Compliance with Framework of Quality Control General & Specific Controls

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Suggested Reading

- ✓ SQC 1 (issued by AASB- called as Mother Standard on Auditing)
- ✓ Implementation Guide to SQC 1 (Gives procedures for each of the six elements)
- ✓ Part B of Blank Questionnaire Format to be submitted by PU for Peer Review

Agenda of this Presentation

- ✓ What are quality controls in the context of peer review?
- ✓ Review of general controls
- ✓ Review of specific controls – additional procedures

FRAMEWORK OF QUALITY CONTROL

What is the Framework of Quality Control?

FRAMEWORK

A framework of quality control in a Chartered Accountant firm is a comprehensive system of policies, procedures, and internal culture established to provide reasonable assurance that the firm and its personnel comply with professional standards and legal/regulatory requirements.

This framework is primarily governed by the Standard on Quality Control (SQC) 1 .

FRAMEWORK

This framework ensures that the reports issued by the firm or engagement partners are appropriate in the circumstances and that high-quality audit and assurance services are maintained.

SQC 1

- **Q: Do SQC 1 requirements apply to all firms?**

  A: Yes

- **Q: Are there any exemptions for small firms?**

  A: No, but the nature of policies and procedures that a small firm is expected to follow may depend upon factors like its size, operating characteristics and whether it is part of a network

- **Q: What is the peer reviewer's responsibility for this?**

  A: A peer reviewer is expected to test if the PU has complied with SQC 1 and, if not, to determine that the PU has failed in complying with general controls.

What does SQC 1 require a firm to do?

- ✓ To establish and communicate QC policies and procedures
- ✓ To implement those standards in its day to day practice
- ✓ To monitor the implementation and effectiveness of the QC policies and procedures that it has adopted
- ✓ The peer reviewer has to evaluate and report if the PU has done all of the above

Six Elements of Policies

As per SQC 1 policies and procedures, Six elements are given which are as follows:

1- Leadership Responsibilities

2-Ethical Requirement

3- Acceptance and continuance of client relationships and specific engagements

4-Human Resources

5-Engagement Performance and

6- Monitoring

(Implementation Guide gives the procedures to be adopted for each policy – Can be used for verifying compliance of General Controls)

Quality Control Manual

Quality control manual is the same as the policies framed by the firm for six elements under SQC 1

Compliance Testing of Controls

- ✓ What are controls? - preventive, detective
- ✓ Controls testing (compliance approach) v substantive testing (substantive approach)
- ✓ Tests of design, implementation, and operating effectiveness
- ✓ Controls testing methods in peer review Inquiry, corroborated by inspection of documents

Types of controls in peer review

- ✓ **General controls (SQCs) (Procedures) –**

  These are quality controls at the firm level, designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements and that reports issued by the firm or engagement partner are appropriate in the circumstances

- ✓ **Specific controls (SAs, SAEs, SREs) (Procedures)–**

  These are controls at the engagement level, designed to ensure that the ET plans and performs an assurance engagement in compliance with the standards on auditing or review and other regulatory and legal requirements.

Compliance Review of General Controls

Review of general Controls

Change in concept of general controls-

– Earlier, there were 5 general controls. Now, SQC 1 has codified all these aspects into one Quality Control Standard

– mandatory wef 1st April 2009 and has 6 elements

– Leadership responsibilities for quality within the firm, ethical requirements, acceptance and continuance of client relationships and specific engagements, human resources, engagement performance, and monitoring

Documentation and communication of QC

- ✓ QC policies and procedures that are established by the firm must be

  (a) documented, (b) communicated to the firm's personnel
- ✓ Such communication describes the policies and their objectives.
- ✓ Emphasizes that each individual has personal responsibility for quality and is expected to comply with the policies
- ✓ Explains that the firm encourages its personnel to communicate their views/ concerns on QC matters

1st element

Leadership responsibilities

Pointers-

- ✓ Tone at the top to be set for quality and its message to percolate down the line
- ✓ QC to tie in to partner/ staff appraisals
- ✓ Commercial considerations must not override quality of work and reporting
- ✓ Sufficient resources are devoted to develop, document and support quality control policies and procedures
- ✓ Firm's quality controller to have sufficient and appropriate experience, ability and authority
- ✓ Performance evaluation and compensation system to be design for personnel

2nd element

Ethical requirements

- ✓ **Code of Ethics:** Integrity, objectivity, professional competence and due care, confidentiality, and professional behaviour
- ✓ **Independence :** Independence Policies to be made based on the "threats and safeguards" approach

What are "threats" to independence?

