performed by accounting bodies and regulators provide a useful insight into the areas where a firm's compliance needs to be benchmarked. Also firms may have specific matters where they require some further assurance.

Chartered Accountants

10. In its most recent results The Institute of Chartered Accountants in Australia uncovered the main areas of non-compliance to continue to include insufficient audit documentation, inadequate documentation of quality control policies and procedures in accordance with APES 320/ASQC 1, and a failure to meet the required hours of training and development, mainly in respect of statutory registrations, such as a registered company auditor.

11. Listed below are auditing standards where there was non-compliance (in descending order of non-compliance; * indicates over 20% of firms inspected were non-compliant):
1. ASA 315 *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement**
 2. ASA 240 *The Auditor's Responsibility to Consider Fraud in an Audit of a Financial Report**
 3. ASA 520 *Analytical Procedures**
 4. ASA 560 *Subsequent Events**
 5. ASA 580 *Management Representations**
 6. ASA 220 *Quality Control for Audits of Historical Financial Information*
 7. ASA 300 *Planning an Audit of a Financial Report*
 8. ASA 230 *Audit Documentation* and ASA 500 *Audit Evidence*
 9. ASA 210 *Terms of Engagements*
 10. ASA 570 *Going Concern*.

12. In relation to auditor independence under APES 110 *Code of Ethics for Professional Accountants* the following non-compliances were noted (in descending order of non-compliance):

1. no documentation or inadequate documentation when considering threats to independence
2. appropriate safeguards inadequately applied when carrying out audit and accounting functions for a client
3. auditing the SMSF of a partner in their practice.

13. In relation to quality control APES 320 *Quality Control for Firms* and ASQC 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Reports and Other Financial Information, and Other Assurance Engagements* the following (in descending order) were noted:

1. consideration of client relationship not documented prior to commencing work*
2. a system of quality control does not appear to have been adequately documented*
3. no annual written confirmation of compliance on independence
4. a system of quality control does not appear to have been documented.

14. In relation to the preparation of financial reports there was non-compliance with (in descending order of non-compliance):

1. APES 205 *Conformity with Accounting Standards* (financial reports do not clearly state that they are special purpose)
2. APES 305 *Terms of Engagements*
3. APES 315 *Compilation of Financial Information* (compilation reports were not in accordance with APES 315* (financial reports did not always clearly state that the financial information had not been audited; no acknowledgement was obtained from the client of their responsibility for the reliability, accuracy and completeness of the accounting records and disclosure of all material and relevant information).

CPA Australia

15. CPA Australia noted that the top 10 reported breaches of ethical standards and other pronouncements were:

1. APES 315 *Compilation of Financial Information* – at 35%
2. APES 305 *Terms of Engagement* – at 13%
3. APES 220 *Taxation Services* – at 11%
4. APES 320 *Quality Control for Firms* – at 9%
5. APES 205 *Conformity with Accounting Standards* – at 7%
6. APES 110 *Code of Ethics for Professional Accountants* – at 5%
7. RMS 1 *Risk Management Statement* – at 3%
8. *Corporations Act 2001 (CA)*, s. 251A minutes – at 3%
9. *CA*, s. 271 *Company to keep documents relating to charges and register of charges* – at 2%, and
10. APS 10 *Trust Accounts* – at 2%.

Australian Securities and Investments Commission

16. ASIC's recent inspection report identified a number of cases requiring improvements in audit quality in audit areas related to the global financial crisis, such as the appropriate use of experts in testing asset valuations. Additionally, the adequacy of audit evidence and documentation for significant audit judgement areas continued to be an area of regulatory focus.

17. ASIC also reminded auditors to adopt a high level of professional scepticism when reviewing significant audit judgement areas in the current economic climate. Future inspections will continue to involve firms that audit entities of greater public interest. ASIC will continue to focus on how firms are complying with auditing standards and other requirements, paying particular attention to those

auditing standards impacted more by the effects of the global financial crisis and those that were not appropriately applied in previous years.

Purpose of compliance monitoring

18. Monitoring of compliance is one of the six elements of APES 320 *Quality Control for Firms*. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of:

- adherence to professional standards and applicable legal and regulatory requirements
- whether the system of quality control has been appropriately designed and effectively implemented
- whether the firm's quality control policies and procedures have been appropriately applied, so that reports issued by the firm or engagement partners are appropriate in the circumstances (APES 320.107).

19. A firm must establish a monitoring process designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate and effective. This process:

- must include an *ongoing consideration and evaluation* of the firm's system of quality control, including, on a cyclical basis, inspection of at least one completed engagement for each engagement partner
- requires responsibility for the monitoring process to be assigned to a partner/s or other persons with sufficient and appropriate experience and authority in the firm to assume that responsibility
- requires that those performing the engagement or the engagement quality control review are not involved in inspecting the engagements (APES 320.106).

Monitoring – Maintenance of QA system and file inspection

20. Monitoring consists of two limbs: ongoing consideration and evaluation of the system of quality control, and engagement file inspection.

