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SELF-STUDY CONTINUING PROFESSIONAL EDUCATION

Companion to PPC's Guide to

Quality Control–Compilation and Review

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Interactive Self-study CPE

Companion to PPC's Guide to Quality Control—Compilation and Reivew

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INTRODUCTION

Companion to *PPC's Guide to Quality Control–Compilation and Review* consists of one interactive self-study CPE course. This is a companion course to *PPC's Guide to Quality Control–Compilation and Review* designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **OnlineGrading.Thomson.com** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **April 30, 2011**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit Answer Sheet.

Taking the Course

This course is divided into lessons. Each lesson addresses an aspect of Quality Control–Compilation and Review. You are asked to read the material and, during the course, to test your comprehension of each of the learning objectives by answering self-study quiz questions. After completing each quiz, you can evaluate your progress by comparing your answers to both the correct and incorrect answers and the reason for each. References are also cited so you can go back to the text where the topic is discussed in detail. Once you are satisfied that you understand the material, **answer the examination questions which follow each lesson**. You may either record your answer choices on the printed **Examination for CPE Credit Answer Sheet** or by logging on to our Online Grading System.

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PPC is registered with the National Association of State Boards of Accountancy as a sponsor of continuing professional education on the National Registry of CPE Sponsors (Registry) and as a Quality Assurance Service (QAS) sponsor. Part of the requirements for both Registry and QAS membership include conforming to the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the standards). The standards were developed jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the standards. Each course is designed to comply with the standards. For states adopting the standards, recognizing QAS hours or Registry hours, credit hours are measured in 50-minute contact hours. Some states, however, require 100-minute contact hours for self study. Your state licensing board has final authority on accepting Registry hours, QAS hours, or hours under the standards. Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program or have adopted the standards and allow QAS CPE credit hours. Alternatively, you may visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours or have adopted the standards. Credit hours for CPE courses vary in length. Credit hours for each course are listed on the "Overview" page before each course.

CPE requirements are established by each state. You should check with your state board of accountancy to determine the acceptability of this course. We have been informed by the North Carolina State Board of Certified Public Accountant Examiners and the Mississippi State Board of Public Accountancy that they will not allow credit for courses included in books or periodicals.

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Online Grading. Log onto our Online Grading Center at **OnlineGrading.Thomson.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. You may search for the exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. For further instructions regarding the Online Grading Center, please refer to the Test Instructions preceding the Examination for CPE Credit Answer Sheet. A certificate documenting the CPE credits will be issued for each examination score of 70% or higher.

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COMPANION TO PPC'S GUIDE TO QUALITY CONTROL–COMPILATION AND REVIEW

COURSE 1

ETHICAL REQUIREMENTS, CLIENT RELATIONSHIPS, ENGAGEMENT PERFORMANCE, AND MONITORING (GCRTG101)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course covers various topics related to quality control–compilation and review including relevant ethical requirements, acceptance and continuance of client relationships, engagement performance, and monitoring procedures.
PUBLICATION/REVISION DATE:	April 2010
RECOMMENDED FOR:	Users of *PPC's Guide to Quality Control–Compilation and Review*
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of compilation and review engagements
CPE CREDIT:	9 QAS Hours, 9 Registry Hours Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.
FIELD OF STUDY:	Business Management & Organization
EXPIRATION DATE:	Postmark by **April 30, 2011**
KNOWLEDGE LEVEL:	Basic

Learning Objectives:

Lesson 1—Ethical and Independence Requirements Relevant to a Firm's Practice

Completion of this lesson will enable you to:
- Identify relevant ethical requirements, policies, and procedures under SQCS No. 7.
- Describe compliance with independence requirements and how to maintain that independence.

Lesson 2—Acceptance and/or Continuance of Client Relationships and Engagements

Completion of this lesson will enable you to:
- Identify the requirements of SQCS No. 7 regarding acceptance and/or continuance.

Lesson 3—Proper Performance of Engagements and Issuance of Reports

Completion of this lesson will enable you to:
- Determine the engagement performance, supervision, and review requirements of SQCS No. 7.
- Summarize consultation and engagement quality control review requirements under SQCS No. 7.
- Identify the firm's quality control policies and procedures and their impact.

Lesson 4—Monitoring Quality Control Systems for Proper Design and Effective Operation

Completion of this lesson will enable you to:
- Describe various aspects of monitoring including types of monitoring activities, monitoring procedures, and documentation.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

Thomson Reuters
Tax & Accounting—R&G
GCRTG101 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700

See the test instructions included with the course materials for more information.

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 431-9025 for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: Ethical and Independence Requirements Relevant to a Firm's Practice

INTRODUCTION

SQCS No. 7

The second element of quality control is relevant ethical requirements. *Relevant ethical requirements* are defined by SQCS No. 7 as "ethical requirements to which the firm and its personnel are subject, which consist of the AICPA *Code of Professional Conduct* together with rules of state boards of accountancy and applicable regulatory agencies, which may be more restrictive." While this definition refers to the many ethical requirements to which a firm may be subject, SQCS No. 7 primarily discusses the ethical requirement of independence.

Learning Objectives:

Completion of this lesson will enable you to:
- Identify relevant ethical requirements, policies, and procedures under SQCS No. 7.
- Describe compliance with independence requirements and how to maintain that independence.

SQCS No. 7 requires the firm's system of quality control to include policies and procedures to address each of the quality control elements. To provide the firm reasonable assurance that relevant ethical requirements are being addressed:

- The firm and its personnel should maintain independence.
- The firm should be notified of breaches of independence requirements and take appropriate actions to resolve such situations.
- The firm should obtain annual written confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent.
- The firm's policies and procedures should address requirements, if any, for the rotation of personnel. This requirement will generally not be applicable for compilation and review-only firms.
- The firm should withdraw from review engagements if threats to independence cannot be mitigated through the application of effective safeguards.

Throughout this course, the phrase *relevant ethical requirements* and *ethical requirements* are used interchangeably to refer to the second element required by SQCS No. 7 to be addressed within the firm's quality control system policies and procedures.

Upcoming Changes to SQCS No. 7

In June 2009, the ASB released for exposure a revised version of SQCS No. 7, A Firm's System of Quality Control (Redrafted), which would supersede SQCS No. 7. The QC standard is being redrafted to apply the ASB's clarity drafting conventions and to converge with the international quality control standard, ISQC 1. The proposed SQCS is expected to be applicable to a firm's system of quality control for its accounting and auditing practice as of January 1, 2011. The proposed SQCS does not change or expand SQCS No. 7 in any significant respect.

ETHICAL REQUIREMENTS THAT ARE RELEVANT

Before beginning the process of designing relevant ethical requirements policies and procedures that fit the firm's practice, it is advisable to become familiar with the ethical rules and regulations under which the firm practices. The AICPA, state boards of accountancy, state societies of CPAs, state statutes, and other regulatory agencies set forth ethical rules and regulations for their members or for CPAs who practice before them. As a result, *all* CPAs (not just members of the AICPA) are subject to such ethical requirements. After relevant ethical requirements policies and procedures are established, it is important for the firm to maintain its familiarity with the ethical requirements under which it operates. Such a familiarity is necessary not only to comply with SQCS No. 7, but also to monitor staff adherence to the firm's policies and procedures, to keep the policies and procedures current, and to ensure that quality control policies and procedures are consistent with the needs of the firm.

SQCS No. 7 (QC 10.20) indicates that the AICPA *Code of Professional Conduct* (the *Code*) establishes the Fundamental Principles of professional ethics. Those Fundamental Principles are listed in SQCS No. 7, but originate from ET 50 of the *Code*. The *Code* identifies those principles as:

- *Responsibilities*. "In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their activities."

- *The Public Interest*. "Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism."

- *Integrity*. "To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity."

- *Objectivity and Independence*. "A member should maintain objectivity and be free of conflicts of interest in discharging professional responsibilities. A member in public practice should be independent in fact and appearance when providing auditing and other attestation services." (While independence is not required to perform compilation services, the accountant's report should specifically disclose the lack of independence.)

- *Due Care*. "A member should observe the profession's technical and ethical standards, strive continually to improve competence and the quality of services, and discharge professional responsibility to the best of the member's ability."

- *Scope and Nature of Services*. "A member in public practice should observe the Principles of the *Code of Professional Conduct* in determining the scope and nature of services to be provided."

The *Code* is comprised of articles, rules, interpretations, and rulings. Exhibit 1-1 details the location of current AICPA ethics requirements within the *Code*.

Exhibit 1-1

Listing of Ethical Requirements in the AICPA *Code of Professional Conduct*

Description	Location
Article I—Responsibilities	AICPA *Code* at ET 52
Article II—The Public Interest	AICPA *Code* at ET 53
Article III—Integrity	AICPA *Code* at ET 54
Article IV—Objectivity and Independence	AICPA *Code* at ET 55
Article V—Due Care	AICPA *Code* at ET 56
Article VI—Scope and Nature of Services	AICPA *Code* at ET 57
Rule 101—Independence	AICPA *Code* at ET 101

Interpretations under Rule 101: Interpretations 101-1 through 101-15	AICPA *Code of Professional Conduct* at ET 101
Rule 102—Integrity and Objectivity	AICPA *Code of Professional Conduct* at ET 102
Interpretations under Rule 102: Interpretations 102-1 through 102-6	AICPA *Code of Professional Conduct* at ET 102
Ethics Rulings on Independence, Integrity, and Objectivity: Ethics Ruling Nos. 1–114	AICPA *Code of Professional Conduct* at ET 191
ET Section 200—General Standards–Accounting Principles	AICPA *Code* at ET 200
ET Section 300—Responsibilities to Clients	AICPA *Code* at ET 300
ET Section 400—Responsibilities to Colleagues	AICPA *Code* at ET 400
ET Section 500—Other Responsibilities and Practices	AICPA *Code* at ET 500

* * *

With the exception of independence, the Fundamental Principles apply to all AICPA members and in all professional engagements. That is, regardless of whether a member is performing an attest service or a consulting service, a member is subject to the requirements of the Fundamental Principles. The principle of independence applies only to members in public practice when they provide audit, review, and other attestation services. As previously mentioned, independence is not required to perform compilation services. Each of the fundamental principles is discussed in more detail in the following paragraphs.

Responsibilities

As members of the AICPA, practitioners are expected to be aware of their responsibility to the users of their professional services. AICPA members also have a continuing responsibility to cooperate with other members and practitioners to improve the profession of accounting, maintain the public's confidence in the profession, and carry out the profession's special responsibilities of self-governance.

The Public Interest

The AICPA defines the accounting profession's public as consisting of clients, credit grantors, governments, employers, investors, the business and financial community, and others who rely on the objectivity and integrity of CPAs to maintain the orderly function of commerce. The public interest is the collective well-being of the community of people and institutions the profession serves. When members encounter conflicting pressures from those groups, members should act with integrity and be guided by their responsibility to the public. The public relies on CPAs to act with integrity, objectivity, due professional care, and a genuine interest in serving the public.

Integrity

Merriam-Webster's Dictionary defines *integrity* as "resolute adherence to a code of especially moral or artistic values; incorruptibility." That definition says a lot about integrity as a foundational value; but the *Code* describes integrity specifically in terms of the member's responsibility. Integrity requires a member to be honest and candid, yet respect the constraints of client confidentiality. Practitioners can make inadvertent mistakes or have honest differences of opinion and still maintain integrity. However, practitioners cannot practice deceit or subordination of principle and keep their integrity. Integrity is measured in terms of what is right and just, and it also requires a member to observe the principles of objectivity, independence, and due care. Integrity requires a member to observe both the form and the spirit of technical and ethical standards. It is the quality against which a member must test all decisions.

Objectivity and Independence

Merriam-Webster's Dictionary defines *objectivity* in general terms as "an expressing or dealing with facts or conditions without distortion by personal feelings, prejudices, or interpretations." The *Code* discusses objectivity as a state of mind that adds value to a member's services, but also imposes an obligation to be impartial, intellectually honest, and free of conflicts of interest. To be independent, members should avoid relationships that may appear to impair their objectivity in rendering attestation services.

Members in public practice maintain objectivity and independence through a continual assessment of client relationships and public responsibility. Members who provide attestation services should be independent in both fact and appearance. In providing all other services, members should maintain objectivity and avoid conflicts of interest.

Generally, objectivity can be viewed in two ways. First, it is similar to integrity in that it relates to the state of mind and is not an ethical decision made before accepting or commencing an engagement. Individuals with integrity will practice with objectivity. As with integrity, it is not believed that procedures should be in the engagement work programs or that questions should be in questionnaires regarding this aspect of the objectivity principle.

Second, objectivity involves conflicts of interest. Ethics Interpretation 102-2 (ET 102.03) states, "A conflict of interest may occur if a member performs a professional service for a client . . . and the member or his or her firm has a relationship with another person, entity, product, or service that could, in the member's professional judgment, be viewed by the client . . . or other appropriate parties as impairing the member's objectivity." It is believed that, as it relates to an accounting and auditing engagement, a conflict of interest generally would impair independence and should be addressed in the quality control system as any other independence consideration.