- ✓ **Self-interest threat:** Auditor could benefit from an interest
- ✓ **Self-review threat:** Auditor audits his own work
- ✓ **Advocacy threat:** Auditor promotes client's position/ opinion
- ✓ **Familiarity threat:** Relationship buys auditor's sympathy
- ✓ **Intimidation threat:** Auditor succumbs to client's threats

Illustrative “safeguards”

- ✓ Involving an additional advisory or reviewing partner or manager
- ✓ Rotation of partner/ manager
- ✓ Discussion of independence matters with audit committee or board
- ✓ Independence confirmations from the engagement team
- ✓ Removing individuals who might cause a threat – eg those with financial/ business interests or having employment relationships
- ✓ Training in independence and ethics to be given

What independence policies should a PU have?

- **Financial interests:** Investments in debt/ equity, making borrowings except commercially, taking insurance, giving loans, being executor/ trustee, etc
- **Employment relationships:** Serving as officer/ director, relatives in accounting/ financial reporting oversight role, taking employment or being in employment negotiations
- **Business relationships:** Having business relationship or joint investment (partnership interest)
- **Long association:** Using the same partner/ staff, rotation policy say after 5 years, cooling off period
- **Gifts and hospitality:** Accepting gifts/ hospitality unless clearly insignificant
- **Fees:** Total fees from auditee are large proportion of firm's fees, long unpaid fees (=loan), contingent fee arrangements
- **Scope of services:** Service proscribed by law (internal audit), behaving/ having authority in a management role, taking decisions for management, custody of auditee's assets, supervising auditee's employees, preparing source documents for the auditee.

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Non-audit services – Companies Act 2013, Section 144

- ✓ Accounting and book keeping services
- ✓ Internal audit
- ✓ Design and implementation of any financial information system
- ✓ Actuarial services
- ✓ Investment advisory services
- ✓ Investment banking services
- ✓ Rendering of outsourced financial services
- ✓ Management services
- ✓ Any other kind of services as may be prescribed

Continued.....

- ✓ **Complying with the policies:** Partners/ staff responsible for understanding policies, provide details for independence control, systems to help compliance

- ✓ **Confirming compliance:** Annual confirmation, engagement confirmation
- ✓ **Understanding consequences of non-compliance:** Firm's disciplinary process/ actions, ignorance no excuse

(If the policies cover these procedures then prima facie there are General Controls)

3rd element

Acceptance and continuance of client relationships and specific engagements

- ✓ Considerations for client acceptance/ continuance: Evaluating client for reputation of integrity – internet media and industry searches, reputation of promoters/ KMPs, related parties, any criminal antecedents
- ✓ Background checks
- ✓ Conflicts of interest – other clients
- ✓ Nature of operations, business practices, aggressive accounting, low fees, time pressures
- ✓ Does firm have resources to handle work?
- ✓ Communication with predecessor auditor
- ✓ Does firm want to associate its name with client?
- ✓ Industry- whether highly sophisticated or closely regulated?

Considerations for engagement acceptance/ continuance

- ✓ Understanding of services to be performed, knowledge and expertise, industry knowledge, quality and quantity of personnel and specialists, ability to perform within time- line, changes in client personnel, reporting requirements, scope of work, delinquency in paying fee, intimidation of team, weak internal controls, going concern

- ✓ Processes for controlling acceptance/ continuance, conflict resolution and withdrawal

- ✓ Formal approval process – engagement acceptance letter and continuance form

4th element

Human resources

- ✓ Resources possess desired characteristics
- ✓ Firm determines required capabilities/ competencies – partners and personnel, assigns responsibility
- ✓ Right person on right job, right partner, effective supervision
- ✓ Continuing professional education, upgradation of industry and accounting/ auditing skills (including IT skills), and ability to exercise professional skepticism
- ✓ Promotion criteria – technical competency and professional maturity, rather than mere seniority
- ✓ Responsibility of each engagement to an engagement partner
- ✓ Designated individual for HR
- ✓ Yearly evaluation of personnel and partners