21. Ongoing consideration and evaluation of the system of quality control includes:

- analysis of:
 - New developments in professional standards and applicable legal and regulatory requirements, and how they are reflected in the firm's policies and procedures, e.g., the new Clarity Auditing Standard (effective from 1 January 2010) or the revised Code of Ethics for Professional Accountants (effective 1 July 2011)
 - continuing professional development, including training
 - decisions related to acceptance and continuance of client relationships and specific engagements
- determination of corrective actions to be taken and improvements to be made in the system, including the provision of feedback into the firm's policies and procedures regarding education and training
- communication to appropriate firm personnel of weaknesses identified in the system, in the level of understanding of the system, or compliance with it
- follow-up by appropriate firm personnel so that necessary modifications are promptly made to the quality control policies and procedures (APES 320.108).

For assurance practices it also includes a written confirmation of compliance with policies and procedures on independence (APES 320.108).

Inspections

22. In the context of completed engagements, inspection means procedures designed to provide evidence of compliance by engagement teams with the firm's quality control policies and procedures (APES 320.2g).

23. APES 320 does not contain guidance for the frequency of inspections of non-assurance engagements. For assurance practices, inspection cycle policies and procedures may specify a cycle that *spans three years*. The manner in which the inspection cycle is organised, including the timing of selection of individual engagements, depends on such factors as:

- size of the firm
- number and geographical location of offices
- results of previous monitoring procedures
- degree of authority both personnel and offices have (e.g., whether individual offices are authorised to conduct their own inspections or whether only the head office may conduct them)
- nature and complexity of the firm's practice and organisation
- risks associated with the firm's clients and specific engagements (APES 320.109).

24. The frequency of inspections of quality control systems and engagements files must be articulated in policies and procedures to comply with APES 320 and ASQC 1. Inspection frequency timetables a firm may wish to consider are dependent on the firm's risk assessment, including the existence within the client portfolio of public interest entities, the extent of general purpose financial reporting, the extent of changes to underlying standards and regulatory frameworks, and monitoring resources available within the firm. A firm may identify the following compliance frequency timetables for inspections:

1. APES 320 (biannually) and ASQC 1 (annually)
2. public interest audit engagement files (annually)
3. other assurance engagements (biannually)
4. compilation accounting files (biannually)
5. other professional services (biannually).

25. *Public Interest Entity* is defined under the revised Code of Ethics (effective 1 July 2011) as:

- a listed entity, and
- an entity defined by regulation or legislation as a public interest entity, or for which the audit is required by regulation or legislation to be conducted in compliance with the same independence requirements that apply to the audit of listed entities. Such regulation may be promulgated by any relevant regulator, including an audit regulator.

26. Remember: Under APES 320 and ASCQ 1 a firm must communicate at least annually the results of the monitoring of its system of quality control to engagement partners and other appropriate individuals within the firm.

27. The inspection process includes the selection of individual assurance engagements. In determining the scope of the inspections, the firm *may* take into account the scope or conclusions of an independent external inspection program such as conducted by the professional bodies or regulator. However, an independent external inspection program is *not a substitute for the firm's own internal monitoring program* (APES 320.110). Inspections programs conducted by the professional bodies or regulator may not meet specific practice needs.

Evaluating, communicating and remedying identified deficiencies

28. A firm must evaluate the effect of deficiencies noted as a result of the monitoring process and determine whether they are either:

- instances that do not necessarily indicate that the firm's system of quality controls is insufficient to provide it with reasonable assurance that it complies with professional standards and applicable legal and regulatory requirements, and that the reports issued by the firm or engagement partners are appropriate in the circumstances, or
- a systemic, repetitive or other significant deficiencies that require prompt corrective action (APES 320.112).

29. A firm must communicate to relevant engagement partners and other appropriate personnel deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action (APES 320.113). Recommendations for appropriate remedial actions for deficiencies noted must include one or more of the following:

- taking appropriate remedial action in relation to an individual assurance engagement or member of personnel
- communicating the findings to those responsible for training and professional development
- making changes to the quality control policies and procedures
- taking disciplinary action against those who fail to comply with the policies and procedures of the firm, especially those who do so repeatedly (APES 320.115).

30. A firm must establish policies and procedures to address cases where the results of the monitoring procedures indicate that a report may be inappropriate, or that procedures were omitted during the performance of the assurance engagement. Such policies and procedures must require the firm to determine what further action is appropriate to comply with relevant professional standards and applicable legal and regulatory requirements and to consider whether to obtain legal advice (APES 320.116).

31. A firm must communicate at least annually the results of monitoring its system of quality control to engagement partners and other appropriate individuals within the firm, including the firm's chief executive officer or, if appropriate, its managing board of partners. This *communication must be sufficient* to enable the firm and these individuals to take prompt and appropriate action, where necessary, in accordance with their defined roles and responsibilities. Information communicated must include:

- a description of the monitoring procedures performed
- the conclusions drawn from the monitoring procedures, and
- where relevant, a description of systemic, repetitive or other significant deficiencies and of the actions taken to resolve or amend those deficiencies (APES 320.117).