When Is Independence Required? Independence requirements that apply to compilation and review-only firms are found in the SSARS and SSAEs (including statements covering prospective financial information). While the authoritative literature governing these various types of engagements contains a great deal of discussion about the concepts of independence and objectivity, identifying independence problems, and resolving nonindependence situations, the basic concept of independence is the same regardless of the level of service or the type of engagement. Accountants are independent if they are free from obligation to or interest in their clients. The basic independence requirements for services performed in a compilation and review practice as found in the SSARS and SSAEs are detailed in Exhibit 1-2.

Exhibit 1-2

A Listing of Independence Rules in the Professional Standards

Type of Engagement	Requirement if Not Independent
Historical Financial Statements:	
• Compilations	The accountant may issue a standard compilation report, but must include a statement about the lack of independence (AR 100.23).
• Reviews	The accountant may not issue a review report if he is not independent, but he may step down to a compilation (AR 100.53).
Prospective Financial Information:	
• Compilations	The accountant may issue a compilation report, but must include a statement about lack of independence (AT 301.23).
• Agreed-upon Procedures	The accountant is precluded from issuing a report (AT 301.52).
Other Attestation Engagements:	
• Reviews	The accountant is precluded from issuing a report (AT 101.35).

• Examinations (other than examinations of prospective financial statements)	The accountant is precluded from issuing a report (AT 101.35).
• Agreed-upon Procedures	The accountant is precluded from issuing a report (AT 101.35).

* * *

Due Care

Due care requires competence and diligence, and obligates performance of professional services to the best of the AICPA member's ability. Competence begins with education and experience and is maintained by continual learning throughout a member's professional life. In all engagements and responsibilities, a member undertakes to achieve a level of competence that assures the quality of the member's services meets the high level of professionalism required by the Fundamental Principles of the *Code*. Being competent also requires consultation when an engagement exceeds the member's or firm's own level of competence. Members are responsible for assessing whether their own education, experience, and judgment are adequate for the engagement. Due care also requires adequate planning and supervision.

Scope and Nature of Services

This Fundamental Principle requires that AICPA members consider whether specific services to be provided are consistent with the other Principles of integrity, objectivity and independence, and due care. Members should do the following:

- Practice in firms with quality control systems.
- Assess, according to individual judgment, whether an activity is consistent with their role as professionals.

Guide for Complying with Nonindependence-related Ethics Rules

In 2008, the AICPA and PEEC issued the *Guide for Complying With Rules 102-505*. Ethics Rules 102-505 address what is required of an AICPA member as it relates to complying with integrity and objectivity, general standards, responsibilities to clients and colleagues, and other responsibilities and practices. The *Guide for Complying with Rules 102-505* is designed as a tool and, while its use is not mandatory, the information can assist members in complying with the rules in situations where nonindependence-related issues arise that are not explicitly addressed by the *Code's* interpretations and rulings. The introduction to the guidance indicates that use of the guidance may be considered a prudent step in achieving compliance with the rules. The guidance applies a *threats and safeguards* approach to complying with Rules 102-505 and the related interpretations and rulings, similar to the AICPA *Conceptual Framework*. (While following the guidance provided in the *Guide for Complying with Rules 102–505* is not required, AICPA members are required to follow the guidance provided in the AICPA *Conceptual Framework*.) The *Guide for Complying with Rules 102-505* can be accessed on the AICPA's website at **www.aicpa.org/download/Guide_for_Complying_with_Rules_102_Through_505_11_10_08_Edited.pdf**.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. In order to provide the firm reasonable assurance that relevant ethical requirements are being addressed, SQCS No. 7 requires that the firm comply with a number of ethical requirements. Which of the following accurately represents one of those requirements?

   a. Only the firm's personnel need to maintain independence, not the firm itself.

   b. The firm should be made aware of violations of independence requirements.

   c. The firm should obtain annual verbal confirmation of compliance with its independence policies and procedures from all firm personnel that are required to be independent.

   d. The firm should disclaim an opinion regarding a review engagement if threats to independence cannot be mitigated by applying effective safeguards.

2. Ethical requirements set forth by the American Institute of Certified Public Accountants (AICPA) *Code of Professional Conduct* (the Code) are applicable to which of the following?

   a. Only members of the AICPA.

   b. All CPAs.

3. Jim, CPA, wants to know where in the AICPA *Code of Professional Conduct* the subject of independence is addressed. Which of the following articles will provide Jim with the guidance he is seeking?

   a. Article I at ET 52.

   b. Article II at ET 53.

   c. Article IV at ET 55.

   d. Rule 102 at ET 102.

4. Sarah is performing a prospective financial information engagement. Which of the following reports may Sarah issue, even if she is not independent?

   a. Compilation report.

   b. Agreed-upon procedures report.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. In order to provide the firm reasonable assurance that relevant ethical requirements are being addressed, SQCS No. 7 requires that the firm comply with a number of ethical requirements. Which of the following accurately represents one of those requirements? **(Page 9)**

   a. Only the firm's personnel need to maintain independence, not the firm itself. [This answer is incorrect. Both the firm's personnel and the firm itself should maintain independence to prevent any perception that there is bias in engagement performance.]

   b. The firm should be made aware of violations of independence requirements. [This answer is correct. The firm should be notified of breaches of independence requirements and take the proper actions to resolve them to avoid any perceptions of impropriety. Independence violations can have significant negative ramifications for the firm and the nonindependent partner.]

   c. The firm should obtain annual verbal confirmation of compliance with its independence policies and procedures from all firm personnel that are required to be independent. [This answer is incorrect. The firm should obtain annual *written* confirmation of compliance with its independence policies and procedures from all firm personnel that must maintain independence. By requiring written confirmation, the firm can produce evidence of enforcement of its policies and procedures regarding independence if questions arise during or subsequent to engagement performance.]

   d. The firm should disclaim an opinion regarding a review engagement if threats to independence cannot be mitigated by applying effective safeguards. [This answer is incorrect. If threats to independence cannot be alleviated by applying effective safeguards, the firm should *withdraw* from the review engagement so as not to be associated with an engagement where independence cannot be adequately demonstrated.]

2. Ethical requirements set forth by the American Institute of Certified Public Accountants (AICPA) Code of Professional Conduct (the Code) are applicable to which of the following? **(Page 10)**

   a. Only members of the AICPA. [This answer is incorrect. Members are subject to the ethical requirements set forth by the AICPA in ET 50 of the Code; however, they are not the only CPAs that are required to adhere to the ethical requirements established by the AICPA.]

   b. All CPAs. [This answer is correct. All CPAs are subject to ethical requirements set forth in ET 50 of the AICPA Code, and by other regulatory agencies including state boards of accountancy, state societies of CPAs, and state statutes.]

3. Jim, CPA, wants to know where in the AICPA *Code of Professional Conduct* the subject of independence is addressed. Which of the following articles will provide Jim with the guidance he is seeking? **(Page 10)**

   a. Article I at ET 52. [This answer is incorrect. Article I at ET 52 addresses the firm's responsibilities regarding review engagements.]

   b. Article II at ET 53. [This answer is incorrect. Article II at ET 53 addresses matters of public interest.]

   c. Article IV at ET 55. [This answer is correct. Article IV at ET 55 provides guidance to the firm concerning objectivity and independence requirements.]

   d. Rule 102 at ET 102. [This answer is incorrect. Rule 102 at ET 102 deals with integrity and objectivity.]

4. Sarah is performing a prospective financial information engagement. Which of the following reports may Sarah issue, even if she is not independent? **(Page 12)**

   a. Compilation report. [This answer is correct. Sarah may issue a compilation report; however, she must include a statement regarding her lack of independence in accordance with AT 301.23.]

   b. Agreed-upon procedures report. [This answer is incorrect. Sarah may not issue an agreed-upon procedures report if she is not independent as cited in AT 301.52.]

REQUIREMENTS FOR INDEPENDENCE

Independence is the aspect of relevant ethical requirements that has traditionally received the most attention. Certainly it is the Fundamental Principle of the *Code* that has generated the majority of readily available additional information. This is primarily because not having independence when required can have significant negative ramifications for the firm and the nonindependent practitioner. Additionally, independence is not only required by the *Code* and SQCS No. 7, but by other authoritative pronouncements (such as the SSARS and SSAEs), as well as other regulatory organizations. Complying with the independence requirements of the *Code* ensures that the related independence requirements of SQCS No. 7, SSARS, and the SSAEs are met.

Practitioners should be aware that independence standards of state boards of accountancy, state CPA societies, the DOL, and other regulatory organizations may be different from and more restrictive than those of the AICPA and should be consulted as applicable. AICPA members are required to also follow other regulatory organization independence requirements when performing applicable services.

General Independence Requirements under the AICPA *Code of Professional Conduct*

Rule 101. Rule 101 of the *Code of Professional Conduct* provides the general guidance for independence. Rule 101 (ET 101.01) states:

> A member in public practice shall be independent in the performance of professional services as required by standards promulgated by bodies designated by Council.

This means that independence is required for a service only if standards for that type of service require independence. For example, standards for consulting services do not require independence, but standards for review services do require independence.

Interpretation 101-1 of Rule 101. The following transactions, interests, or relationships impair independence (ET 101.02):

a. During the period of a professional engagement, a *covered member*—

   (1) Had a direct or material indirect financial interest in a client or a commitment to acquire such an interest.

   (2) Was a trustee, executor, or administrator of a trust or estate that had, or was committed to acquire, a direct or material indirect interest in a client, and

      (a) the covered member (individually or with others) had the authority to make investment decisions for the trust or estate; or

      (b) the trust or estate owned or was committed to acquire more than 10% of the client's outstanding equity securities or other ownership interests; or

      (c) the value of the trust or estate's holdings in the client exceeded 10% of the total assets of the trust or estate.

   (3) Had a joint closely held investment that was material to the covered member.

   (4) Had a loan to or from a client or its officer, director, or any individual owning 10% or more of the client's outstanding equity securities or other ownership interests, except as permitted by Interpretation 101-5.

b. During the period of the professional engagement, a partner or professional employee of the firm, his or her immediate family, or any group of such persons acting together owned more than 5% of a client's outstanding equity securities or other ownership interests.

c. During the period covered by the financial statements or of the professional engagement, the firm or a partner or professional employee of the firm was simultaneously associated with the client as a—

(1) Director, officer, employee, or equivalent of a member of management.

(2) Promoter, underwriter, or voting trustee.

(3) Trustee for a client's pension or profit-sharing trust.

d. An individual who was formerly employed by a client or was associated with a client as a(n) officer, director, promoter, underwriter, voting trustee, or trustee for a pension or profit-sharing trust of the client—

(1) Participated on the attest engagement team or was in a position to influence the attest engagement covering any period that includes the former employment or association with the client; or

(2) Was otherwise a covered member with respect to the client unless the individual first disassociates from the client by—

(a) terminating any relationships described in item c. above with the client;

(b) disposing of any direct or material indirect financial interest in the client;

(c) collecting or repaying any loans to or from the client, except for loans specifically permitted or grandfathered under Interpretation 101-5;

(d) ceasing to participate in all employee benefit plans sponsored by the client, unless the client is legally required to allow the individual to participate in the plan (for example, COBRA) and the individual pays 100 percent of the cost of participation on a current basis (Ruling 107 provides exceptions to this provision); and

(e) liquidating or transferring all vested benefits in the client's defined benefit plans, defined contribution plans, deferred compensation plans, and other similar arrangements at the earliest date permitted under the plan. However, liquidation or transfer is not required if a penalty (such as an early withdrawal penalty levied under tax laws, but not other income taxes or market losses on the liquidation) significant to the benefits is imposed upon liquidation or transfer.

e. An individual participating on the attest engagement team has a close relative who had—

(1) A key position with the client, or

(2) A financial interest in the client that—

(a) the individual knows or has reason to believe was material to the close relative; or

(b) enabled the close relative to exercise significant influence over the client.

f. An individual in a position to influence the attest engagement or any partner in the office in which the lead attest engagement partner primarily practices in connection with the attest engagement has a close relative who had—

(1) A key position with the client; or

(2) a financial interest in the client that—

(a) the individual or partner knows or has reason to believe was material to the close relative; and

(b) enabled the close relative to exercise significant influence over the client.

Interpretation 101-1 cannot address all circumstances in which the appearance of independence might be questioned. The *Conceptual Framework for AICPA Independence Standards* should be used by members when making decisions on independence matters that are not explicitly addressed by the *Code*.