5th element

Engagement performance

- ✓ **Firm has practice aids and performs engagement planning :** Selection of team, responsibilities, developing/ updating background information, risk assessment and responses to risks including fraud considerations, tailored detailed audit programs, time budget, engagement planning memorandum

- ✓ **Engagement performance, supervision, review, documentation, reporting, file archival :** Consistency in engagement quality (manuals), written audit programs, managing new risks, compliance with standards (checklists), documentation, consultation, and resolving differences of opinion, supervision, review, engagement summary memorandum, EQCR, report issuance, file assembly, back-up/ archival, file retention

6th element

Monitoring

- ✓ **Quality controller:** Updating policies, procedures, manuals, checklists Monitoring compliance with firm manuals and ethical policies, review (EQCR, PR) observations

- ✓ **Annual inspection (practice review):** Covering all general and specific controls – Firm QC inspection checklist

- ✓ Complaints and allegations

- ✓ Documentation of all elements of firm's QC system Can be used by Peer Reviewer to Assess the PU's compliance with Quality Controls

Review of General Controls– bearing on PR s

- ✓ A review of general controls under SQC 1 also encompasses the 'compliance procedures' under Review of Records
- ✓ Review of general controls should take up at least or more than half of the time allowed for peer review if the PU has documented policies and procedures
- ✓ Having completed this review, the peer reviewer is ready to move directly to 'substantive procedures' – which essentially means 'file review'
- ✓ If results of testing general controls are good, the peer reviewer may reduce the sample size for file review that he may have selected originally
- ✓ If results of testing general controls are not good, or if the PU does not have documented policies and procedures, the peer reviewer will not be able to provide a "clean report" to the PU

Compliance Review of Specific Controls

Review of specific controls – additional procedures

What are specific controls?

Specific controls are those that ensure that the engagement teams in the PU, when doing audit, **uphold compliance with –**

- ✓ Laws and regulations – eg Income Tax Act, 1961/2025 for tax audits or Banking Regulation Act, 1949 for bank audits
- ✓ Accounting standards – either of the ICAI or those prescribed under Sec 133 of the Companies Act 2013
- ✓ Standards on auditing of the ICAI –or Any other applicable standards of the ICAI – eg standards on review engagements (references of various SA's will come in upcoming slides)

How far does review of general controls also cover specific controls?

- ✓ When testing QC for the 5th element – Engagement Performance, a reviewer may call for checklists used by PU for compliance with standards
- ✓ When testing general controls, the peer reviewer would therefore perform test of 'design' and 'implementation' on those controls
- ✓ By these additional procedures for testing specific controls, the peer reviewer now tests the 'operating effectiveness' of those controls

What is the difference?

- ✓ The control objective is that the specific controls ensure that all laws, regulations and accounting and auditing standards are complied with by the PU
- ✓ To meet this objective the PU may have designed checklists or other controls. Controls testing is done to find out if this objective is met
- ✓ Test of design = To see if the checklists, as designed, have the level of detail and accuracy to meet the objective
- ✓ Test of implementation = To see if the firm actually uses those checklists when performing its audits in all cases
- ✓ Test of operating effectiveness = To see if, by using the checklists, the desired compliance is indeed achieved at the engagement level

How should the peer reviewer check operating effectiveness?

- ✓ The most efficient way would be to combine this testing with the file reviews
- ✓ When reviewing an audit file, ask how the engagement team (ET) has ensured compliance with all relevant laws, regulations and various standards
- ✓ If there are checklists, ask to see them in the working paper file
- ✓ Then, pick out items at random from each checklist and ask the ET to show from other workpapers in the same file how they actually ensured what they have asserted

Performing file reviews

(Testing of Specific Controls)

Basic Principle of Documentation

- लिहिलेले करायचे आणि केलेले लिहायचे ’
- Whatever is written (in SAs, technical standards etc.) is to be done and whatever is done is to be written

Selection of files

- ✓ General considerations
- ✓ Period of coverage is three years
- ✓ Different types of engagements should be selected
- ✓ Files of various partners and from all significant branches should be selected

Understanding the firm's audit approach

When reviewing general controls the peer reviewer may get an overall understanding of the PU's processes – however, now for compliance of specific controls he should see each engagement file.

