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## **STANDING ADVISORY GROUP MEETING**

### **POTENTIAL STANDARD—ELEMENTS OF QUALITY CONTROL**

**NOVEMBER 17-18, 2004**

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#### **Introduction**

The Standing Advisory Group ("SAG") discussed the development of a new Public Company Accounting Oversight Board ("PCAOB" or the "Board") standard on quality control at its meeting in June 2004. During that discussion, SAG members raised important issues that warrant further discussion. Also, because of time constraints, some of the issues identified in the briefing paper for that meeting were not fully discussed. Therefore, these issues are on the agenda for the November 2004 meeting. SAG members should consider the issues described in this paper in the context of the overall issues raised in the briefing paper for the June meeting.

In June, the SAG discussed quality control issues related to firm culture, governance, compensation and rewards, quality control risk assessment, and monitoring. To further the development of a proposed quality control standard, the staff would like the SAG's advice on the following matters:

- Elements of an audit quality control system;
- Mechanisms that encourage "whistle-blowing" and enhance the likelihood that violations of professional standards and the public interest would be detected, reported, and corrected;
- Quality control considerations for smaller registered firms; and
- Requirements for competence, continued professional education, and continuing competency development for auditors of public companies.

This paper was developed by the staff of the Office of the Chief Auditor 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.

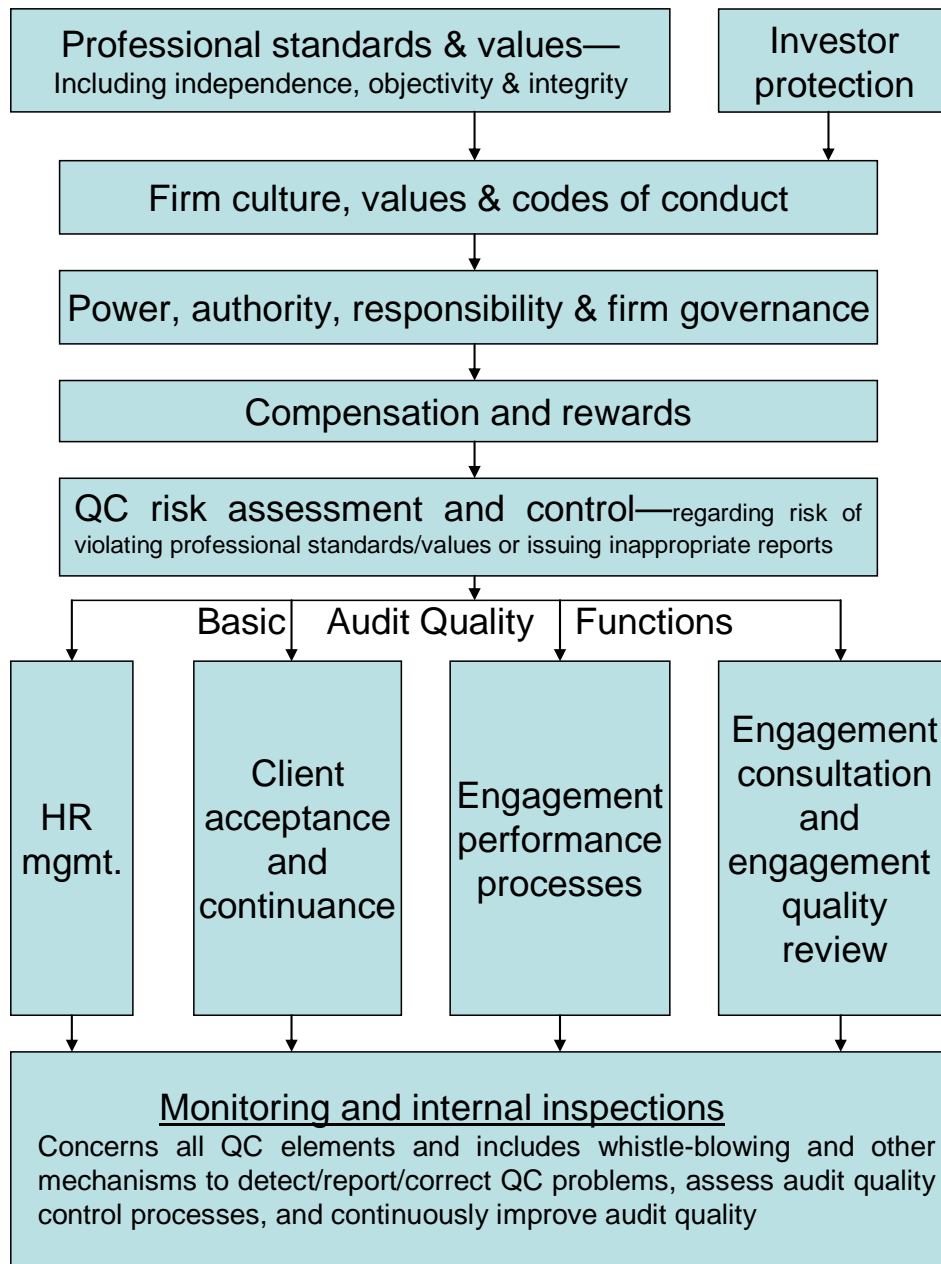
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The overall objective of a registered firm's quality control system is to ensure that a registered firm and its partners, staff, and associated persons comply with PCAOB standards. PCAOB standards are grounded on a set of professional values that places highest priority on providing high quality professional services that serve the public interest and protect the integrity of financial reporting, which is critical to the investing public.