Interpretation 101-1, item a., applies to *covered members*. As defined in ET 92.06 and ET 92.13 of the *Code*, a *covered member* is any one of the following:

a. An individual on an attest engagement team;

b. an individual in a position to influence the attest engagement by doing any of the following:

   (1) evaluating the performance or recommending the compensation of the attest engagement partner,

   (2) directly supervising or managing the attest engagement partner and all of that partner's superiors,

   (3) consulting with the attest engagement team about technical or industry-related issues specific to the engagement, or

   (4) participating in or overseeing quality control activities, including internal monitoring, with respect to the attest engagement;

c. a partner or manager who provides nonattest services to the attest client beginning once he or she provides ten or more hours of nonattest services to the client within any fiscal year and ending on the later of the date:

   (1) the firm signs the report on the financial statements for the fiscal year during which those services were provided or

   (2) he or she no longer expects to provide ten or more hours of nonattest services to the attest client on a recurring basis;

d. a partner in the office in which the lead attest engagement partner primarily practices with respect to the attest engagement;

e. the firm and its employee benefit plans; or

f. an entity in which operating, financial, or accounting policies can be controlled (as defined by GAAP for consolidation purposes) by any of the preceding individuals or entities or by two or more such individuals or entities acting together.

Omnibus Proposal of Ethics Interpretations and Rulings. In September 2009, PEEC issued an exposure draft that proposes revisions to certain Ethics Interpretations, Ethics Rulings, and a proposed new definition of the term *confidential client information*. The proposed revisions include:

- Changes to "Application of the Independence Rules to Covered Members Formerly Employed by a Client or Otherwise Associated with a Client," and "Application of the Independence Rules to a Covered Member's Immediate Family," of Interpretation 101-1, under Rule 101.

- Modifications to Ethics Ruling No. 107, "Participation in Health and Welfare Plan Sponsored by a Client," of ET section 191.

- Revisions to "Retirement, Savings, Compensation, or Similar Plans" of Interpretation No. 101-15, "Financial Relationships," under Rule 101.

- Changes to "Distribution of Client Information to Trade Associations," Ethics Ruling No. 2 of ET section 391.

- An addition to the definition of *confidential client information* at ET section 92.

Certain of the proposed revisions indicate that they will be effective on the last day of the month in which they are published in the *Journal of Accountancy*. Certain other more restrictive provisions indicate application to covered members of attest engagement teams or persons in a position to influence attest engagements which have an effective date of January 1, 2011. The exposure drafts are available from the AICPA's website at **www.aicpa.org/download/ethics/Final_Ethics_Exposure_Draft_090209.pdf**.

The *Conceptual Framework for AICPA Independence Standards*

The *Conceptual Framework for AICPA Independence Standards* (ET 100) of the *Code* describes the risk-based approach used by PEEC to determine whether a member's relationship with a client poses an unacceptable risk to the member's independence. In conjunction with issuing that framework, PEEC revised the *Other Considerations* section of Interpretation No. 101-1, "Interpretation of Rule 101" (ET 101.02), of the *Code*. The provisions of the *Conceptual Framework for AICPA Independence Standards* (the *Conceptual Framework*) and the revision to Interpretation 101-1 were effective April 30, 2007.

The *Conceptual Framework* is intended to assist members in understanding independence. Further, members are required to apply the risk-based approach in the *Conceptual Framework* when making independence decisions, unless the related circumstances are explicitly addressed by the *Code*. However, the *Conceptual Framework* may not be used to overcome prohibitions or requirements contained in independence interpretations and rulings (ET 100.03).

Under the *Conceptual Framework's* risk-based approach, a member's relationship with a client is evaluated to determine whether it presents an unacceptable risk to independence. The evaluation gives consideration to threats to independence and related safeguards. If a relationship would compromise the member's professional judgment when rendering an attest service, the risk is unacceptable. The risk is also unacceptable if an informed third party having knowledge of all relevant information would perceive the relationship to be compromising (ET 100.01). Under the risk-based approach (ET 100.04–.05):

- Threats to independence are identified and evaluated, both individually and in the aggregate.
- If identified threats are considered to be at an acceptable level, the risk is at an acceptable level and consideration of safeguards is not required.
- If identified threats are not considered to be at an acceptable level, a determination needs to be made as to whether safeguards already eliminate or sufficiently mitigate the threats. If identified threats have not been eliminated or mitigated, consideration then needs to be given as to whether safeguards can eliminate or sufficiently mitigate them. A threat has been sufficiently mitigated if, after application of the safeguards, it is not reasonable to expect that the threat would compromise professional judgment.
- If no safeguards are available to eliminate an unacceptable threat or reduce it to an acceptable level, the threat would impair independence.

The *Conceptual Framework* defines *threats to independence* as circumstances that could impair (i.e., effectively extinguish) independence. Impairment depends on the nature of the threat, whether it would be reasonable to expect that the threat would compromise the member's professional judgment, the specific safeguards applied to reduce or eliminate the threat, and the effectiveness of those safeguards (ET 100.10).

While it is not possible to identify every circumstance (or combination of circumstances) that creates a threat, seven broad categories of threats need to be considered when threats to independence are being identified and evaluated (ET 100.12–.19):

- *Self-review Threat*—Whether a member reviews, as part of an attest engagement, evidence that resulted from nonattest work performed by the member or his or her firm, e.g., preparing source documents used to generate the financial statements.
- *Advocacy Threat*—Whether a member promotes an attest client's interests or position, such as by promoting the client's securities as part of an initial public offering or representing the client in a U.S. tax court.

- *Adverse Interest Threat*—Whether actions or interests between the member and the client are in opposition, such as whether the client or member has commenced, or expressed intent to commence, litigation against the other.

- *Familiarity Threat*—Whether a member has a close or longstanding relationship with an attest client or knows individuals or entities (including by reputation) who provided nonattest services for the client.

- *Undue Influence Threat*—Whether an attest client's management or other interested parties attempt to coerce or exercise excessive influence over the member.

- *Financial Self-interest Threat*—Whether a member might potentially benefit as a result of having a financial interest in, or some other financial relationship with, an attest client.

- *Management Participation Threat*—Whether a member has taken on the role of client management or otherwise performs management functions on behalf of an attest client.

The *Conceptual Framework* defines *safeguards* as controls that mitigate or eliminate threats to independence. These could range from partial to complete prohibition of the threatening circumstance to procedures that counteract the threat's potential influence. To be effective, a safeguard needs to eliminate a threat or reduce to an acceptable level its potential to impair independence (ET 100.20).

The effectiveness of a safeguard depends on many factors (ET 100.21). Safeguards can be broadly categorized as (ET 100.22):

- Safeguards created by the profession, legislation, or regulation, e.g., requirements for continuing education on independence and ethics.

- Safeguards implemented by the attest client that operate in combination with other safeguards, e.g., policies that identify the types of services the client can hire the firm to provide without causing the firm's independence to be impaired.

- Safeguards implemented by the firm, e.g., an individual at the senior management level is responsible for overseeing the adequate functioning of the firm's quality control system.

ET 100.24–.26 provide numerous examples of specific safeguards relating to each of the categories described above.

Effect on Independence of Performing Nonattest Services for an Attest Client

Interpretation 101-3, "Performance of Nonattest Services," sets general requirements for remaining independent of an attest client, as well as for completing the engagement when performing nonattest services for the client. It also identifies nonattest services that would and would not impair independence. Consulting and tax compliance services typically are nonattest services.

The Interpretation incorporates by reference the independence requirements of other authoritative bodies. It states that failure to meet more restrictive independence requirements of regulatory bodies (such as the DOL and state boards of accountancy) to which the member is subject constitutes a violation of the Interpretation.

Firms that provide compilation and review-only attest services may frequently encounter independence issues for their small business clients because those clients often need more accounting assistance from their CPA firm. To maintain the firm's independence, before providing accounting assistance or performing any nonattest services for attest clients, the firm should determine that the requirements of Interpretation 101-3 have been met. Interpretation 101-3 requires the following with respect to the performance of nonattest services for attest clients:

- The CPA should not perform management functions or make management decisions for the attest client.

- The client must agree to perform certain specific functions in connection with the nonattest services.

- The CPA should document in writing the understanding with the client regarding the nonattest services and the client's responsibilities.

CPAs May Not Perform Client Management Functions or Decisions. The first general requirement for performing nonattest services indicates that a CPA who performs nonattest services for an attest client should not perform management functions or make management decisions. However, the CPA may assist management in those functions or decisions. Performance by the member of certain general activities, regardless of whether the CPA complies with the other requirements of Interpretation 101-3, will impair the member's independence.

Management Responsibilities. The second general requirement is that the CPA be satisfied that the client will be in a position to make an informed judgment on the results of the nonattest services and agree and be able to do the following with respect to the nonattest services engagement:

- Make management decisions and perform management functions.
- Designate a suitably skilled, knowledgeable, and/or experienced, management-level, preferably senior individual to oversee the services to be performed.
- Evaluate the adequacy and results of the services performed.
- Accept responsibility for the results of the nonattest services.

The CPA should be satisfied that the client will be able to meet these requirements and make an informed judgment on the results of the nonattest services. The CPA should be satisfied that the designated individual understands the services to be performed well enough to oversee them. However, the designated individual does not have to possess the expertise necessary to perform the services.

It is not intended that the client designee possess a level of technical expertise equal to the CPA's. The client designee need only understand the nonattest services enough to be able to:

- Provide general direction for the services.
- Understand the key issues the CPA identifies.
- Make any required management decisions.
- Evaluate the adequacy of, and accept responsibility for, the results of the CPA's work.

This may mean the CPA will need to educate client personnel in order to allow them to assume these responsibilities. For example, if the CPA performs routine bookkeeping services for an attest client, he or she could ensure compliance with the client designee competency requirements of the Interpretation by reviewing the proposed journal entries with the client and explaining in general terms how each entry affects the financial statements. The client would then be in a position to approve the journal entries and accept responsibility for the financial statements. The client might otherwise be unable or unwilling to assume these responsibilities because, for instance, the client does not have an employee with the necessary skills to oversee the nonattest services or does not have the time or desire to perform the necessary functions. If the client is unable or unwilling to assume these responsibilities, providing the nonattest services would impair the member's independence.

Establish a Written Understanding with the Client. The third general requirement is that, before performing nonattest services, the member should establish and document in writing an understanding with the client about the objectives and limitations of the nonattest services engagement, the services to be performed, the client's acceptance of its responsibilities, and the member's responsibilities. The understanding may be with the client's board of directors or management, as appropriate. The Interpretation does not specify any particular form of documentation, but leaves the form to the member's discretion as long as the documentation clearly articulates the matters required to be documented. Accordingly, the understanding might be documented in a separate engagement letter, in the workpapers, in an internal memo, or in the engagement letter obtained in conjunction with the compilation or review.

If the CPA establishes the required understanding with the client, but fails to prepare the required documentation of such understanding, Interpretation 101-3 at footnote 6 indicates that the member has violated Rule 202, *Compliance With Standards*, but has not impaired his or her independence. Additionally, the CPA is not required to follow the Interpretation 101-3 documentation requirements for:

- Certain routine activities that the CPA performs (such as providing advice and responding to the client's technical questions as part of the normal client-CPA relationship).
- Nonattest services performed prior to the client becoming an attest client. However, after accepting the attest engagement, the CPA must document his or her compliance with the other general requirements, including the requirement to establish an understanding with the client.

General Activities That Impair Independence. The Interpretation lists general activities that impair independence, including the following:

- Authorizing, executing, or consummating a transaction; otherwise exercising authority on behalf of the client; or having authority to do so. Note that just having the authority to authorize, execute, or consummate a transaction impairs the member's independence, even if that authority is not exercised.
- Preparing source documents, in electronic or other form, that evidence the occurrence of a transaction. Source documents are defined as "documents upon which evidence of an accounting transaction are initially recorded," such as customer orders, purchase orders, and payroll time cards. Related additional records and reports created following the creation of source documents are not initial recordings.
- Having custody of client assets.
- Supervising client employees in performing their normal recurring activities.
- Serving as a client's stock transfer or escrow agent, registrar, or general counsel.
- Determining which of the CPA's recommendations need to be implemented.
- Reporting to the board of directors on behalf of management.
- Establishing or maintaining internal controls, including performing ongoing monitoring activities for a client.

ET Interpretation 101-3 includes a table identifying the effect that performance of certain nonattest services for an attest client can have on a member's independence.

Tax Compliance Services. Interpretation 101-3 also addresses tax compliance services. Preparing a tax return and transmitting the tax return and related payment, either electronically or in paper form, to a taxing authority does not impair independence as long as the member does not have custody or control of the client's funds and the individual overseeing the tax services (a) reviews and approves the return and payment and (b) signs the return prior to transmittal, if required for the filing. Signing and filing a tax return impairs independence unless the CPA has legal authority to do so and:

- The taxing authority has prescribed procedures, allowing the taxpayer to permit the CPA to sign and file a return on their behalf, that meet the standards for electronic return originators and officers outlined in IRS Form 8879, or
- An individual in client management who is authorized to sign and file the tax return provides the CPA with a signed statement that indicates:
  - The return is being filed.
  - That the individual is authorized to sign and file the return.

- •• That the individual has reviewed the return, including accompanying schedules and it is true, correct, and complete to the best of their knowledge and belief.

- •• That the individual authorizes the CPA to sign and file the return on behalf of the client.