- ✓ **Step 1:** Therefore the peer reviewer needs to sit with them and understand how that ET did the audit – the work flow and the documentation .When doing so, he also simultaneously tests whether the process followed by ET is the same as was explained to him earlier – otherwise it is apparent that the general and specific controls installed by the PU are not operating effectively

Understanding the risks identified

Step 2: The peer reviewer should then ask the ET to explain what audit risks they identified (SA 315) and the rationale behind them; he should then inspect the related documentation

Also, what processes the ET follow to identify the risk of fraud (SA 240)

Step 3: Then the peer reviewer should obtain an understanding of what audit procedures the ET planned to perform to respond to the identified risks – including fraud risks (SA 330); he should then inspect the related documentation

(This is relevant for ‘ Engagement Performance ‘ 5th element of Quality control)

What if no risks were identified responded to?

- ✓ If, based on his examination of related documentation, the finding is that the ET has not identified and responded to risks, a “risk- based audit” as per auditing standards may not have been done – this would be a major weakness in complying with the standards
- ✓ Besides, if duties cast on the auditor under SA 240, Auditor’s Responsibilities for Fraud, are not recorded in the audit documentation, the PU could well be exposed to significant risk – and this would again be a major weakness in complying with the standards

Materiality and planning

- ✓ **Step 4:** The peer reviewer may then inquire about the materiality established by the ET for performing the audit (SA 320); he should then inspect the related documentation
- ✓ **Step 5:** He should then inspect the Engagement Planning Memorandum (SA 300) to ensure that the ET had spent adequate time and effort in properly planning the audit – commensurate with the size and complexity of the entity audited
- ✓ If, based on his examination of related documentation, the finding is that the ET has not adequately planned the audit, this would be a major weakness in complying with the standards

Controls testing

- ✓ In large sized engagements it is not possible to obtain sufficient audit assurance without performing tests of internal controls (SA 315) – ie by performing only tests of detail (transaction vouching)
- ✓ **Step 6:** If he has selected a large entity, the peer reviewer should understand the process and inspect documentation of identification and testing of internal controls
- ✓ If, based on his examination of related documentation, the finding is that in a large audit controls were not adequately tested, the peer reviewer should challenge how the ET claims to have obtained sufficient appropriate audit evidence (SA 500) by performing only tests of detail

Substantive testing and sampling

- ✓ Having performed controls testing in large entities, the auditor uses the result of his "control assurance" to decide the scope and extent of substantive procedures, which may be of two types: analytical and tests of detail
- ✓ In audits of smaller entities, the ET may rely completely on substantive procedures as the number of transactions is manageable
- ✓ The peer reviewer should inquire and inspect documentation to determine if the ET has followed SA 530, Sampling – as adequacy of scope of work depends on appropriate sampling
- ✓ Determining sample size is the auditor's judgement, but the peer reviewer should inspect documentation to see if this judgement is as required under SA 530

Compliance with accounting standards

- ✓ The peer reviewer should read the Notes to the Financial Statements to understand if the significant accounting policies are, prima facie, in accord with accounting standards
- ✓ If that is not the case, he should inquire if the appropriateness of such policy is supported by other evidence and/ or consultation
- ✓ When obtaining an understanding of the entity's business, he should also inquire how accounting is done for various types of transactions and corroborate the explanation with relevant documentation in the workpapers
- ✓ He should also examine how the ET ensured compliance, using the PU's accounting standards checklist

Audit of estimates and judgements

- ✓ From a study of the financial statements, the peer reviewer should identify major management estimates and judgements
- ✓ He should then ask the ET to explain how they audited these estimates and judgments
- ✓ He should then inspect the related documentation to see if sufficient work was done to validate the estimates as per SA 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures
- ✓ If, based on his examination of related documentation, the finding is that the ET has not done sufficient work per SA 540 or has not tested sufficient appropriate audit evidence to evaluate judgements, this would be a major weakness in complying with the standards

