SQC 1 in Audit Firms and its Impact

In the light of the recent corporate failures, resignation of auditors and perceived audit failures, there is a reemphasised need to focus on firm level quality control procedures. Auditing Standards have always focused on the firm's quality of audit performance. The tone at the top, by the CEO/ Managing Partner of the firm ensuring that the culture of the firm breathes quality is imperative. SQC-1 outlines six fundamental elements through which the firm can create and implement a system of quality control to obtain reasonable assurance that both the firm and its personnel adhere with professional standards. One of the major impediments in the implementation of SQC-1 especially for small and medium practitioners is the limited resources available to them and SQC-1 does provide some guidance towards the same. However, importantly SQC-1 will help firms develop a culture of quality, and the benefits of proper implementation will far outweigh its cost in the long run. Read on to know more...

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Quality refers to "a measure of excellence or a state of being free from defects, deficiencies and significant variations." It is brought about by strict and consistent commitment to certain *standards*. The Auditing Standards have been traditionally output oriented towards ensuring that the engagement output complies with the relevant standards. It was noted that in order to improve performance of audit firms, there should also be sufficient emphasis on the 'input' – which would refer to the overall culture that the firm imbibes into its processes to ensure consistency in quality and ultimately, the output. The ICAI, thus endorsed Standard on Quality Control 1 *"Quality Control for Firms that perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements"* (SQC).

SQC applies not only to statutory audit engagements but also to other related services like limited reviews, agreed upon procedures, certification etc.

The objective of SQC is to *enable every firm to establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements. The auditors must have reasonable assurance that reports issued by them are appropriate to the circumstances.* Emphasis is on leadership, documentation and communication of the policies and procedures to ensure that it acts as an essential document for firm and its employees. Further, the firm needs to encourage its personnel to communicate their views or concerns over quality control matters.

SQC has defined six elements of system of quality control that the firm's policies and procedures should include.

1) Responsibilities for Quality within the firm

Analysis: With the trust bestowed on the top level of the firm, it is imperative that the chief executive officer/ managing partner (or equivalent) who drives the culture of the firm, assumes ultimate responsibility for the firm's system of quality control. The management of the firm may assign the operational responsibility to someone within the firm with appropriate experience, ability and authority. Clear, frequent and consistent communication from all levels of the firm's management is important in building this culture. Communicating the importance of quality can be done through various means, including in person meetings, internal newsletters, training programs, communication of the performance evaluation matrices, internal portals etc.

> SQC emphasises that commercial considerations should not override the quality of work performed; and performance evaluation and promotions with regard to its personnel should demonstrate the firm's commitment to quality.

In multi-locational firms or in firms with multiple service lines and greater complexity, there may be several people assigned with operational responsibility of quality by location, specialisation (by industry or by service line), who report in to the partner with overall operational responsibility who in turn reports in to the firm's CEO/ Managing Partner or Board of Partners. The point being, that each firm may need to design its quality control leadership depending on its size, complexity, geographical spread, sectors and services of operations, but needs to fundamentally adhere to the SQC principles.

Quite often firms and partners have financial targets to achieve and often their compensations are linked to the same. SQC emphasises that commercial considerations should not override the quality of work performed; and performance evaluation and promotions with regard to its personnel should demonstrate the firm's commitment to quality.

Impact:

- Chief executive officers or managing partners need to formally hold ultimate responsibility of the firm's system of quality control and the operational responsibility may be designated to a person with appropriate competence and authority.
- Clear, consistent and frequent communication in quality control matters from all levels of the firm's management to build the culture of quality.
- Performance evaluation procedures of employees to demonstrate the firm's commitment to quality of work.

2) Ethical Requirement

Analysis: The Code of Ethics issued by ICAI establishes fundamental principles of professional ethics viz *Integrity, Objectivity, Professional competence and due care, Confidentiality, and Professional behaviour*. The firm's policies and procedure should provide reasonable assurance that the Code of Ethics is being complied with at firm level.

The Code of Ethics also includes a conceptual framework to 'Independence'. The firm should have a demarked definition of 'Independence' documented in its policies and procedures as to "what would constitute compromise of Independence". Several statutes and guidance are available in this regard which need to be referred to while formulating an independence policy viz. The Companies Act (2013), SEBI (Prohibition of Insider Trading Regulations), Code of Ethics etc. There are several areas where conflicts and ethical issues can emerge and it is advisable to document appropriate policies in this regard – for example receiving gifts, buying products at discounted prices or other business transaction with clients, provision of other services to audit clients.