The Interpretation also indicates that the CPA's representation of the client in an administrative proceeding before a taxing authority does not impair independence providing the member obtains the client's agreement prior to committing the client to a specific resolution with the taxing authority. However, independence is impaired if the member represents the client in court to resolve a tax dispute.

Appraisal, Valuation, or Actuarial Services. According to Interpretation 101-3, performing appraisal, valuation, or actuarial services impairs independence if the results of the service, individually or in the aggregate, would be material to the financial statements and the service involves significant subjectivity. The Interpretation states that valuations related to employee stock ownership plans, business combinations, or appraisals of assets or liabilities generally involve a significant degree of subjectivity and, thus, would impair independence if the results produced are material to the financial statements. Actuarial valuations of pension or postemployment benefit liabilities do not involve a significant degree of subjectivity and, thus, would not impair independence. Other appraisal, valuation, or actuarial services that would not impair independence include those performed for nonfinancial statement purposes, such as for tax planning or compliance, estate and gift taxation, and divorce proceedings. Note, however, that even for these allowed services, the Interpretation's general requirements discussed in preceding paragraphs must be met to preserve independence.

Forensic Accounting Services. Under Interpretation 101-3, certain types of forensic accounting services may impair independence. Independence is impaired if a CPA conditionally or unconditionally agrees to provide expert witness testimony for a client. However, under certain defined conditions, independence is not impaired if the CPA provides expert witness testimony for a large group of plaintiffs or defendants that includes the CPA's client. If the CPA provides litigation services where he or she is a trier of fact, special master, court-appointed expert, or arbitrator in a matter involving a client, independence is impaired.

Internal Audit Assistance Services. Interpretation 101-3 states that assisting with a client's internal audit function impairs the member's independence if the member in effect manages the client's internal audit activities. Specific activities that would impair independence include:

- Performing ongoing monitoring activities.

- Determining which recommendations for control improvement should be implemented.

- Reporting to the board of directors or audit committee on behalf of management or the individual responsible for internal audit.

- Approving or being responsible for the overall internal audit work plan.

- Being listed as an employee in client directories or publications or allowing oneself to be referred to as being in charge of the client's internal audit function.

Performing other internal audit assistance services would not impair independence if the CPA ensures that the client understands its responsibility for directing and managing the internal audit function. To maintain independence, the CPA should ensure that management:

- designates an individual or individuals, who possess suitable skill, knowledge, and/or experience, preferably at the senior management level, to be responsible for the internal audit function;

- determines the scope, risk, and frequency of the services the CPA will perform;

- evaluates the findings and results of the CPA's services; and

- evaluates the adequacy of the internal audit procedures performed and the resulting findings by, among other things, obtaining reports from the CPA.

Independence also would not be impaired by performing engagements under the attestation standards, separate evaluations of the effectiveness of the client's controls, or separate evaluations of the client's ongoing monitoring activities.

Review Nonattest Services Performed for the Client for Possible Independence Problems. The engagement partner assigned to each client should be aware of all services being performed for that client. He or she should also have the primary responsibility for identifying all such services, including nonattest services, and determining if such services impair independence with respect to the client. This identification and determination needs to be performed before each nonattest and attest engagement is performed, including compilation engagements. PPC engagement work programs for all attest engagements include steps to ensure compliance with this procedure. (Although a compilation engagement does not require an accountant to be independent of a client for whom a compilation service is provided, the accountant's report must disclose that he or she is not independent.)

Generally, partners in many local firms will have knowledge of all services performed for each client for which they perform attest and compilation services and a formal system to prepare and maintain a list of such services is unnecessary.

Unpaid Fees and Independence

An accountant's independence can be impaired by unpaid fees. Specifically, Ethics Ruling No. 52 (ET 191.103–.104) states that independence will be considered to be impaired if fees (billed or unbilled) or a note receivable arising from such fees for professional services rendered more than one year prior to the date of the accountant's report remain unpaid when the current year's report is released. (While Ruling No. 52 does not indicate that the unpaid fee must be of a certain amount before it impairs independence, generally, amounts that are trivial would not impair independence.)

The engagement partner assigned to each client should be aware of not only the status of uncollected fees, but also of unbilled fees applicable to that client. Accordingly, the engagement partner (or the accountant in charge under the partner's supervision) should generally have the primary responsibility for determining if there are unpaid fees that would impair the firm's independence. The partner needs to determine that all prior year fees are collected *before* the current year's report is issued. (PPC engagement work programs include program steps to ensure compliance with this procedure.) An alternative to having each engagement partner monitor accounts receivable for each client is to assign the monitoring responsibility for the entire firm to one partner. Some firms adopt both procedures. The firm's QC policies and procedures needs to include consideration of the unpaid client fees on independence.

Additional AICPA Guidance

In addition to the *Code*, including the *Conceptual Framework* and the underlying interpretations and rulings, a variety of independence-related resources are available to members. The AICPA provides resources, publications, and recent developments on the topic of professional ethics on its website at **www.aicpa.org** (select the Professional Ethics/Code of Conduct option under the Professional Resources link on the home page). One regularly published free resource is the AICPA Professional Ethics Division's online newsletter, "Ethically Speaking," that is updated quarterly and provides information about PEEC's current projects and activities. This electronic newsletter provides links to additional ethics-related resources. The AICPA also periodically issues an *Independence and Ethics Alert* that addresses recent developments in independence and ethics and provides information to assist members with their understanding of the independence rules. The July 2009 alert can be ordered at **www.cpa2biz.com**, or it is available on Checkpoint for practitioners who subscribe to the AICPA materials.

Other Independence Requirements

Rules of State Boards of Accountancy and State Societies of CPAs. Most state boards of accountancy and CPA societies adopt the ethics rules of the AICPA as the same rules that govern practices within their states. However, practitioners should determine whether their state has particular rules that are different from those of the AICPA.

Other Regulatory Independence Rules. Practitioners performing engagements for certain government agencies must comply with independence rules that, in some instances, are more restrictive than the AICPA rules. For example, a firm that performs bookkeeping services for a HUD project or an employee benefit plan is not considered independent of the project or plan by HUD or the Department of Labor.

Use of Other Accountants in a Review. A firm may also perform reviews in which significant components are reviewed by other accountants. Although not required by the SSARS, the firm may want to obtain a written or oral confirmation of the other accountants' independence. The SSARS do require, however, that the accountant obtain reports from the other accountants as a basis, in part, for his or her report on his or her review of the financial statements of the entity. Obtaining the other accountants' reports also substantiates the other accountants' independence.

HOW TO MAINTAIN INDEPENDENCE

The discussion of the relevant ethical requirements quality control element in SQCS No. 7 includes multiple *presumptively mandatory* requirements as part of establishing policies and procedures for that quality control element. Each of those requirements is discussed more fully in the following paragraphs of this section.

Initial Thoughts

Does the Firm Need to Be Independent? Because the concept of independence is generally understood and acknowledged by all CPAs, there may be a tendency to establish policies and procedures for this quality control element without a proper degree of forethought. However, some firms may choose *not* to be independent for certain client relationships. Such a business decision for some firms may be to purposely provide only compilation and nonattest services to clients that do not require the firm to maintain independence with respect to those clients. For example, in sole practitioner or small firms, the partners may choose to hold an ownership interest in a client's business, or the firm may generate significant revenue by providing controllership services. While those relationships would impair a firm's independence and, thus, limit the services a firm could provide, such a trade-off might be more desirable to both the client and the firm. In summary, a firm may choose to have independence policies and procedures flexible enough to allow occasional client relationships where the firm is not independent. Obviously, the firm makes such a trade-off decision in full recognition that it will be unable to perform attest services for those clients that require independence.

Minor Independence Violations. Some firms believe that minor independence and other types of ethics violations can be ignored. Additionally, some firms believe such violations can be resolved any time before year-end. However, not taking an independence breach seriously or postponing the resolution of the violation until the firm has time to deal with it (generally after the engagement is completed or even after the report has been issued), can have serious repercussions for the firm and its reputation. Firms are encouraged to treat all ethics violations with an equal degree of importance and to deal with all ethics violations promptly. As undesirable as it may seem to resign from an engagement or to step down to a compilation service because the firm is unable to satisfactorily resolve an ethical conflict, such an action is a better solution than performing a substandard engagement and receiving a modified or even adverse peer review report.

SQCS No. 7 Requirements

SQCS No. 7 requires the firm's system of quality control to include policies and procedures to address each of the quality control elements. To ensure that relevant ethical requirements are being addressed, the firm should establish policies and procedures designed to provide it with reasonable assurance that the firm, its personnel, and, where applicable, others subject to independence requirements maintain independence where required. Independence requirements are set forth in Rule 101 and its related interpretations and rulings of the *Code* and the rules of state boards of accountancy and applicable regulatory agencies.

Many threats to independence are specifically addressed in Rule 101 and its related interpretations and rulings. For independence-related matters that are not explicitly addressed in the *Code*, AICPA members are required to apply the risk-based approach found in the *Conceptual Framework*.

SQCS No. 7 (QC 10.21) indicates that quality control policies and procedures should be designed to enable the firm to accomplish the following:

a. Communicate the independence requirements to its personnel and, where applicable, others subject to those independence requirements.

b. Identify and evaluate circumstances and relationships that create threats to independence. Additionally, the firm should take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards. If effective safeguards cannot be applied, the firm should withdraw from the engagement.

General Requirements. SQCS No. 7 (QC 10.22) indicates that the firm should require the following policies and procedures related to maintaining independence:

a. The engagement partner should consider relevant information about engagements, including the scope of services, to evaluate the overall effect on independence requirements, if any.

b. Personnel should promptly notify the engagement partner and the accounting partner about relationships and situations that create an independence threat so that appropriate action can be taken.

c. The firm should accumulate and communicate relevant information to appropriate personnel so the accounting partner—

   (1) And the engagement partner can determine whether they satisfy independence requirements.

   (2) And the engagement partner can take appropriate action to address identified threats to independence.

   (3) Can maintain current independence information.

Independence Representations. SQCS No. 7 (QC 10.24) states that the firm should, at least annually, obtain confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent. The representations should indicate whether the employee is complying with all of the requirements of Rule 101 and its related interpretations and rulings of the *Code*, as well as the rules of state boards of accountancy and applicable regulatory agencies.

Independence Breaches. SQCS No. 7 (QC 10.23) requires that firms establish policies and procedures to attain reasonable assurance that the firm is notified of breaches of independence and take appropriate actions to resolve such breaches. The firm's policies and procedures should include the following requirements:

a. Personnel should promptly notify the accounting partner of independence breaches once they become aware that a breach exists.

b. The accounting partner should promptly communicate identified breaches of the firm's ethical requirements policies and procedures and the required corrective actions to—

   (1) The engagement partner, who (along with the firm) has the responsibility to address the breach.

   (2) Other relevant personnel in the firm and those subject to the independence requirements who need to take appropriate action.

c. The engagement partner should confirm to the firm when the required corrective actions have been taken.

If the firm receives notice that a breach of its independence policies and procedures has occurred, the firm promptly communicates relevant information to engagement partners and others as appropriate, so that appropriate action can be taken. Additionally, the firm may consider providing independence education to personnel who are required to be independent.

Rotation of Personnel. Certain regulatory agencies or other authorities may require rotation of audit or attestation personnel after a specified period. SQCS No. 7 (QC 10. 26) requires the firm's policies and procedures to address any requirements for rotation of personnel, if applicable.

Upcoming QC Changes

The ASB has issued an exposure draft that would supersede SQCS No. 7. The proposed SQCS keeps all the presumptively mandatory requirements currently existing under SQCS No. 7. Revisions include:

- Adding network firm personnel as others who may be subject to independence requirements (QC 10.21 and QC 10.23).
- Indicating that, if considered appropriate by the firm, engagement withdrawal may occur where withdrawal is possible under applicable law or regulation (QC 10.21).
- Replacing the engagement partner with the firm as being responsible to evaluate independence considerations (QC 10.22–.23).
- New explanatory information relating to the fundamental principles and considerations specific to governmental entities.

Engagement Partner Consideration of Independence

The engagement partner will generally consider relevant information about client engagements and evaluate the overall effect, if any, on independence requirements as part of the engagement acceptance and continuance decision.

To ensure that personnel consider independence on each engagement, many firms include in their work programs and checklists, for each type of service, a step that asks the engagement team whether an independence problem exists and, if so, what steps need to be taken on the engagement. (PPC engagement work programs and checklists include procedures to ensure compliance with this requirement.)

Designating a Partner to Be Responsible for Compliance with Independence Requirements

For a firm that performs attest services, maintaining independence is of the utmost importance. Compilation and review firms generally designate the accounting partner to take responsibility for overseeing compliance with ethical requirements. In this capacity, the accounting partner needs to have a current and detailed working knowledge of the relevant rules and requirements relating to independence, integrity, and objectivity discussed earlier in this lesson. In addition, the accounting partner may oversee the administration of all firm independence-related matters, including performance of the following:

- Answering questions relating to relevant ethical issues.
- Maintaining a current client list.
- Informing personnel of independence requirements.
- Obtaining periodic (at least annual) independence representations from personnel and following up on potential threats to independence.
- When notified of a potential threat to independence, accumulating and communicating information within the firm about the threat.
- Assisting in evaluating threats and resolving breaches, including determining whether outside consultation may be needed.

