

Agenda Item 11

Standing Advisory Group Meeting

June 21-22, 2004

Potential Standard – Quality Control Standards

The Standing Advisory Group ("SAG") will discuss the issues associated with developing and issuing a new Public Company Accounting Oversight Board ("PCAOB") standard for quality control pursuant to the requirements of the Sarbanes-Oxley Act of 2002 (the "Act"). The purpose of the discussion is to (a) review requirements of the Act, (b) describe the current PCAOB interim standards on quality control, and (c) consider issues for a potential new quality control standard that would enhance the current standard and provide greater safeguards that firms and their personnel comply with applicable auditing and related professional practice standards of the PCAOB and conduct the firm's audit practice in a manner that is congruent with professional standards, professional values, the public interest and the protection of investors.

Overview

The Act directs the Board to establish quality control standards to be used by registered public accounting firms in the preparation and issuance of audit reports, as required by the Act or the rules of the Securities Exchange Commission ("SEC" or "Commission"), or as may be necessary or appropriate in the public interest or for the protection of investors.^{1/} The Act further states that the Board –

^{1/} Section 103 (a)(1). Also, Section 102 of the Act requires that every public accounting firm that prepares or issues, or participates in the preparation or issuance of,

This paper was developed by the staff of the Office of the Chief Auditor in order to foster discussion among the members of the SAG. It is not a statement of the Board; nor does it necessarily reflect the views of the Board or PCAOB staff.

shall include, in the quality control standards that it adopts with respect to the issuance of audit reports, requirements for every registered public accounting firm relating to –

- (i) monitoring of professional ethics and independence from issuers on behalf of which the firm issues audit reports;
- (ii) consultation within such firm on accounting and auditing questions;
- (iii) supervision of audit work;
- (iv) hiring, professional development, and advancement of personnel;
- (v) the acceptance and continuation of engagements;
- (vi) internal inspection; and
- (vii) such other requirements as the Board may prescribe.^{2/}

In developing a standard for quality control, the advice of the SAG is sought as described in this briefing paper.

Background

Interim Quality Control Standards – The AICPA developed the first quality control standards for accounting firms in the United States in the 1970s, at approximately the same time that it established the two divisions for firms (the SEC Practice Section and the Private Companies Practice Section) and related peer review requirements. Each of the respective practice sections required its members to comply with the quality control standards and to have periodic peer reviews to assess and report on compliance. Prior to the establishment of the PCAOB, the Auditing Standards Board ("ASB") of the AICPA issued the quality control standards as Statements on Quality Control Standards.

The PCAOB has designated the Statements on Quality Control Standards issued by the Auditing Standards Board, as they existed on April 16, 2003, as the Board's interim quality control standards.^{3/} These include the following three sections^{4/}

any audit report for any company subject to the reporting requirements of the Securities and Exchange Commission ("SEC" or "Commission") must register with the PCAOB.

^{2/} Section 103(a)(2)(B) of the Act.

- QC sec. 20 – *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*;
- QC sec. 30 – *Monitoring a CPA Firm's Accounting and Auditing Practice*; and
- QC sec. 40 – *The Personnel Management Element of a Firm's System of Quality Control – Competencies Required by a Practitioner-in-Charge of an Attest Engagement*.

The Board also designated certain membership requirements of the AICPA SEC Practice Section ("SECPS") as additional interim quality control standards, although those membership requirements are applicable only to those registered firms that were members of the SECPS. (See Appendices A and B)

The interim quality control standards define quality control as "a process to provide the firm with reasonable assurance that its personnel comply with applicable professional standards and the firm's standards of quality."^{5/} The interim quality control standards identify the following five broad elements of quality control –

- Independence, integrity, and objectivity;
- Personnel management;
- Acceptance and continuance of clients and engagements;
- Engagement performance; and
- Monitoring.

^{3/} PCAOB Rule 3400T, Release No. 2003-006, *Establishment of Interim Professional Auditing Standards*. (See Appendices A and B.)