There should be policies and procedures for all who are subject to independence requirements to promptly notify the firm of independence breaches to promptly take corrective action. Holding any form of securities in an auditee company or trading in a company where one has access to insider information is one of the key threats that may emerge. Appropriate policies and controls over securities held by the firm's partners and personnel including family members need to be instituted. The firm should take declarations from its personnel regarding its Independence in respect of all its assignments at least annually in electronic or paper form.

Familiarity threats may be created by using the same senior personnel on an assurance engagement over a long period

of time. The firm should have Policies and Procedures to reduce the threat to acceptable level. In audit of listed clients, the engagement partner should be rotated after a pre-defined period, normally not more than 7 year (as per SQC-1).

Impact:

- Policies and procedures should emphasize the fundamental principles of ethics.
- Formulate a policy to **define, evaluate and communicate 'Independence'**. In determining this, the firms may refer to Companies Act, 2013; SEBI (Prohibition of Insider Trading Regulation, 2015 and Code of Ethics).
- Obtain written confirmation of compliance with policies and procedures on Independence from all its employees **at least annually either in paper form or electronically** and monitor securities holdings of partners and personnel and their relatives in any auditee/ client company.
- Set criteria for rotation of engagement partner in any engagement after a span of period not exceeding 7 years in case of listed companies to reduce familiarity threat to an acceptable level.

3) Acceptance and Continuance of Client Relationships and Specific Engagements

Analysis: This is an area, which the profession has learnt the importance of, the hard way. With the auditor rotation requirements triggering a couple of years ago, the firms and partners were aggressive in securing business for survival and growth of their firms and people. There were subsequently a host of auditor resignations for a variety of reasons. This has re-emphasised the need for auditors to accept audit engagements only with adequate background checks, assessing the client's integrity, understanding the contentious issues and communication with those charged with governance by the previous auditors to form a well thought through and documented acceptance process.

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Like some of the western countries, we may gradually see the evolution of engaging independent agencies to conduct background checks of the promoters and management. It may also be appropriate to have a personal meeting or discussion with the previous auditor to get a better understanding of the issues, and any practical difficulties faced by them. Where issues have been identified on the integrity of the client, or other matters despite which the firm decides to accept the clients, the resolution of such issues should be documented.

Impact:

- Evolving a culture of accepting 'good business' viz-a-viz 'any business'.
- Greater integrity checks, risk assessment, and engagement with the ecosystem including erstwhile auditors prior to acceptance.
- Documented checklists for client acceptance and continuance with consideration of risks, identified issues and resolution including approval processes within the firm.

4) Human Resources

Analysis: Human Capital is the key asset of any audit firm. Appropriate Policies and Procedures to promote that Human capital is best utilised for quality across the firm are critical. Such policies and procedures must address issues such as:

- Recruitment
- Performance evaluation
- Capabilities
- Competence
- Career development
- Promotion
- Compensation and
- Estimation of personnel needs.

> The methodology a firm adopts in assigning the appropriate engagement partner and teams is one of the important elements defining the input quality and there by the output quality

The firm's expectation from the personnel regarding performance, progress and professionalism (ethics) must be well communicated to the personnel. There is a large amount of research and articles on performance measurement of employees. Firms have customarily measured performance in terms of financial metrics linked to profitability such as enhancing revenue or decreasing costs. Measuring performance basis quality is subjective and not easy, but critical. The size and circumstance of the firm will influence the evaluation of individual performance and consequent promotions.

The methodology a firm adopts in assigning the appropriate engagement partner and teams is one of the important elements defining the input quality and thereby the output quality. In traditional firms, the partner bringing in the business and holding the client relationship continues to act as the Engagement Partner. This needs to evolve to ensure that the Engagement Partner and team with the appropriate experience and capability is assigned to the task.

In many European countries the two most difficult areas have been performance evaluation and training. Performance evaluation is an issue because more senior staff especially partners do not like being subjected to this. The issue with training isn't usually 'having training'. Firms put on lots of training. The issue is whether it is appropriate. The drivers of training should always include need identified through monitoring and the performance appraisal process.

The firm must thrive towards developing the competence and capabilities of its employees on-job and off-job. They may be provided structured training by professionals and unstructured learnings specific to the assignments. A training plan at a firm level as well as an individual level would be useful to plug any capability gaps.

Impact:

- Designing policies and procedures for recruitment, evaluating performance, promotion, compensation etc.
- Assignment of engagement teams including engagement partner needs to be stringent with focus on competence rather than relationships.
- Invest appropriately in training and competence of the staff at firm level as well as individual level.
- Ensure that compensation and promotion are based on performance evaluation which is linked to quality.