Maintaining a Current Client List

Before employees can evaluate whether they are independent with respect to attest clients, the firm needs to develop and maintain a list of clients for which financial interests or business relationships are prohibited. Personnel usually need to review a current list of the firm's attest clients in order to make an informed decision about whether a possible independence violation exists. While personnel in small firms may be familiar with all the firm's clients, that situation generally begins to change as the firm grows. Additionally, some firms may choose to maintain a list of all clients for firm personnel to review, in the event that a current tax client becomes a review client, for example. Preparation of client lists can be relatively easy through the use of time and billing software commonly used in many firms.

To facilitate periodic review of the client list, it is helpful if the client list is readily accessible to all professional employees, perhaps by maintaining it electronically on the firm's network, as well as posting the list in the firm library, copy room, break room, or some other location where employees can easily and regularly review the list of firm clients. New professional staff need to be given a copy of the current client list and be instructed about the firm's procedures for maintaining client independence.

Informing Employees of Changes to Client List. Since a firm needs to establish procedures designed to provide it with reasonable assurance that the firm and its personnel maintain independence where required, a firm needs to provide updated client lists to professional personnel frequently enough to achieve that reasonable assurance. Employees need to be informed on a timely basis of changes (both additions and deletions) to the firm's client list. It is recommended that the list be updated on an ongoing basis so that independence evaluations are always based on the most current firm client information. A firm can replace any out-of-date posted client lists with current lists as needed to keep such information current. Along with updating the client list, some firms inform their personnel that there has been a change in the firm's clients by sending out email notifications each time such a change occurs. Alternatively, such information may be periodically disseminated, for example, once a month.

Informing Employees of Independence Requirements

While most professional employees are generally familiar with the independence rules, many subtle independence interpretations exist that they may not be aware of. Also, employees may not be aware of special or unique independence requirements of various regulatory bodies to which the firm may be subject, including state CPA societies and boards of accountancy, state statutes, and other regulatory bodies. As a result, it is critical for the firm to take deliberate measures to ensure that employees are fully aware of both the independence rules and the clients for which financial or business relationships are prohibited.

Once the client list is available, the firm can communicate the requirements relating to independence, integrity, and objectivity, as well as prohibited client relationships. To communicate the rules, a current copy of the rules affecting the firm (including rules of applicable regulatory bodies) may be accessible electronically on the firm's network, as well as in the firm's library or any other location accessible to the employees.

Some firms may want to know in advance of proposing on an engagement whether independence issues might exist at the professional staff level. At the time these firms are asked to propose on an attest engagement, the firm can send notification to professional employees and ask them to communicate back any personal independence conflicts with the prospective client.

To reinforce the awareness and importance of maintaining independence, firms may also consider establishing regular periodic communications about professional responsibilities to personnel as a way to assist in keeping independence in the forefront of the minds of engagement teams.

Obtaining Written Representations of Independence

As previously mentioned, SQCS No. 7 requires the firm to obtain confirmation of employee independence annually, *at a minimum*. Many firms accomplish this by requiring their professional employees to review the firm's independence requirements and sign an independence representation form at time of employment and annually thereafter. The firm may attach a copy of its independence requirements to the back of the independence representation form when distributed to each employee to better ensure the requirements are reviewed. Professional employees may provide their confirmation of independence in either written or electronic form.

The "Independence, Integrity, and Objectivity Representation" form can be used by firms to help ensure that professional employees have considered their individual compliance to the firm's independence rules. This representation can be used to—

- Communicate firm policy to all professionals.
- Document that each professional has reviewed the client list for possible independence problems.
- Communicate any financial interests or business relationships that create possible threats or certain breaches of independence.
- Identify any prohibited transaction entered into by any professional.

Evaluating Independence Representations. Once independence representations are obtained from all professional staff, it is important for the firm to take appropriate action to address any information indicating potential noncompliance with independence requirements. The accounting partner is often responsible for accumulating and evaluating employee responses to identify independence breaches and potential threats to independence. If any threats or breaches are identified based on the evaluation, he or she will then accumulate and communicate the relevant information to the appropriate personnel in the firm.

Identifying Independence Threats

An important aspect of establishing quality control policies and procedures to ensure that the firm and its personnel comply with ethical requirements includes prompt notification of potential threats and breaches once identified. Personnel should promptly notify the engagement partner and the firm (ordinarily the accounting partner) of any circumstance or relationship they notice that could appear to create a threat to the firm's independence. If a staff person is unsure whether a threat exists, he or she should not hesitate to discuss the situation with the engagement partner. However, once it is determined that a threat exists, the accounting partner should be notified and the threat be documented and formalized for further consideration.

Accumulating and Communicating Information about Identified Threats

Threats to independence may be identified either through responses to employee independence representations or by personnel notification of potential threats. Either way, once the threat is identified, the accounting partner begins accumulating pertinent information for further analysis of the circumstance. As much information as possible needs to be obtained so the firm can make an informed and appropriate evaluation about whether or not the independence threat can be mitigated.

Once adequate information is collected about the potential threat, that information should be communicated to the engagement partner, accounting partner, and other firm personnel as appropriate so the threat can be evaluated.

Evaluating Threats to Independence

To evaluate circumstances and relationships that create threats to independence, the accounting partner needs to be familiar with the authoritative guidance relating to independence.

Taking appropriate action to resolve independence threats will depend upon the type of independence threat identified. The *Conceptual Framework* identifies seven different types of threats to independence. Based on the unique facts and circumstances, the firm should evaluate the type of threat and determine whether or not the threat can be mitigated, or if it represents an independence breach requiring corrective action.

One example of a threat that the firm could mitigate would be a familiarity threat identified because a member of the attest engagement team has a close friend who accepts a key management position in the client's business. In that situation, the firm could remove that member from the attest engagement team. Once the team member is moved, the threat to independence has been mitigated.

Taking Appropriate Action When Independence Breaches Are Identified

To ensure that corrective action is taken once an independence breach is discovered, the firm needs to carefully determine the appropriate course of action. To remedy an independence breach, a firm considers whether the situation that caused the breach can be undone. Breaches to independence are typically not as simple as mitigating an identified threat. To actually resolve the independence breach, often the firm has no choice but to withdraw from the engagement. In some cases, especially if the breach was accidental, it may be possible to reverse the situation that created the breach, such as terminating any financial interest in the client. However, if the financial interest has existed for some period of time, often the firm will need to withdraw from the engagement.

Accordingly, it is recommended that formal procedures be established so that once an independence breach is identified, the engagement partner, the accounting partner, and others in firm management as appropriate determine if or how the breach can be corrected and what type of continuing relationship the firm may pursue with the client. If necessary, the accounting partner needs to consult the authoritative literature in resolving the matter. The resolution may range from taking appropriate actions to resolve the problem to deciding to maintain the relationship and, in turn, limit the services and the report that can be rendered to the client. Whatever the resolution, once the appropriate actions are taken, the engagement partner should formally confirm to the accounting partner that such actions have taken place.

SQCS No. 7 (QC 10.125) states that the firm should establish policies and procedures requiring appropriate documentation to provide evidence of the operation of each element of its system of quality control. Accordingly, once the independence breach matter has been resolved, the resolution should be documented in a manner of the firm's choosing.

It is also recommended that firms communicate the resolution of the independence matter to the affected engagement staff. Such a procedure not only promotes transparency and may address the communication to appropriate personnel required by SQCS No. 7, but it also provides an excellent training opportunity for staff to learn about how appropriate action is taken when independence matters are discovered.

Determining How the QC System Failed

The firm may receive notice that a breach of its independence policies and procedures has occurred. In addition to addressing this situation in compliance with responding to any other identified independence threat or breach, it is recommended that the firm put guidelines in place to analyze and evaluate "what went wrong" that allowed the independence breach to occur. When a firm discovers that professional employees have not followed the firm's policies and procedures for relevant ethical requirements, the firm needs to consider investigating the matter in depth to determine why the QC system did not work and what changes are necessary to obtain reasonable assurance that the QC system will work more effectively in the future. Perhaps the firm did not include a comprehensive set of procedures to ensure compliance with the policy. Perhaps the firm did not provide adequate training to its employees (particularly new staff) to ensure that professional personnel understood the procedures they were expected to follow.

It is not unusual for a firm that has recently begun providing attest services to experience a period of trial and error with its QC system before the firm attains the right set of policies and procedures. Additionally, a firm may have some setbacks before it finds the best method to ensure compliance with its QC system.

DRAFTING THE QUALITY CONTROL POLICIES AND PROCEDURES FOR THE FIRM

For some of the elements of quality control, professional standards contain considerations or requirements that should be incorporated into the design of the quality control system. Therefore, it is always important to begin the design of any of the quality control elements with a review of the authoritative literature.

AICPA Practice Aid

After reviewing authoritative literature, the illustrative examples suggested by the AICPA for designing the relevant ethical requirements element of the quality control system should be reviewed. Those examples are found in the AICPA's Practice Aid, *Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (the AICPA's Practice Aid).

While the AICPA's illustrative policies and procedures provide a logical starting point for designing the relevant ethical requirements quality control system, careful consideration of the firm's needs before adopting them is recommended. Many firms will find that the suggested policies and procedures may not meet their firm's particular needs.

Developing Relevant Ethical Requirements Policies and Procedures

Quality control policies are designed to achieve the overall objectives of the QC system and the specific objectives of the individual QC elements. Quality control procedures are designed to provide the actions necessary to implement and monitor compliance with the stated policies. Generally, factors such as the size of the firm, operating characteristics of the firm, the knowledge and experience of firm personnel, and the nature and complexity of the firm's practice can impact the QC policies and procedures for a given firm.

There is more than one way to develop a firm's quality control policies and procedures. For example, this course chooses to develop one policy statement for each QC element and then design appropriate procedures for each element that implements that one policy. Alternatively, the AICPA Practice Aid illustrative policies and procedures include multiple policy statements for each QC element with procedures related to each policy. Firms need to choose an approach in developing their QC policies and procedures that meets the needs and desires of the firm.

Because of the sheer volume and complexity of the independence rules and other ethical requirements under the *Code*, employees cannot be expected to remember all the specifics of the ethical requirements governing the firm. Accordingly, some firms may choose to list as a part of the overall policy, the most common or obvious transactions, relationships, or circumstances that would impair the firm's independence and would, thus, violate its relevant ethical requirements policy.

The most common types of transactions that impair independence and that are communicated to the firm's partners and employees in the policy are:

- Investments in a client's business.
- Investments with a client or with client personnel.
- Borrowings from or loans to a client or a client's personnel; in this regard, past due accounts receivable from a client could be viewed as a loan.
- Accepting or offering gifts or entertainment from or to a client.
- Certain family relationships between professionals of the CPA firm and client employees.
- Involvement as directors and/or management of non-profit organizations, banks, or other organizations.

Does the Policy Concerning Independence Apply to All Services and All Employees of the Firm? A potentially confusing consideration when adopting an independence policy is determining to whom it applies. The AICPA's independence rules and those of most state boards of accountancy and CPA societies are aimed at covered members, which include individuals on an attest engagement team or individuals in a position to influence the attest engagement. Independence does not apply to tax or consulting clients for which no attest services are provided, and, accordingly, professionals within the firm who work on those engagements technically would not be subject to the independence requirements of the quality control system. However, certain of the AICPA's independence rules do apply to all partners regardless of their functional or departmental classifications. For example, if a tax partner holds an investment of more than five percent in an attest client, independence would be impaired, even though that partner performs no services for the client. Also, the AICPA independence rules apply to partners or managers who provide ten or more hours of nonattest services to an attest client during a specified period and to partners in the office in which the lead attest engagement partner primarily practices with respect to an attest engagement. Thus, if the firm has separate tax and consulting departments, the partners in those departments must adhere to some or all of the firm's independence policy and procedures, even though they may never perform accounting and attest services.

Some firms use paraprofessionals to do accounting and review services and to assist in other attest engagements. ET 92.06 states that a covered member (to whom the independence rules apply) includes a member of the attest engagement team, but ET 92.02 states that the attest engagement team excludes "individuals who perform only routine clerical functions, such as word processing and photocopying." A paraprofessional participating in an engagement, in any capacity other than providing administrative support, generally is acting as a professional. Consequently, the firm's quality control policy on relevant ethical requirements need only refer to professional personnel.

The Firm's Quality Control Procedures

Once overall policy statements are formulated, the next step is to design the procedures needed to implement and monitor the policies. It is important for firms to design procedures that can be easily monitored by the firm and ultimately be assessed by a practice monitoring unit. Elaborate documentation is not necessarily required; instead, it should be based on the size, structure, and nature of the firm's practice. Documentation should provide sufficient evidence that the quality control policies and procedures were followed.

