Audit firms' quality control

The faculty has issued a new edition of *Quality Control in the Audit Environment*, its practical guide for firms on ISQC (UK and Ireland) 1. A hard copy of the guide is included with this mailing and is also available at icaew.com/aaf.

Why are we issuing this updated guidance on ISQC 1?

The new guide takes into account recent developments, including the clarified ISQC (UK and Ireland) 1, which is effective for engagements relating to periods ending on or after 15 December 2010. It is important for auditors to consider the requirements of the redrafted standard carefully, as it does eliminate ambiguity that might have existed in the previous version. One possible matter to consider is establishing lines of communication with external reviewers who may now be called upon to do reviews where they were not before. This is likely to be a particular action point for sole practitioners and firms with a very small number of responsible individuals.

The publication identifies seven key areas for firms to consider (covered below). Illustrative policies and procedures are provided for selected aspects of each key area, including some examples for sole practitioners. The guide also includes an appendix with answers to a number of frequently asked questions on the standard.

ISQC 1 objective (paragraph 11)

The objective of the firm is to establish and maintain a system of quality control to provide it with reasonable assurance that:

a) The firm and its personnel comply with professional standards and applicable legal and regulatory requirements; and
b) Reports issued by the firm or engagement partners are appropriate in the circumstances.

As with the ISAs, in order to obtain an understanding of the standard, it is vital to appreciate the objective which the standard's requirements are designed to achieve. The reference to 'reasonable assurance' in the objective means a high, but not absolute, level of assurance (paragraph 12 (p)).

It is also worthwhile to emphasise that paragraph 13 requires those responsible for the quality control system to understand the **entire text** of the standard and to apply its requirements properly.

1. Documentation

Document the operation of the quality control system so that the firm complies with the relevant ISQC 1 requirements (paragraphs 17, 57-59 of ISQC (UK and Ireland) 1).

The standard requires firms to establish, maintain and document both policies and procedures in respect of the various areas included. These should be appropriate to the size and nature of the firm. Put simply, a policy is a statement of intent and a procedure is the means by which the firm seeks to ensure the related policy is achieved.

Example: Documentation of the quality control system

Policy: The firm's system of quality control is appropriately documented to demonstrate compliance with ISQC 1 and *[name of sole practitioner]* takes responsibility for ensuring this happens.

Procedure: The firm maintains an ISQC 1 file, which includes policies to address the elements of a quality control system as set out in ISQC 1 and how the firm will deliver them. This is kept up to date and the contents are clearly communicated to staff.

Many of the required procedures are likely to be covered by a firm's standard audit and other documentation. Others might happen; it is just that they might not have been fully documented in the past. The key is to bring it all together for ISQC (UK and Ireland) 1 purposes, for example:

- audit manual;
- ethics manual;
- staff manual;
- standard letters and checklists;
- and so on…..

All the above will be referred to in the firm's ISQC (UK and Ireland) 1 documentation.

2. Leadership responsibilities

Lead from the top giving consistent messages on the importance of quality control (paragraphs 16(a), 18-19).

A key feature is that the firm's chief executive or senior partner or managing board (or equivalent) assumes the ultimate responsibility for the firm's quality control system. They should promote an internal culture that makes quality central to the way the firm operates its audit practice. It might be helpful for firms to have a quality control partner but, of course, the senior partner retains the ultimate responsibility.

3. Ethical requirements

Act ethically in accordance with the relevant Standards and pronouncements (paragraphs 16(b), 20-25).

The standard gives particular guidance on auditor independence. UK audit firms can be confident that they will meet the requirements if they comply with the APB's Ethical Standards for Auditors www.frc.org.uk/apb/publications/ethical.cfm, and ethical standards and guidance from ICAEW icaew.com/ethics. Annual written statements on independence are required from all firm personnel required to be independent by relevant ethical requirements.