**Elements of an Audit Quality Control System.** An effective audit quality control system needs to have appropriate policies and procedures related to all critical elements of quality control. In thinking about what elements are critical to a registered firm's quality control, the staff has developed the example of elements of an audit quality control system shown in Figure 1. Following the example is a brief description of each of the elements.

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**Figure 1**  
**Illustrative Audit Quality Control System**



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**Professional Standards & Values and Investor Protection.** A distinguishing mark of a profession is acceptance of its responsibility to the public. One way to reflect this responsibility is for registered firms to establish systems of quality control that ensure conformity with PCAOB standards, including those related to independence, objectivity, and integrity as the underpinnings for professional work.

**Firm Culture, Values, and Codes of conduct.** A registered firm's culture and values are of utmost importance to the effective functioning of its quality control system. High quality professional work is an important consideration in the context of a firm's culture.

The effectiveness of a firm's culture and values would be meaningless without a way to communicate them to partners, staff, and all other persons associated with the firm. A firm's written code of conduct is an important method of communicating the firm's values. Other methods of formal and informal communications, whether internal or external to the firm, that are congruent with the stated firm values and with professional values, applied and reinforced consistently by actual behavior, business strategies, and professional decisions, reinforce the culture and values.

**Power, authority, responsibility and firm governance.** The power, authority and responsibility vested in a registered firm result from the public trust granted to the firm to fulfill its societal role related to the protection of the integrity of financial reporting, which is crucial to the functioning of commerce and capital markets. Top management in the firm can make it clear that firm governance processes and the allocation of power, authority, and responsibility within the firm are based on the recognition of the ultimate importance of high quality professional work, PCAOB standards, professional values, and protecting investors.

**Compensation and rewards.** Policies and procedures for evaluating, compensating, and otherwise rewarding partners and staff can ensure that the highest priority is given to performance of high quality audits and audit-related services in conformity with PCAOB standards, professional values, and the protection of investors. Factors for the firm to consider in compensating and rewarding its personnel would include the person's demonstrated independence, objectivity and professional skepticism in the performance of professional responsibilities, especially as they relate to audit and audit-related work.

The firm can provide consistent positive recognition for compliance with its quality control policies and procedures through methods that include partner and staff appraisals as well as promotion and remuneration policies. In addition, the firm can

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maintain and clearly communicate an appropriate disciplinary framework for non-compliance that sets out clear penalties for instances of non-compliance together with guidance on how and in what circumstances such penalties will be applied.

**Quality Control Risk Assessment and Control.** Continuing or periodic assessment of potentially significant risks of violation of PCAOB standards or professional values is important. An analysis and action plan related to how each potentially significant risk can be controlled adequately would accompany any assessment.

**Human Resources Management.** The firm must ensure that it has sufficient personnel with the competencies and professional characteristics necessary to perform its engagements in accordance with PCAOB standards and applicable regulatory and legal requirements and to ensure that engagements reports are appropriate in the circumstances. Attracting and hiring only those individuals who possess the appropriate characteristics to enable them to perform competently and in conformity with PCAOB standards, professional values, and the public interest is important.

**Client Acceptance and Continuance.** Controls regarding the acceptance and continuance of client relationships are important in a firm's system of quality control. Appropriate policies and procedures can help to ensure that the firm undertakes or continues only those relationships and engagements in which the firm:

- Has considered the integrity of company management and does not believe that the client lacks integrity;
- Is competent to perform the engagement and has the resources to do so; and
- Can comply with all PCAOB standards in the conduct of the engagement.

**Engagement Performance Processes.** Engagement performance processes should be designed so that engagements are performed in accordance with PCAOB standards and applicable regulatory and legal requirements, and that engagement reports are appropriate in the circumstances. Such processes address matters on which the firm seeks to establish consistency in the quality of engagement performance by its personnel. Often, this is accomplished by establishing written or electronic manuals, software tools, or other forms of standardized documentation, and industry or specific subject matter guidance materials. The firm must ensure that all members of the

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engagement team understand the objectives of the work they are to perform and that all work performed by the engagement team is adequately reviewed.