Should the Firm Design a Separate Personnel Manual? An important consideration in designing a quality control system is to determine where the quality control procedures will reside and in what form they will be documented. Some firms develop a comprehensive quality control document that contains all personnel procedures related to the requirements of SQCS No. 7. Other firms may use both a quality control document and a personnel manual. Those firms might state a basic requirement for complying with relevant ethical requirements in the quality control document and make reference to the personnel manual for specific requirements. For example, the quality control document may contain the basic requirement that all employees must adhere to the firm's independence requirements and include a reference to the listing of prohibited transactions in the personnel manual.

Firms that use more than one document to cover their quality control system need to be careful to make the documents consistent and comprehensive. When working with two different documents, it is easy to inadvertently omit a procedure or to make conflicting statements. In this lesson, a comprehensive quality control statement has been designed that includes all relevant ethical requirements. The statement contains not only the relevant ethical requirements needed to meet the quality control standards, but also the personnel matters related to achieving compliance with relevant ethical requirements. It can easily be adapted to firms that choose to place some of the relevant ethical requirements in a personnel manual.

Communicate the Firm's Policies and Procedures to Employees. Regardless of the firm's size, the firm's quality control system policies and procedures generally should be communicated to its personnel in a written document. By doing so, communicating the firm's policy and procedures is rather easy, as the accounting partner or personnel administrator can determine that each employee has received the written document. In addition, when distributing copies to employees, firm management can make it clear that each employee is required to be familiar with the contents of the document.

Many firms communicate the firm's policy and procedures by attaching them to the annual employee independence, integrity, and objectivity representation that all professional personnel are required to sign upon hiring and annually thereafter. Regardless of the method used to communicate the policy and procedures, circulating a copy along with the instructions for completing the employee independence, integrity, and objectivity representation letter is a good way to reemphasize the importance of adherence to the rules.

MONITORING COMPLIANCE WITH THE FIRM'S POLICIES AND PROCEDURES

The firm should review, on an ongoing basis, its relevant ethical requirements policies and procedures to determine if they continue to be appropriate for the firm. This review and assessment is normally accomplished in coordination with the monitoring phase of the firm′s quality control system. Based on this review and assessment, the firm's relevant ethical requirements policies and procedures should be revised as appropriate.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

5. Which of the following is the primary authority on independence requirements that, compliance with, will ensure all other independence requirements of other authoritative pronouncements have been met as well?

   a. SQCS No. 7.

   b. *Code of Professional Conduct.*

6. Which of the following statements regarding independence standards is correct?

   a. AICPA independence standards are always more restrictive than those of other regulatory organizations; therefore, when conflicts arise, AICPA standards should be the final authority regarding independence requirements.

   b. Independence standards of other regulatory organizations may be different from those of the AICPA, and should be consulted as applicable.

7. Under the Conceptual Framework's risk-based approach, which of the following statements regarding independence is accurate?

   a. A threat would impair independence any time there are insufficient safeguards available to eliminate an unacceptable threat.

   b. A threat has been sufficiently alleviated if, after safeguards have been applied, it is reasonable to assume that the threat would not compromise professional judgment.

   c. Even if identified threats are considered to be at an acceptable level, consideration of safeguards is customary.

   d. Threats to independence are identified and evaluated only in the aggregate.

8. Andy, CPA, is performing tax compliance services for ABC Company, an attest client. Which of the following actions is required when Andy is performing these nonattest services?

   a. Andy should perform management functions per prior agreement with ABC Company.

   b. Andy should perform all necessary functions for ABC Company related to the nonattest services.

   c. Andy should make management decisions per directions from ABC Company.

   d. Andy should document in writing the agreement with ABC Company as to what nonattest services he will provide.

9. Which of the following appraisal, valuation, or actuarial services generally would **not** impair independence?

   a. Valuations of postemployment benefit liabilities.

   b. Valuations of appraisals of liabilities.

   c. Valuations of business combinations.

   d. Valuations of employee stock ownership plans.

10. Which of the following internal audit assistance services performed by the CPA on behalf of the client would impair independence?

    a. Performing separate evaluations of the effectiveness of the client's controls.

    b. Performing ongoing monitoring activities.

    c. Performing separate evaluations of the client's ongoing monitoring activities.

11. Of the following actions a firm can take when it is unsuccessful in resolving an ethical conflict, which one is the **least** desirable solution to pursue when independence is a concern?

    a. Step down to a compilation from a review or attest engagement.

    b. Perform the engagement below normal standards.

    c. Resign from the engagement.

12. How often, as a minimum, should a firm obtain confirmation of compliance with its policies from all personnel in the firm that are required to be independent?

    a. Semi-annually.

    b. Annually.

    c. Bi-annually.

    d. At its own discretion.

13. A current client list should be readily accessible by which of the following within the firm in order to ensure client independence?

    a. Only partners.

    b. Partners and senior management.

    c. All professional employees.

    d. All employees of the firm.

14. A firm's quality control procedures should be based on a number of factors, but do not necessarily include which of the following?

    a. The firm's size.

    b. The firm's structure.

    c. Detailed documentation.

    d. The nature of the firm's practice.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

5. Which of the following is the primary authority on independence requirements that, compliance with, will ensure all other independence requirements of other authoritative pronouncements have been met as well? **(Page 18)**

   a. SQCS No. 7. [This answer is incorrect. SQCS No. 7 is one authoritative pronouncement that addresses independence requirements; however, compliance with the requirements in SQCS No. 7 does not ensure that all independence requirements of other authoritative pronouncements have been met.]

   b. *Code of Professional Conduct*. [This answer is correct. Compliance with the independence requirements of the AICPA *Code of Professional Conduct* will ensure that all related independence requirements of SQCS No. 7 (as well as those of SSARS, SSAEs, and other regulatory organizations) are met.]

6. Which of the following statements regarding independence standards is correct? **(Page 18)**

   a. AICPA independence standards are always more restrictive than those of other regulatory organizations; therefore, when conflicts arise, AICPA standards should be the final authority regarding independence requirements. [This answer is incorrect. AICPA independence standards can be less restrictive than those of other regulatory agencies; thus, AICPA independence standards should never be the final authority regarding independence requirements. AICPA members are required to also follow other regulatory organization independence requirements when performing applicable services.]

   b. Independence standards of other regulatory organizations may be different from those of the AICPA, and should be consulted as applicable. [This answer is correct. Independence standards of other regulatory organizations such as state boards of accountancy, state CPA societies and the DOL may be different from and more restrictive than those of the AICPA and should always be consulted regarding guidance on independence standards.]

7. Under the Conceptual Framework's risk-based approach, which of the following statements regarding independence is accurate? **(Page 21)**

   a. A threat would impair independence any time there are insufficient safeguards available to eliminate an unacceptable threat. [This answer is incorrect. A threat would impair independence in cases where no safeguards are available to eliminate an unacceptable threat *or reduce it* to an acceptable level as cited in ET 100.04–.05.]

   b. A threat has been sufficiently alleviated if, after safeguards have been applied, it is reasonable to assume that the threat would not compromise professional judgment. [This answer is correct. If safeguards are applied sufficiently that professional judgment would not be compromised by a threat, the threat has been mitigated such that there is not an unacceptable risk to independence pursuant to ET 100.04–.05.]

   c. Even if identified threats are considered to be at an acceptable level, consideration of safeguards is customary. [This answer is incorrect. ET 100.04-.05 stipulates that, in cases where identified threats are considered to be at an acceptable level, the risk is at an acceptable level, and consideration of safeguards is not required.]

   d. Threats to independence are identified and evaluated only in the aggregate. [This answer is incorrect. According to ET 100.04–.05, threats to independence are identified and evaluated *both individually and in the aggregate* under the risk-based approach.]

8. Andy, CPA, is performing tax compliance services for ABC Company, an attest client. Which of the following actions is required when Andy is performing these nonattest services? **(Page 22)**

    a. Andy should perform management functions per prior agreement with ABC Company. [This answer is incorrect. Interpretation 101-3 requires that the CPA *not* perform management functions on behalf of an attest client when performing nonattest services; however, the CPA may assist management in those functions or decisions.]

    b. Andy should perform all necessary functions for ABC Company related to the nonattest services. [This answer is incorrect. The client (ABC Company) must agree to perform certain specific functions related to the nonattest services being provided by the CPA (Andy) as cited in Interpretation 101-3.]

    c. Andy should make management decisions per directions from ABC Company. [This answer is incorrect. The CPA (Andy) should not make management decisions for the attest client (ABC Company) pursuant to the requirements of Interpretation 101-3.]

    d. Andy should document in writing the agreement with ABC Company as to what nonattest services he will provide. [This answer is correct. Interpretation 101-3 requires the CPA (Andy) to document in writing the understanding with the client (ABC Company) concerning the nonattest services he will provide, as well as ABC Company's responsibilities.]

9. Which of the following appraisal, valuation, or actuarial services generally would **not** impair independence? **(Page 25)**

    a. Valuations of postemployment benefit liabilities. [This answer is correct. Since valuations of postemployment benefit liabilities do not involve a significant degree of subjectivity, they would not impair independence as spelled out in Interpretation 101-3.]

    b. Valuations of appraisals of liabilities. [This answer is incorrect. Valuations of appraisals of liabilities (or assets) generally involve a substantial degree of subjectivity and, as a result, would impair independence if the results produced are material to the financial statements according to Interpretation 101-3.]

    c. Valuations of business combinations. [This answer is incorrect. Interpretation 101-3 states that valuations related to business combinations usually involve a significant degree of subjectivity if the results of the valuation are material, and would impair independence.]

    d. Valuations of employee stock ownership plans. [This answer is incorrect. Valuations of employee stock ownership plans usually involve a large measure of subjectivity if the results of the valuation are material and would, therefore, impair independence as indicated in Interpretation 101-3 if the valuation results are material.]

10. Which of the following internal audit assistance services performed by the CPA on behalf of the client would impair independence? **(Page 25)**

    a. Performing separate evaluations of the effectiveness of the client's controls. [This answer is incorrect. Performing separate evaluations of the effectiveness of the client's controls will not impair independence according to Interpretation 101-3.]

    b. Performing ongoing monitoring activities. [This answer is correct. Interpretation 101-3 states that assisting with a client's internal audit function impairs the member's independence if the member manages the client's internal audit activities. One such example is the performing of ongoing monitoring activities by the member (CPA).]

    c. Performing separate evaluations of the client's ongoing monitoring activities. [This answer is incorrect. Independence is not impaired as a result of performing separate evaluations of the client's ongoing monitoring activities as spelled out in Interpretation 101-3.]

11. Of the following actions a firm can take when it is unsuccessful in resolving an ethical conflict, which one is the **least** desirable solution to pursue when independence is a concern? **(Page 27)**

    a. Step down to a compilation from a review or attest engagement. [This answer is incorrect. Stepping down to a compilation service eliminates the need to ensure independence in the performance of the engagement.]

    b. Perform the engagement below normal standards. [This answer is correct. If a firm chooses to perform a substandard engagement, it runs the risk of receiving a modified or adverse peer review report which would tarnish the firm's image and reputation regarding integrity.]

    c. Resign from the engagement. [This answer is incorrect. By resigning from the engagement, a firm precludes any possibility of questions arising regarding independence.]

12. How often, as a minimum, should a firm obtain confirmation of compliance with its policies from all personnel in the firm that are required to be independent? **(Page 28)**

    a. Semi-annually. [This answer is incorrect. It is not necessary for a firm to confirm compliance with its policies and procedures on independence by its personnel that are required to be independent on a semi-annual basis as detailed in SQCS No. 7 (QC 10.24).]

    b. Annually. [This answer is correct. A firm should, at a minimum, confirm compliance with its policies and procedures on independence from all firm personnel required to be independent on an annual basis as spelled out in SQCS No. 7 (QC 10.24). The representations should confirm whether the employee is complying with all requirements of Rule 101 and its related interpretations and rulings of the AICPA *Code of Professional Conduct*, as well as the rules of state boards of accountancy and applicable regulatory agencies.]

    c. Bi-annually. [This answer is incorrect. As stated in SQCS No. 7 (QC 10.24), a firm should confirm compliance with its policies and procedures on independence by its personnel that are required to be independent more frequently than every two years.]

    d. At its own discretion. [This answer is incorrect. The recommendation cited in SQCS No. 7 (QC 10.24) does not allow a firm to use its own discretion to determine the frequency with which it should confirm that its personnel required to be independent are in compliance with its policies and procedures on independence.]

13. A current client list should be readily accessible by which of the following within the firm in order to ensure client independence? **(Page 30)**

    a. Only Partners. [This answer is incorrect. Partners are not the only individuals within the firm that should have access to a current list. Others in the firm need access to the client list in order to ensure client independence.]

    b. Partners and senior management. [This answer is incorrect. Others within the firm besides just the partners and senior management need access to a current list to ensure client independence.]

    c. All professional employees. [This answer is correct. To make periodic review of the client list easier, it is helpful for all professional employees to have ready access in order to ensure that client independence is maintained.]

    d. All employees of the firm. [This answer is incorrect. Not every employee of the firm needs access to a current client list in order to ensure client independence. Clerical personnel, administrative assistants, and other nonprofessional personnel need not have access.]