4. Acceptance and continuance

Accept only those engagements where the firm is confident it can provide a service in compliance with requirements with particular emphasis on integrity and competencies (paragraphs 16(c), 26-28).

Firms need to consider and document as appropriate the following factors when accepting or continuing audit relationships and engagements:

- the integrity of the client;
- the firm's competence to perform the engagement; and
- whether ethical requirements can be complied with.

Typical questions that firms might ask include the following:

- Is this a specialist area where specialist skills will be required?
- Are we satisfied on auditor independence, eg, if we are providing non-audit services?
- Have there been examples of fraud?

Issues that are identified will not necessarily preclude the firm from accepting the engagement, for example where there has been a significant fraud but appropriate action has been taken to deal with this.

5. Human resources

Recruit, develop and support capable and competent staff giving due attention to the firm's human resources policies and procedures (paragraphs 16(d), 29-31).

Human resources (HR) policies and procedures will cover areas such as:

- recruitment;
- obtaining references;
- induction; and
- career development.

Firms will need to assess the effectiveness of the firm's performance evaluation and reward system with appraisal reviews being fully documented. The HR policies/procedures should help to ensure:

- partners and staff assigned to audits have the competencies they need and the necessary commitment to quality;
- they are sufficiently independent and approach audits with a mindset of professional scepticism;
- training is tailored to the needs of the firm and its clients; and
- there is a commitment to partners and staff complying with Continuing Professional Development (CPD) requirements.

Post audit reviews and audit compliance reviews play an important part in identifying personal development and training issues and there is a need for an integrated approach between HR and audit policies.

6. Engagement performance

Deliver quality audits that comply with law, regulations and standards, including consulting when needed and meeting requirements for engagement quality control review (paragraphs 16(e), 32-47).

There is a great deal covered under this heading but in summary it's all about ensuring audits are performed to the standards expected. Some key issues for achieving quality audits include the following:

- timely planning;
- appropriate and timely use of technical specialists; and
- effective post audit reviews which are linked to HR appraisals (see above) and planning the audit for the next year.

Consultation

Firms need to know when they should consult, for example if there is:

- an unusual accounting treatment;
- concern about going concern; or
- a complex valuation.

Firms should have people lined up that they can use for this purpose. It is important for firms to be able to demonstrate that the conclusions from consultations have been acted upon.

Engagement quality control review (EQCR)

An EQCR is required for all audits of listed entities and other entities as appropriate (determined by the firm's own criteria). These criteria would normally include:

- public interest;
- the nature of the engagement; and
- unusual circumstances or risks.

The EQCR reviewer should have the necessary skills and experience, and be independent. Firms should be able to demonstrate that the EQCR has been acted upon and this is all fully documented. It is worth emphasising that the responsibilities of the engagement partner remain the same.

7. Monitoring

Monitor and seek continuous improvement of the firm's system of quality control and carry out a periodic objective inspection of a selection of completed audit engagements (paragraphs 16(f), 48-56).

This section covers firms' internal reviews. Reviewers of completed engagements ('cold-file reviews') should not be involved with the engagement or the EQCR and this might create a challenge for very small firms where there is no independent person within the firm suitably qualified to fulfil this role. Paragraph A66 gives an example of three years for the review cycle but points out that the manner in which the review cycle is organised depends on a number of factors including the size of the firm. The guide emphasises the possible value to firms of external reviews at a time of rapid change in the standards and legal and regulatory framework underpinning audits.

ICAEW Member Services provide an audit compliance review service for smaller audit firms including cold-file reviews: icaew.com/membersupport.

ICAEW Audit Regulations

The audit regulations have also been updated for the new standard – see icaew.com/index.cfm/route/113613.

IFAC guidance

IFAC has issued a second edition of its lengthy *Guide to Quality Control for Small and Medium-Sized Practices*: http://press.ifac.org/news/2010/07/ifac-smp-committee-publishes-quality-control-implementation-guide.
This guide includes sample manuals for firms to use.

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