^{4/} The Statements on Quality Control Standards are shown in the *AICPA Professional Standards, Vol. 2*, and are referenced with the "QC" prefix.

^{5/} QC sec. 20.03.

Items Emphasized in the Interim Quality Control Standards – In general, the interim quality control standards specify policies and procedures related to the basic auditing functions, including management of auditing personnel, client acceptance and continuance, and audit engagement performance, in addition to the monitoring of these policies and procedures. These standards also contain a brief discussion of policies and procedures related to independence, integrity, and objectivity.

Items Not Addressed in Interim Quality Control Standards – Considerable evidence exists that many audit failures and problems that led to passage of the Act were largely attributable to factors that are not addressed in the existing quality control standards. While the current interim quality control standards cover several elements of a firm's system of quality control, they do not contain certain other elements. For instance, factors not specifically addressed in the interim quality control standards include –

- Professionalism – Central importance of professional standards, professional values, the public interest, and the protection of investors
- Firm governance
- Distribution of responsibility within the firm, especially with respect to the relative power of those with primary responsibility for professional standards and those with primary responsibility for client service
- System of compensation and rewards for partners and staff
- Assessment of the risks that professional standards, professional values, and the public interest may be violated and the failure to adequately respond to and control those risks, or both, and
- Mechanisms to detect, report, and correct quality control problems and to continuously improve audit quality.

The *International Standard on Quality Control* – In February 2004, the International Auditing and Assurance Standards Board ("IAASB") issued International Standard on Quality Control ("ISQC") No. 1, which establishes international requirements for accounting firm quality control related to assurance engagements. ISQC No. 1 addresses several factors not covered in the previous quality control standards and may be a useful resource as the SAG considers quality control requirements that are necessary and appropriate for firms registered with the PCAOB.

Establishing a New Standard – The Act directs the PCAOB to establish new quality control standards and to amend or otherwise modify or alter existing quality control standards "as may be necessary or appropriate in the public interest or for the protection of investors."^{6/} Accordingly, the SAG is asked to consider whether the current PCAOB interim standards on quality control should be enhanced to provide greater safeguards that firms and their personnel comply with applicable professional standards and standards of quality and to provide reasonable assurance that the practice of auditing of public companies is conducted in a manner that protects the interests of investors and furthers the public interest in the preparation of informative, fair, and independent audit reports.

Basic Foundation Underlying a Quality Control System

Firm Culture: Focus on Professionalism—Professional standards, values and the public interest – A registered firm's culture and values are of utmost importance to the effective functioning of its quality control system. A firm's culture and values are closely intertwined and permeate every aspect of the firm's operations. The culture and values of the firm should reflect the basic principle that high quality professional work – consistent with professional standards, professional values, and the public interest – is the firm's ultimate and pre-eminent goal.

A written statement of the firm's values and a written code of conduct, consistent with professional standards, professional values, and the public interest, would be consistent with a firm's commitment to professionalism. To be effective, these written policies would need to be communicated effectively to partners, staff, and other persons associated with the firm.

1. Discussion Question – What should the PCAOB quality control standard require with respect to a firm's culture, including a central focus on professionalism and the public interest?

Related question –

- a. What assessment methods are realistic and practical to use to measure a firm's culture, including whether the firm's actual behavior, informal communications, and business decisions are consistent with the firm's

^{6/} Section 103(a)(1) of the Act.

stated values and code of conduct, PCAOB standards, and the public interest?

Firm Governance – Appropriate firm governance is important to the proper functioning of a quality control system. Firm governance issues include the firm's distribution of authority and responsibility. For example, a firm's governance practices may include the designation of individuals to have primary responsibility for establishing the firm's policies for accounting methods or auditing procedures and policies regarding whether their decisions may be overruled by individuals responsible for client service.

Good corporate governance practices for issuers require the establishment of a board of directors that is independent of management. Another commonly accepted corporate governance practice is to have the internal audit staff of issuers report directly to an independent audit committee.