14. A firm's quality control procedures should be based on a number of factors, but do not necessarily include which of the following? **(Page 34)**

    a. The firm's size. [This answer is incorrect. The firm's size determines, in part, what quality control procedures are needed. The larger the size of the firm, the more attention must be paid to the procedures to ensure that quality and independence are maintained.]

    b. The firm's structure. [This answer is incorrect. The structure of the firm will dictate how quality control procedures are developed in a way that will address the firm's structure effectively.]

    c. Detailed documentation. [This answer is correct. Detailed documentation is not usually required and adds little to the process of developing effective quality control procedures. Documentation should provide adequate evidence that the quality control policies and procedures were followed.]

    d. The nature of the firm's practice. [This answer is incorrect. Quality control procedures can be developed most effectively if the type of firm and its business model are known in advance.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (GCRTG101)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Jack Murphy and Associates is a CPA firm performing a review engagement. Bill is the principal auditor on the engagement and wants to know what the AICPA *Code of Professional Conduct* has to say regarding ethical requirements related to the scope and nature of services to be provided. Where will Bill find the information he is seeking?

   a. Article II at ET 53.

   b. Article III at ET 54.

   c. Article V at ET 56.

   d. Article VI at ET 57.

2. Smith, Johnson, Black, and Murphy are a CPA firm performing a compilation engagement. David Murphy is the engagement partner and is seeking ethical guidance in the AICPA Code of Professional Conduct (the Code) regarding Ethics Ruling No. 74 on independence, integrity, and objectivity. Which of the following ethics documents in the Code will have the guidance David is seeking?

   a. ET 53.

   b. ET 56.

   c. ET 101.

   d. ET 191.

3. Of the following Fundamental Principles of professional ethics originating from ET 50 of the AICPA *Code of Professional Conduct*, which one applies only to members in public practice if they provide audit, review, and other attestation services?

   a. Integrity.

   b. Independence.

   c. Due care.

   d. Scope and nature of services.

4. AICPA members must test all decisions made in the performance of their accounting duties against which of the following qualities?

   a. Accuracy.

   b. Objectivity.

   c. Integrity.

   d. Independence.

5. AICPA members are required to comply with which of the following when dealing with issues related to integrity and objectivity?

   a. Guide for Complying With Rules 102-505.

   b. AICPA *Conceptual Framework.*

   c. Do not select this answer choice.

   d. Do not select this answer choice.

6. According to Interpretation 101-1 of Rule 101 (ET 101.02), during the period of a professional engagement, a covered member's independence would be impaired if he had a loan to a client owning what percent of the client's outstanding equity securities (except as permitted by Interpretation 101-5)?

   a. 3% or more.

   b. 5% or more.

   c. 7% or more.

   d. 10% or more.

7. According to ET 92.06 and ET 92.13 of the AICPA *Code of Professional Conduct*, Joe, CPA, is considered a covered member if he is a partner or manager who provides nonattest services to the attest client beginning after he has provided how many hours of nonattest services to the client within any fiscal year?

   a. 10 or more.

   b. 20 or more.

   c. 25 or more.

   d. 30 or more.

8. A member of a firm is engaged to perform a review engagement and reviews evidence that resulted from nonattest work performed by the member or his/her firm as part of an attest engagement. This is an example of which of the following broad categories of threats to independence?

   a. Management Participation Threat.

   b. Adverse Interest Threat.

   c. Self-review Threat.

   d. Familiarity Threat.

9. Which of the following is the first general requirement a CPA should follow when performing nonattest services?

   a. Establish and document in writing an understanding with the client about the objectives and limitations of the nonattest services engagement.

   b. Be confident of the client's ability to make an informed judgment on the results of the nonattest services.

   c. Avoid performing management functions or making management decisions.

   d. Do not select this answer choice.

10. Generally, which of the following actions causes independence to be impaired?

    a. Preparing a tax return and transmitting it to a taxing authority.

    b. Representing the client in an administrative proceeding before a taxing authority.

    c. Representing the client in court to resolve a tax dispute.

    d. Ensuring that the client's management reports activities to their board of directors.

11. According to Interpretation 101-3, certain types of forensic accounting services may impair independence. However, under certain specified conditions, independence is **not** impaired:

    a. If the CPA provides litigation services where he/she is a court-appointed expert in a matter involving a client.

    b. If the CPA provides expert witness testimony for a large group of defendants that includes the CPA's client.

    c. If the CPA provides litigation services where he/she is an arbitrator in a matter involving a client.

    d. If the CPA conditionally agrees to provide expert witness testimony for a client.

12. Susan is an accountant who has provided professional services to a client for which the billed fees have not been paid. The date of her report was October 25, 2009. The current year's report was released on February 15, 2010 and her fees continue to be unpaid. Based on this information, which of the following circumstances would cause Susan's independence to be impaired?

    a. Her services were rendered on December 10, 2008 in the amount of $1,500.

    b. Her services were rendered on September 15, 2009 in the amount of $125.

    c. Her services were rendered on November 8, 2008 in the amount of $150.

    d. Her services were rendered on October 9, 2008 in the amount of $1,650.

13. Are all state boards of accountancy required to adopt the ethics rules of the AICPA as the rules that govern practices within their states?

    a. Yes.

    b. No.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

14. It is recommended that a firm's client list be updated how frequently to ensure independence evaluations are based on the most current firm client information.

    a. Weekly.

    b. Bi-weekly.

    c. Monthly.

    d. On an ongoing basis.

15. Professional employees may elect to confirm their independence by means of which of the following?

    a. Either verbally or written.

    b. Either verbally or electronic form.

    c. Either written or electronic form.

    d. Verbally, written or electronic form.

Lesson 2: Acceptance and/or Continuance of Client Relationships and Engagements

INTRODUCTION

A CPA firm is often faced with difficult decisions regarding acceptance and/or continuance of client relationships and engagements. Balancing a firm's economic needs against maintaining the integrity of the firm can be challenging, as the solutions to difficult client decisions are sometimes not clear—even to seasoned professionals. A firm's natural desire for growth can create pressure to accept or retain problematic clients, or to continue relationships and engagements with marginally profitable clients. On the other hand, practitioners generally recognize that selecting clients who run their businesses well and with integrity not only strengthens the firm's ability to provide high quality, profitable services, but also limits the ever-increasing risk of legal exposure or liability. Faced with opposing pressures, all firms, regardless of size, can benefit from a quality control (QC) system to evaluate the acceptance and continuance of clients and engagements. This lesson focuses on the QC element covering acceptance and continuance of client relationships and specific engagements.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the requirements of SQCS No. 7 regarding acceptance and/or continuance.

General Requirements of SQCS No. 7

The QC element, "Acceptance and Continuance of Client Relationships and Specific Engagements," is defined at QC 10.27–.28 of SQCS No. 7, *A Firm's System of Quality Control*. The acceptance and continuance guidance provided by those paragraphs generally indicates that the firm should establish policies and procedures for the acceptance and continuance of client relationships and specific engagements. Those policies and procedures should be designed to provide the firm with reasonable assurance that it will only undertake or continue relationships and engagements where the firm:

a. Has considered the integrity of the client, including the identity and reputation of the client's owners, key management, related parties, and those charged with its governance. [The SQCS exposure draft changes this presumptively mandatory requirement. Under the proposed standard, the firm undertakes or continues relationships and engagements only where the firm has considered the integrity of the client and does not learn anything that indicates that the client lacks integrity.]

b. Has considered the risks associated with providing professional services in the particular circumstances. [The SQCS exposure draft removes this presumptively mandatory requirement.]

c. Is competent to perform the engagement and has the capabilities and resources to do so.

d. Can comply with legal and ethical requirements.

e. Reaches an understanding with the client regarding the services to be performed.

SQCS No. 7 also provides guidance and matters to consider in developing and implementing the policies and procedures for acceptance and continuance of client relationships and specific engagements. Those areas include—

- Timing and scope of clients and engagements subject to the policy.

- Conflicts of interest.

- Significant issues discovered after the engagement begins.

- Withdrawing from an engagement or ending a client relationship.

Further, if in the course of the acceptance and continuance process, issues are identified that do *not* prevent the firm from accepting the client or a new engagement with an existing client, SQCS No. 7 (QC 10.29) states that the firm should document how the issues were resolved.

Upcoming Changes to SQCS No. 7

In June 2009, the ASB released for exposure a revised version of SQCS No. 7, A Firm's System of Quality Control (Redrafted), which would supersede SQCS No. 7. The QC standard is being redrafted to apply the ASB's clarity drafting conventions and to converge with the international quality control standard, ISQC 1. The proposed SQCS is expected to be applicable to a firm's system of quality control for its accounting and auditing practice as of January 1, 2011. The proposed SQCS does not change or expand SQCS No. 7 in any significant respect.

EVALUATING THE CLIENT'S INTEGRITY

When deciding whether to accept or continue an engagement, the firm should establish policies and procedures to consider the integrity of the client. Specifically, SQCS No. 7 (QC 10.27) states—

> "The firm should establish policies and procedures . . . designed to provide the firm with reasonable assurance that it will undertake or continue relationships and engagements only where . . . the firm has considered the integrity of the client. . . . "

An important point to understand is that evaluating the integrity of the client does not mean the firm guarantees that only clients with the highest, indisputable integrity are accepted, but rather imposes a requirement that the firm, in making an acceptance or continuance decision, take into consideration all known facts relating to the integrity of the client. [The SQCS exposure draft additionally indicates that as firms consider the integrity of the client, the firm does not have information that would lead it to conclude that the client lacks integrity. Having information that the prospective client or existing client lacks integrity would generally prevent the firm from undertaking or continuing a relationship or engagement.]

When considering the integrity of *the client*, who should be evaluated? According to SQCS No. 7, *the client* includes various individuals such as the principal owners, key management, related parties, and those charged with governance. (The SQCS exposure draft eliminated consideration of related parties as part of the acceptance and continuance decision because the ASB indicated that evaluating related parties is more realistically accomplished after the engagement acceptance decision is made.) This normally includes any individuals who have more than just a passing involvement with the business, for example, spouses of owners who are active in the business need to be included in the evaluation.

Determining the identity of those individuals may be very difficult. Methods of obtaining that information include—

- Interviewing the individuals who contacted the firm.

- Contacting known professionals who have, or have had, dealings with the business such as predecessor accountants, bankers, or lawyers.

- Reviewing tax returns, credit reports, corporate filings, and information from services such as Dun & Bradstreet.

SQCS No. 7 does not define *related parties* or *those charged with governance*, but those terms generally should be applied as they are defined in applicable AICPA standards. (For example, when making a decision about a compilation and review client or engagement, consult SFAS No. 57, *Related Party Disclosures*, and SSARS No. 17, *Omnibus Statement on Standards for Accounting and Review Services—2008.* SSARS No. 17, effective for compilations and reviews of financial statements for periods ending on or after December 15, 2008, introduces a definition of *those charged with governance*.)

Factors to Consider When Evaluating Integrity

When evaluating the integrity of the client, SQCS No. 7 (QC 10.30) offers the following factors to consider:

- Nature of operations and specific business practices.
- Attitude towards aggressive accounting and internal control matters.
- Length of the relationship with the client.

Exposure Draft. The ASB has issued an exposure draft that would supersede SQCS No.7. The proposed SQCS adds several more factors to consider in addition to the factors listed in the preceding paragraph. The additional factors include:

- Identity and business reputation of the client's principal owners, key management, and those charged with its governance.
- Inappropriate client limitation regarding the scope of work.
- Indications that the client may be involved in money laundering or other criminal activities.
- Reasons for the proposed appointment of the firm and nonreappointment of the previous firm.

Nature of Operations and Specific Business Practices. The firm should obtain as much information as possible about the nature of the prospective client's operations from various sources such as financial statements, reports filed with regulators, credit reports, and tax returns. The firm should be concerned if the nature of operations is ambiguous, potentially illegal, or otherwise questionable. Red flags that should alert the firm include sources and disbursements of cash flows that are not easily identifiable. Also, business practices employed by the prospective client should not differ significantly from those of other businesses in the same industry, unless the result of a technical innovation or process improvement.

Attitude toward Aggressive Accounting and Internal Control Matters. A prospective client's attitude about aggressive accounting positions or control over financial reporting can be determined through direct discussion with the prospective client or indirectly through discussions with predecessor accountants and other third parties such as bankers. Reviewing financial statements (especially carefully worded notes to the financial statements) and tax returns may also provide actual evidence of an aggressive stance on an accounting position. Internal communications such as mission statements and procedures manuals, if available, may provide insight into the attitudes of owners, management, and those charged with governance with regard to internal control procedures and the approach to reporting accounting transactions.