Network Firms

32. *Network Firm* or *Network Assurance Practice* means a firm, practice or entity that belongs to a network (APES 320.2(j)). A network is a larger structure that is aimed at cooperation and that is clearly aimed at profit or cost-sharing or shares common ownership, control or management, common quality control policies and procedures, common business strategy, the use of a common brand name, or a significant part of professional resources (APES 320.2k).

33. Where a firm operates as part of a network, for consistency, they may implement some of their monitoring procedures on a Network basis. Where firms within a Network operate under common monitoring policies and procedures designed to comply with APES 320, and these firms place reliance on such a monitoring system, the firm's policies and procedures must require that:

- at least annually, the Network communicate the overall scope, extent and results of the monitoring process to appropriate individuals within the network firms
- the Network communicate promptly any identified deficiencies in the system of quality control to appropriate individuals within the relevant network firm/s so that the necessary action can be taken, in order that engagement partners in the network firms can rely on the

results of the monitoring process implemented within the network, unless the firms or the network advise otherwise (APES 320.118).

Engagement performance

34. One of the elements of quality control addresses the generic issue of policies and procedures regarding engagement performance. The specific issues of engagement performance are prescribed in the service specific standards for non-audit services, e.g., APES 315 *Compilation of Financial Information*, the Code of Professional Conduct issued by APESB and Australian Auditing Standards issued by AUASB.

35. The policies and procedures regarding engagement performance that would be evident in the engagements files cover:

1. consistent engagement quality, supervision, and review practices (APES 320.58 and 320.63)
2. consultation (APES 320.64)
3. engagement quality control review for assurance practice (APES 320.70, 320.72–73, 320.77, 320.80, 320.83, 320.87–90)
4. engagement documentation (APES 320.93, 320.96, 320.101).

Levels of QA engagements with GAAP Consulting

36. *GAAP Consulting* undertakes the following engagements in relation to quality control aspects of auditing and assurance standards, ethical standards and compilation engagements.

37. Level 1: Quality control systems inspection under APES 320 and/or ASQC 1

Objective: To determine whether the firm has established and maintained a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and applicable legal and regulatory requirements, and that reports issued by the firm or engagement partners are appropriate in the circumstances in accordance with APES 320 *Quality Control for Firms* for non-assurance and ASQC 1 *Quality Control for Firms that Perform Audits and reviews of Financial Reports and Other Financial Information, and Other Assurance Engagements* for assurance practices.

Scope: Firm audit and assurance QA systems, and firm non-audit QA systems engagements.

38. Level 2: Engagement file inspection for specified services under auditing and/or ethical standards

Objective: To determine whether the service line has obtained reasonable assurance that the selected engagement file has complied with professional standards and applicable legal and regulatory requirements, and that reports issued by the firm or engagement partners are appropriate in the circumstances in accordance with auditing, ethical, accounting and compilation standards.

Scope: Audit and assurance engagements and compilations engagements.

39. Level 3: Agreed-upon procedures for specified services under auditing and/or ethical standards

Objective: To apply agreed audit procedures and report factual findings.

Scope: Audit and assurance engagements, compilations engagements, ethical standards application

40. Level 4: Consulting engagements

Objective: To meet the specific needs of the firm. General consulting engagements involve:

- assistance with developing and maintaining quality assurance policies, policies and procedures for audit and assurance and compilation engagements, and monitoring reporting to governance of the firm
- assistance with preparing the annual *Quality Control Monitoring Report*
- consultations on accounting, ethical and auditing standards and regulatory reporting
- training on quality control, accounting, auditing and assurance, ethics and compilation standards

- forensic accounting services, including independent expert and consulting expert reports.

41. *GAAP Consulting* has eight partner equivalents that provide access to *some of Australia's best* to address financial reporting, auditing, superannuation, and ethical issues:

- **Colin Parker** – GAAP, GAAS and Ethics
- **Michal Cain** – GAAP, GAAS and Ethics
- **Jim Dixon** – GAAP, GAAS and Ethics
- **Stephen LaGreca** – GAAP and GAAS
- **Susan Orchard** – Superannuation, GAAS and Ethics
- **Carmen Ridley** – GAAP and GAAS
- **Justin Reid** – GAAS and Ethics
- **David Sauer** – GAAP, GAAS and Ethics.

42. An accounting firm can also select from over 30 services provided by *GAAP Consulting* covering the disciplines of financial reporting, superannuation, professional ethics and auditing. These services are provided under the following captions:

- Technical Advice: Access to some of Australia's Best
- Methodology Update: Improved Business Practices
- Technical Resources: Proprietary Information and Tools
- Training (in-house): Tailor-made and Passionate
- *Quality Assurance: Better Risk Management*
- Alliance Partner Access: Other Technical Services Available
- Marketing: Profile and Practice Growth.

43. *GAAP Consulting's* existing clients have designated primary and secondary points of contacts. Requests for assistance with quality control standards and inspections should be directed to these points of contact. New clients should direct initial enquiries to *Colin Parker, Head of the GAAP Consulting Network*, colin@gaap.com.au or 0421 088 611.

April 2011
Version 1
(c) gaap.com.au