The SAG is asked to consider whether it also would be a sound firm governance practice to have registered firms – especially larger registered firms – establish independent review boards of highly respected, highly competent individuals who are independent of the firm to oversee the firm's quality control system. Additionally, the SAG is asked to consider whether registered firms should appoint a quality control monitoring officer, completely independent from firm management, with authority, responsibility, and resources to effectively monitor and oversee the firm's quality control system

2. Discussion Question – What should the PCAOB quality control standard require with respect to a registered firm's governance?

Related questions –

- a. Should the PCAOB quality control standard address aspects of the firm's distribution of authority and responsibility that have an effect on audit quality?
- b. Should the PCAOB require (or strongly encourage) firms to establish independent review boards of highly respected, highly competent individuals who are independent of the firm to oversee the firm's quality control system? Should the firm's internal inspection personnel report directly to this independent board?

- c. Should the PCAOB quality control standard require firms to appoint an independent quality control monitoring officer?

Firm's System of Compensation and Rewards – The effectiveness of a quality control system could be seriously weakened by a system of compensation that rewarded audit partners and staff for selling non-audit services, for example, rather than conducting high quality audits. Accordingly, the SAG is asked to consider issues relating to a firms' system of compensation and rewards.

3. Discussion Question – What should the PCAOB quality control standard require with respect to a registered firm's system of compensation and rewards for partners, professional staff, and others associated with the firm?

Related question –

- a. What are the key elements in ensuring that a firm's system of compensation and rewards (for partners, professional staff, and others associated with the firm) is consistent with PCAOB standards, professional values, and the public interest?

Firm's Process of Identifying, Assessing and Controlling the Risk of Violating Professional Standards, Values and the Public Interest – An accounting firm's quality control system has many similarities to an issuer's system of internal control. The Committee of Sponsoring Organizations of the Treadway Commission ("COSO") document, *Internal Control: Integrated Framework*, which is used by most issuers as criteria for management reports and audits of internal control over financial reporting, includes risk assessment as one of the basic components of internal control. The COSO framework describes the rationale for including risk assessment as a basic component as follows –

Every entity faces a variety of risks from external and internal sources that must be assessed. A precondition to risk assessment is establishment of objectives, linked at different levels and internally consistent. Risk assessment is the identification and analysis of relevant risk to achievement

of the objectives, forming a basis for determining how the risks should be managed.^{7/}

A risk assessment process would, likewise, be an important basic component in a firm's quality control system.

4. Discussion Question – What should the PCAOB quality control standard require with respect to a registered firm's processes for identifying, assessing and controlling significant risks that PCAOB standards, professional standards, professional values, or the public interest might be violated?

Quality Controls for the Basic Audit Quality Functions

The interim quality control standards address some of the basic audit quality functions including the following –

- Human resources – attracting and developing people with appropriate competencies and ethical values to perform high quality professional services;
- Client acceptance and continuance – attracting and accepting appropriate issuer-clients who demand high quality professional services and rejecting or discontinuing other issuers; and
- Engagement performance – performing the auditing service at a high professional quality and in the public interest.

The interim quality control standards provide a limited discussion of the quality control policies and procedures related to these basic audit quality functions, and ISQC No. 1 provides somewhat greater discussion of these topics.

Although no discussion questions related to these areas are presented for discussion at this SAG meeting, the PCAOB's Office of the Chief Auditor would welcome input from SAG members regarding recommendations for significant changes related to these areas that they believe are necessary in the interim quality control standards.

^{7/} *Internal Control—Integrated Framework*, Committee of Sponsoring Organizations of the Treadway Commission ("COSO"), Volume 1 (1994), page 33.

Monitoring and Internal Inspections – Including Mechanisms to Detect, Report, and Correct Quality Control Problems and Continuously Improve Audit Quality

Monitoring and internal inspection are important functions in a firm's quality control framework and may, with engagement quality reviews and PCAOB inspections, help ensure that registered firms consistently conduct high quality audits. The purpose of the monitoring and internal inspection functions is to provide reasonable assurance that the quality control policies and procedures are appropriately designed, operating effectively, complied with in practice, and sufficient to achieve the overall quality control objective that the firm and its personnel comply with professional standards, standards of the PCAOB, and the firm's quality standards. Monitoring and internal inspection include the ongoing evaluation of all of the elements of quality control and periodic inspections of completed engagements and of various aspects of the quality control system. The monitoring and internal inspection functions should evaluate quality control deficiencies and identify systemic or repetitive deficiencies that require timely corrective action.