**Engagement Consultation and Engagement Quality Review.** An important consideration for a quality audit engagement centers on whether:

- Appropriate consultation takes place on difficult or contentious matters;
- Sufficient resources are available to enable appropriate consultation to take place;
- Conclusions resulting from such consultations are adequately documented; and
- Conclusions resulting from consultations are implemented.

The firm also should ensure that, for every audit or review engagement of an issuer, an engagement quality review (a second partner review, as required by the Sarbanes-Oxley Act of 2002) is performed in accordance with PCAOB standards.

**Monitoring and Internal Inspections.** Monitoring and internal inspection processes help ensure that the policies and procedures relating to the system of quality control are relevant, adequate, appropriately updated, adapted to changing conditions, and operating effectively. In addition, they can provide a reliable evaluation of whether the firm's system of quality control ensures that the firm and all persons associated with the firm comply with PCAOB standards.

### Discussion Question –

1. **Should a new PCAOB standard on quality control address all elements shown in Figure 1? If not, which component(s) should be omitted, added or changed?**

**Whistle-Blowing.** An effective quality control system could ensure that violations of professional standards, the firm's stated values or code of conduct, and applicable laws and regulations are detected, reported, and corrected on a timely basis. To accomplish this, registered firms could establish appropriate policies and procedures that encourage "whistle-blowing." Then, complaints and allegations originating from within or outside the firm, by firm personnel, clients or other third parties and by engagement

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team members or other firm personnel, could be addressed by the whistle-blowing process.

Certain features that will encourage the appropriate reporting of violations might include, among others:

- Clear communication from firm leaders to all personnel regarding the methods available for reporting complaints or allegations including the provision of anonymity or confidentiality if desired by the complainant;
- A clear policy that retribution or sanctions against complainants will not be tolerated and procedures to enforce the policy effectively;
- Thorough investigation of complaints and allegations in accordance with established policies and procedures under the supervision of a partner (or other appropriate person) with sufficient competence and authority who is not otherwise involved in the situation being addressed; and
- Appropriate action by the firm in response to the findings of the investigation.

### Discussion Question –

2. **What features of a whistle-blowing process would provide reasonable assurance that appropriate "whistle-blowing" action will occur when individuals become aware of violations?**

**Smaller Registered Firms.** Effective quality control for both larger and smaller registered firms is essential to the PCAOB mission of protecting the interests of investors and furthering the public interest. However, some quality control policies and procedures that are appropriate and cost-effective for larger registered firms may not be appropriate and cost-effective for smaller registered firms. For example, larger firms may have a policy that an engagement quality review must be performed by another partner within the firm, but a smaller registered firm may find that no other partner within the firm is appropriately qualified to perform the review and decide to select an appropriately qualified reviewer outside the firm. As another example, certain small firms are exempt from the SEC's requirement for mandatory partner rotation. To compensate for this, the SEC's rule requires that engagements subject to this exemption automatically be selected for PCAOB inspection.

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### Discussion Question –

3. **To what extent, if any, should the PCAOB allow exceptions to quality control standards or requirements for smaller firms? Or is it sufficient to note that the way quality control is implemented in each firm may be different, but each firm must nevertheless have an effective quality control system?**

**Auditor Competence Requirements.** High-quality audits and effective audit quality control require auditors who possess a high level of professional competence with respect to all aspects of the audit. The interim quality control standards have limited requirements regarding competency including a requirement that a firm should have policies and procedures that address practitioner-in-charge competencies related to:

- Understanding of the role of a system of quality control and the code of professional conduct;
- Understanding of the service to be performed;
- Technical proficiency;
- Familiarity with the industry;
- Professional judgment; and
- Understanding the organization's information technology systems.<sup>1/</sup>

PCAOB interim quality control standards include certain membership requirements of the former SEC Practice Section, including CPE requirements, which are applicable to registered firms that were members of the SEC Practice Section. The SEC Practice Section membership requirements contained a provision that firms ensure that all professionals in the firm residing in the United States participate in at least 20 hours of qualifying continuing professional education ("CPE") every year and at least 120 hours every three years, with individuals who have at least 25% of their time

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<sup>1/</sup> Statements on Standards for Quality Control, QC Section 40.09.



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devoted to audit, review, or attest engagements required to have 40% of their required CPE in subjects related to accounting and auditing.<sup>2/</sup>

Future auditors of issuers will likely need to develop and maintain high levels of competence with respect to understanding and evaluating information systems and internal controls, preventing and detecting fraud, and evaluating the fair value of assets and liabilities.

### **Discussion Questions –**

- 4. Should the PCAOB quality control standard establish requirements for competency, continuing professional education, and continuing competency development for auditors of public companies?**
- 5. Should auditor competency requirements be established with respect to each of the following areas:**
  - Evaluation of information systems and internal controls;**
  - Prevention and detection of fraud; and**
  - Evaluation of fair value?**

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The PCAOB is a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.

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<sup>2/</sup> SEC Practice Section Manual, SECPS Section 1000.08 (d).