5) Engagement Performance

Analysis: The firm must establish policies and procedures to ensure that the engagement performance is in compliance with professional standards, regulatory and legal requirements and the reports are issued appropriate to the circumstances. Maintaining consistency in the quality of engagement performance across clients is imperative. Each team member must understand the objective of their work before the commencement of the work. This can be done by team briefing meetings by the engagement partner prior to commencement of the work and constant engagement during the course of the audit. Supervision to track the progress of work, ascertaining the competence and timeliness of the team member and identification and escalation of significant matters to appropriate level is of great importance.

The firm must have the policies and procedures for consultation on important issues arising in the course of audit. Consultation may be with the experienced personnel within the firm or with external experts. The competence and qualification of the consultant must be duly evaluated and documented before the consultancy is relied upon. Smaller firms may not have in house expertise within the firm on some contentious areas and may need to discuss with the clients to engage outside professionals for the same.

Engagement quality control review process is important as it provides an objective evaluation of the significant judgments made by the engagement team and the conclusions reached in formulating the report. The policies relating to the same must touch upon:

- *nature, timing and extent of quality control review,*
- *criteria for eligibility of quality control reviewer* - Sole practitioners may use other firms to facilitate engagement quality control reviews, and
- *documentation requirements.*

> The firm must ensure to have robust policies and procedures to ensure confidentiality, safe custody, integrity, accessibility of engagement documentation.

For the assembly of audit documentation, not more than 60 Days from the end of audit report is generally considered appropriate (as per SQC-1).

The firm must ensure to have robust policies and procedures to ensure confidentiality, safe custody, integrity, accessibility of engagement documentation. With greater digitisation and use of laptops by audit teams, it become very important to review data security as the teams hold several client sensitive information. Appropriate policy with regard to dealing with data leaks also needs to be instituted. Auditor needs to retain the documentation of engagement for a period not less than 7 years from the date of the auditor's report or if later the date of group auditor's report (Para 83) (as per SQC-1).

Impact:

- ***Documentation,*** There is greater emphasis on documentation when compared to how small and medium practitioners generally document :
  - ❖ Planning, Risk Assessment and Risk based auditing,
  - ❖ Consultation process, and
  - ❖ Engagement quality control review by an independent partner, prior to signing off an audit.
- Proper kick-off meetings, ongoing supervision and client engagement during the course of performance.
- Install appropriate procedures to secure data in both electronic and paper form.

Individual Auditing Standards describe the engagement performance requirements for each aspect of the engagement performance and are not included here.

6) Monitoring

Analysis: The firm should establish policies and procedures designed to develop an Internal Monitoring Program (IMP) provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice. The IMP needs to review both the firm level quality controls (compliance with SQC) as well as individual engagement level controls.

The IMP would cover inspection of documentation of completed engagements. At least one engagement of an engagement partner must be selected for inspection once in every 3 years (inspection cycle). Inspection cycle depends on factors like:

- Size of firm.
- Number and geographical location of the firm.
- Results of previous monitoring procedures.
- Risks associated with specific client and engagement.

Once IMP has been performed, firms need to evaluate findings, perform root cause analysis and communicate the same to the staff and engagement partner at least annually. Then they need to act on those findings. The training plan needs to be tailored based on the results of monitoring program. Monitoring should always be driving improvements.

Impact:

- Large sized firms may set up quality control review teams and an IMP system within the firm, while small to mid- sized practitioners may consider using external firms/ resources for this.
- The IMP shall consider firm level compliance with SQC-1 as well as engagement specific documentation.
- IMP shall inspect the specific engagements and communicate the findings to the Engagement Partner in order for appropriate remediation and action.

Conclusion:

Given the nature of the auditing profession in India, with its complexity of size, industries, commercial considerations, the small to mid sized practitioners have faced difficulties in genuine implementation of some of the SQC requirements. Further in wake of various recent developments, the need to review and re-assess implementation of SQC in audit firms has been underlined. The Quality Review Board in its findings has mentioned the need for compliance in various areas of the SQC including establishing policies, engagement quality control, familiarity threat assessment, confidentiality and data security and independence declarations.

The *tone at the top*, by the CEO/ Managing Partner of the firm ensuring that the culture of the firm breathes quality is imperative.

Finally, audit is an important pillar in the economic and financial system of our country. High performance is not an accident. It is a result of continuous, sustained efforts towards improvement. ■