Both the PCAOB interim quality control standards and ISQC No. 1 address policies and procedures for monitoring and internal inspections of a firm's quality control system. Accordingly, the SAG is asked to consider whether a new PCAOB standard on quality control should adapt and build on the basic concepts in these standards related to monitoring and internal inspection.

5. Discussion Question – What significant changes, if any, should be made in the PCAOB interim quality control standards with respect to monitoring and internal inspections?

Related questions –

- a. What policies, procedures, and mechanisms are likely to be most effective to enhance the likelihood that violations will be properly detected, reported, and corrected?
- b. What quality control requirements are needed to provide reasonable assurance that appropriate "whistle-blowing" action will occur when individuals become aware of violations of professional standards, professional values, the firm's stated values or code of conduct, or the public interest?

APPENDIX A

EXCERPT ON INTERIM QUALITY CONTROL STANDARDS FROM PCAOB RELEASE NO. 2003-006

Interim Quality Control Standards

(Note: Footnotes to this excerpt are not included here.)

Section 103(a)(1) authorizes the Board to establish quality control standards for registered public accounting firms. Until enactment of the Act, the ASB's Statements on Quality Control Standards ("SQCS") were the primary source of such standards. In addition, public accounting firms that are members of the AICPA's SEC Practice Section have committed to satisfying a number of other quality control-related requirements. Consistent with the Interim Auditing Standards and the Interim Attestation Standards, the Board's Rule 3400T designates the Statements on Quality Control Standards adopted by the ASB, as they existed on April 16, 2003, as the Board's Interim Quality Control Standards.

Rule 3400T also designates certain AICPA SEC Practice Section membership requirements as additional Interim Quality Control Standards. It should be noted that the Board is not adopting as interim standards the entirety of the AICPA SEC Practice Section's membership requirements. Further, because the Board intends the Interim Quality Control Standards to preserve existing standards as they apply currently, consistent with Section 103(a)(3) of the Act, those Interim Quality Control Standards adapted from the AICPA SEC Practice Section requirements apply only to those firms that are members of the AICPA SEC Practice Section. The requirements incorporated in Rule 3400T, which are described in more detail in Appendix B, relate to the following matters –

- Continuing professional education of audit firm personnel;

- Concurring partner review of the audit report and the financial statements of Commission registrants;
- Communication by written statement to all professional personnel of firm policies and procedures on the recommendation and approval of accounting principles, present and potential client relationships, and the types of services provided;
- Notification of the Commission of resignations and dismissals from audit engagements for Commission registrants;
- Audit firm obligations with respect to the policies and procedures of correspondent firms and of other members of international firms or international associations of firms; and
- Policies and procedures to comply with applicable independence requirements.

APPENDIX B

***EXCERPT ON INTERIM QUALITY CONTROL STANDARDS,
INCLUDING TECHNICAL AMENDMENTS, FROM RULE 3400T***

Rule 3400T – Interim Quality Control Standards – A registered public accounting firm, and its associated persons, shall comply with quality control standards, as described in –

- (a) The AICPA's Auditing Standards Board's Statements on Quality Control Standards, as in existence on April 16, 2003 (AICPA Professional Standards, QC sections. 20-40 (AICPA 2002)), to the extent not superseded or amended by the Board; and
- (b) The AICPA SEC Practice Section's Requirements of Membership (d), (f)(first sentence), (l), (m), (n)(1) and (o), as in existence on April 16, 2003 (AICPA SEC Practice Section Manual § 1000.08(d), (f), (j), (m), (n)(1) and (o)), to the extent not superseded or amended by the Board.