Going concern

- ✓ If the entity's net worth is eroded or business suspended or such other information is available, it may raise a question about the appropriateness of using the going concern assumption in preparation of the financial statements
- ✓ If such indicators exist, the peer reviewer should ask to examine the ET's documentation of how they have dealt with the going concern matter and whether the audit is in compliance with the disclosure and reporting requirements of SA 570
- ✓ If, based on his examination of related documentation, the finding is negative, this would be a major weakness in complying with the standards

Evaluation of misstatements

- ✓ Often, errors found by ET in tests of detail by sample are corrected by the management, but no audit procedures are performed to evaluate if the extent of likely misstatements in the untested population is expected to be material – unless this is done, it is not possible to conclude that the financial statements are not materially misstated to give a true and fair opinion
- ✓ The peer reviewer should inquire about such procedures in accordance with SA 450, Evaluation of Misstatements Identified During the Audit, and examine corroborative evidence in the workpapers file
- ✓ If, based on such examination, it is found that the ET did not perform any such procedures, it would be a major weakness in complying with the standards

Other auditing standards

- ✓ The peer reviewer should evaluate if the other auditing standards of the Institute are complied with.
- ✓ Some of these important standards are :
  - SAs 501 (audit evidence – special),
  - 505 (external confirmations),
  - 550 (related parties),
  - 560 (subsequent events), and
  - 580 (written representations)

Reporting
The auditor's report

- ✓ It is his "finished product" and is the document that gives his audit opinion – a conclusion of all his efforts
- ✓ Any intended or unintended error or omission in the auditor's report could invite disciplinary action and other litigation on the auditor and PU
- ✓ Inappropriate audit opinions also tarnish the image of the Institute as well as the whole profession and may even invite regulatory retribution
- ✓ It is necessary for the peer reviewer to spend time to examine if the audit documentation supports the auditor's opinion

Continued.....

He should also carefully examine-

-If matters that should be qualified are in fact qualified, and if not, whether the audit documentation contains justification for that.

-If matters that are significant to a user's understanding of the financial statements are reported as matters of emphasis.

-If there are pervasive misstatements where audit evidence was available, or pervasive possible misstatements where audit evidence was not available or denied, or where there are multiple uncertainties whose aggregate possible effect could be pervasive, the auditor should not have given a "qualified" opinion but rather a disclaimer of opinion or an adverse opinion.

REFERENCES OF SQC 1 IN PEER REVIEW REPORTING

- ✓ In questionnaire submitted by PU for peer review application, PART B gives general controls (based on SQC 1) which is to be filled in by PU.
- ✓ In annexure I of peer review report (Q No. 5) the peer reviewer has to report whether general controls for six elements are in existence and operating effectively.
- ✓ In annexure I of peer review report (Q No. 24a) peer reviewer has to report :
  - has the practice unit shared quality control manual with reviewer
  - is the quality control manual in compliance with the responses submitted by the PU under PART B of the questionnaire.

- ✓ In annexure II of peer review report at serial no. 1 the peer reviewer has to report whether the PU's system of quality control include policies and procedures addressing the SIX Elements.
- ✓ In annexure II of peer review report at serial no. 3 & 4 responses about some para's of SQC 1.
- ✓ In final audit report of peer reviewer the peer reviewer has to give opinion on the implementation of quality control policies.

Request to peer reviewer

- ✓ Reviewers will have to revise knowledge of accounting and auditing standards, including SQC 1 – this will be professionally enriching
- ✓ Reviewers will realise weaknesses in QC and documentation within their own practices and therefore should conduct mock Peer Review of their own office first

Lesson from Drishyam Movie

कौनसी चीजे हमें याद रहती हैं ?

‘जो जिंदगी हम जितें हैं वो हमें याद रहती हैं ‘

Request to Peer Reviewer

- And before starting Peer Review of the PU allotted to you, please set right your own office reasonably well ….

REMEMBER THE DIALOGUE FROM WAQT MOVIE

चिनॉय शेठ , जिनके घर शिशेंके हो , वो दुसरेपर पत्थर नहीं फेंका करते

'अजी रूठकर अब कहाँ जायीयेगा
जहाँ जायीयेगा हमें पायियेगा'

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Everest Cantu

Thanks!