Length of the Relationship with the Client. In evaluating whether to continue a relationship with an existing client, another factor to consider is the length of the relationship, as the amount of information known about the client will increase over time. If a client relationship has existed for a long period of time, yet knowledge of that client is still limited, the firm may wish to consider whether the client has been open enough with the firm.

Conversely, the opposite situation can occur. If firm partners and staff work on the same engagement for years and develop close working relationships with a client's management, it may be difficult to maintain a sufficient level of professional skepticism about the client's activities and integrity. In such a case, a familiarity threat to independence could exist.

Gathering Evidence of Integrity

The firm should consider conducting a thorough and complete screening of any current and prospective clients. For small firms and acceptance of relatively small clients, cost-benefit considerations are involved in determining the extent to which the firm would ordinarily perform client screening. However, SQCS No. 7 requires firms to consider current and prospective client integrity, and firms generally should consider performing thorough client screening procedures whenever feasible.

Client screening is performed for the purpose of discovering evidence of questionable behavior. Screening may include a combination of interviews, research, investigation, and analysis. The firm should consider consulting with legal counsel in certain cases prior to investigating a current or prospective client to determine if there are any federal, state, or local statutes that require permission from, or disclosure to, the prospective client.

Obtaining a critical mass of information can be difficult to do when the client is a nonissuer; however, there are ways to gain knowledge about nonpublic prospective clients by exploring key areas, such as those discussed in the paragraphs that follow. Also, in many cases, much of the information will be more readily available to a firm that is assessing an ongoing client relationship than to firms that are evaluating a prospective client.

In performing client screening procedures, key areas to evaluate may include the following:

- Interaction with CPAs and other professionals.
- Reputation in the community.
- Profile as a corporate citizen.
- Fiscal responsibility.
- Formal company communications.
- Openness of the client.
- Dealings with employees.

The paragraphs that follow refer to the prospective client; however, this guidance is also applicable to evaluating current clients to decide whether to continue existing client relationships.

Interaction with CPAs and Other Professionals. Firms may engage in discussions with other CPAs in the community and other professionals, such as lawyers or bankers, to make specific inquiry of professionals who have served the prospective client. In discussions with other professionals, asking questions such as the following might be helpful:

- Has the prospective client experienced a more than normal frequency in changing its accounting firm? This may be a sign of disagreements involving questionable practices that other professionals are unwilling to accept or endorse.
- Has the client been unwilling to sign engagement or representation letters?
- Has the client imposed scope limitations on previous engagements?
- Has the client imposed unreasonable deadlines on prior accountants or other professionals?
- Is the management team known for taking unreasonable business risks?
- Does the client have a propensity for litigation? Review current court dockets, including the U.S. Bankruptcy and Tax Court dockets, for ongoing litigation. A comprehensive investigation will discover how often the prospective client uses its legal counsel and in what context. A firm is wise to avoid clients who seem to solve their disagreements in court.
- Has this been a difficult client to satisfy?

Reputation in the Community. A business that is well respected by the community can generally be assumed to have won that respect through honest dealings with customers and the public. Firms might consider the following in determining the client's reputation in the community:

- Visit store locations of the prospective client, if any. Is there good customer traffic? Is there community support for the business? Do conversations with customers elicit positive responses? Do the store locations demonstrate care for customers by presenting a clean appearance and providing a safe environment?

- Do suppliers and other vendors seek a business relationship with the prospective client? If the business has experienced turnover with several vendors, this may be an indicator of deeper problems.
- What is the tone of press reports? The investigative phase of the client screening process includes searches of news retrieval agencies and trade publications that might contain information on prospective clients and their management. Accessing and searching electronic archives of local newspapers will speed up the research process and may surface relevant issues to discuss with the prospective client.
- What information is available from on-line services? Some of those providers allow the firm to search for bankruptcy records, litigation history, Dun & Bradstreet reports, corporate filings, and corporate affiliations and can be performed from the office at a relatively low cost.
- Reports filed with the Better Business Bureau are a good source of information regarding the business dealings of the company. Those reports may have a degree of reliability in that a fee is charged to customers and others who wish to file a report about the business.
- Other sources of information include websites that offer opportunities for users to post comments about a business. While these comments must be evaluated on their own merit, they are, nonetheless, public opinions of individuals with firsthand dealings with the prospective client.

Exhibit 2-1 provides sources of background information available to firms online.

Exhibit 2-1

SOURCES OF BACKGROUND INFORMATION

INFORMATION SOURCE	HOW TO CONTACT
Credit Rating Services	
Dun & Bradstreet	**www.dnb.com**
Equifax	**www.equifax.com**
Experian	**www.experian.com**
Moody's Investors Service	**www.moodys.com**
National Association of Credit Management	**www.nacm.org**
Online Database Services	
Access Information	**www.access-information.com**
BRINT Institute	**www.brint.com**
ChoicePoint	**www.choicepoint.com**
The Dialog Corporation	**www.dialog.com**
Hoovers	**www.hoovers.com**
LexisNexis	**www.lexisnexis.com**
PublicData.com	**www.publicdata.com**
Standard & Poor's	**www2.standardandpoors.com**
General Business Information	
AT&T Information	**www.anywho.com**
National White and Yellow Pages	**www.switchboard.com**
Yahoo Business Directory	**http://dir.yahoo.com/business_and_economy**

* * *

Profile as a Corporate Citizen. How a business is involved with its community also demonstrates the character of its leadership. A business that cares about doing the right thing will likely be actively involved in the community. To determine whether a prospective client is a good corporate citizen, a firm might consider the following:

- Does the business sponsor local charitable events? If members of the firm are also involved in community events, there may already be ample sources of information within the firm to evaluate this area.
- Make inquiries of local business groups or associations, such as the local Chamber of Commerce or trade associations.
- Have any complaints been filed with any state or federal agencies? What is the nature of those complaints and are the sources credible?

Fiscal Responsibility. Maturity in fiscal matters demonstrates an attitude of responsibility and an ability to meet financial obligations. Businesses that are able to meet their financial obligations may be less likely to engage in inappropriate business practices. Moreover, the importance a business places on meeting its financial obligations may indicate how readily accounting fees will be paid. The firm might consider the following in determining whether a prospective client exhibits fiscal responsibility:

- Even without performing a review of a prospective client's business records, a firm may be able to get a preliminary financial picture by evaluating its creditworthiness. A prospective client's creditworthiness can often be obtained through inquiring of a commercial credit rating service such as Equifax, Experian, D&B, or Moody's.
- The physical state of the facilities may also be an indicator of how a company manages its assets, including financial assets. Facilities in obvious need of repair may be an indicator of severe cash flow issues.
- Information regarding any tax or real estate liens is publicly available. Many counties have this information available online.
- If a prospective client initially refuses to agree to a reasonable fee estimate, that may indicate future fee issues. The firm might consider collecting a retainer fee in advance of performing certain services.

Formal Company Communications. How does the business present itself to its employees, customers, and other business partners? A firm might consider the following:

- A good way to evaluate the company's tone at the top is to review formal company communications such as the mission statement, ethics policies, and customer policies. Some of those documents may be available on the company website, while others may only be available if the prospective client agrees to share them.
- Company-sponsored advertising offers another view of how the business presents itself. Advertisements can be found in local newspapers, the company website, and store locations, if any. Advertising that is too slick or promises too much may be a cause for concern.
- Internal policies over the financial process may demonstrate the company's commitment to sound accounting policies and internal control procedures. Good faith efforts to collect and communicate accurate and technically correct financial information may mean that the firm might be less likely to encounter fraud (which is not to say that the firm may be less alert to the possibility of fraud).
- Review minutes of board of directors meetings, if available, for discussions of issues that bring the integrity of the client into question.

Openness of the Client. The degree of openness of the prospective client may be an indicator of general integrity. For example, a client with nothing to hide will not have anything to fear by the firm contacting customers, vendors, employees, or other third parties who have had dealings with the client. Information obtained from those discussions can be valuable in evaluating the integrity of the client. However, if the prospective client is very selective about the contacts the firm will be allowed to make, the firm needs to be aware that the client will be putting its best foot forward and will likely offer up only those contacts with glowing recommendations. In evaluating client openness, the firm might consider the following:

- If a tour of the operations is given, is the firm allowed to speak with any employees? Are there any activities that appear suspicious?
- What degree of freedom does the firm have in selecting contacts to question?
- In cases where the client is not forthcoming with information, a background investigation may be performed by an investigative services company.

Dealings with Employees. How a company deals with its employees may also reveal the measure of its integrity. Issues do not have to be resolved in the employee's favor—whether the company has acted in a fair and equitable manner can be a litmus test for integrity. Consider the following questions in determining how the company deals with its employees:

- Is there frequent turnover in management positions?
- Have any issues with employees become public? A search of newspaper databases may reveal any such disagreements.
- Have there been any actions filed with federal agencies, such as the Equal Employment Opportunity Commission or the Department of Labor?
- What is the nature of any pending lawsuits? Review current court dockets for ongoing litigation.
- Does the company have an employee policy manual? If it is made available to the firm, are the policies reasonable and comprehensive, and do they demonstrate an expectation of integrity in the actions of employees?
- What is the company's attitude toward confidential information? Respecting the privacy of others is a facet of high integrity. Review the company's privacy policy regarding the personal information of employees, customers, and vendors.

Special Considerations—Attestation Engagements

The third general attestation standard at SSAE No. 10 (AT 101.23), *Attest Engagements*, states that "the practitioner must have reason to believe that the subject matter is capable of evaluation against criteria that are suitable and available to users." AT 101.29 states that "practitioners should not perform an engagement when the criteria are so subjective or vague that reasonably consistent measurements, qualitative or quantitative, of subject matter cannot ordinarily be obtained." Professional judgment is required in concluding whether these requirements will allow acceptance of a particular attest engagement.

Special Considerations—Compilation and Review Engagements

Unlike the mandatory communication required by auditing literature, under SSARS an accountant is not required to communicate with a predecessor accountant as a prerequisite to acceptance of an engagement (AR 400.03). However, SSARS emphasizes that, in some circumstances, the successor may wish to make inquiries of the predecessor. In those cases, the accountant should request permission from the client and request that the client authorize the predecessor to respond fully to the inquiries. If the client refuses, the accountant should consider the reasons for the refusal and its implications on accepting the engagement. According to SSARS at AR 400.05, if a successor accountant decides to communicate with the predecessor, he or she should consider making the following inquiries:

- Is there information that might reflect on the integrity of management?

- Were there disagreements about accounting principles or the necessity for performing certain procedures?
- When necessary, did management cooperate in providing additional or revised information?
- What is the predecessor's understanding of the reasons for changing accountants?
- Does the predecessor know of any fraud or illegal acts perpetrated within the client?

SSARS literature (AR 100.08 and AR 100.33) also requires an accountant to possess a certain level of knowledge about the principles and practices of the industry in which the entity operates. The accountant is permitted to obtain this level of knowledge after accepting the client.

EVALUATING RISK BASED ON THE NATURE OF THE ENGAGEMENT

In addition to evaluating the integrity of the client, the firm should also evaluate the client for any special risks associated with the nature of the engagement. SQCS No. 7 (QC 10.27) directs the firm to "consider. . . the risks associated with providing professional services in the particular circumstances."

One of the key factors in reducing liability and managing risk is understanding the risk associated with a new client or engagement before accepting the work. That understanding can help the firm determine whether the client relationship will be cost-beneficial. If the client is accepted, that advance understanding of the client also helps the firm properly assess engagement risk and the related procedures that may be necessary. For instance, engagements for new ventures ordinarily have inherently higher risk than engagements with established entities. By understanding this risk, the nature, timing, and extent of procedures can typically be expanded on first-year engagements to help mitigate the additional risk (assuming those engagements are accepted).

Some of the key steps of the client acceptance and continuance process that deal with evaluating the risk resulting from the nature of an engagement are discussed in this lesson and include the following:

- Evaluating risk of violating ethical requirements.
- Evaluating practice area risk.
- Evaluating industry risk.
- Evaluating engagement risk.
- Evaluating the financial reporting system and financial statements.
- Determining if scope limitations exist.

Evaluating Risk of Violating Ethical Requirements

CPAs are required to comply with very specific ethical requirements. Maintaining independence in fact and appearance can be challenging, especially in cases where the client relationship is cozy and the client has the highest integrity, operates in an ideal industry, and the engagement fits perfectly within the firm profile. Additionally, the discovery of any potential conflicts of interest should cause the firm to seriously consider whether an engagement should be accepted or continued.

Evaluating Practice Area Risk

Will the Engagement Consume a Disproportionate Amount of Firm Resources? In deciding whether to provide a given type of service, consideration of the amount of time spent providing such services throughout the year can assist the firm in making a decision. For example, it may not be worthwhile to provide review services if the firm has no other review clients. A small practice may not support the time and effort it will take for the firm's partners and staff to remain familiar with professional standards that address performing review engagements.

Will the Engagement Constitute a Marginal Level of Practice? Generally firms should also avoid developing a marginal level of practice in a given area (particularly a high-risk practice area). Firms need to clearly commit to providing services in a given area (thereby developing adequate expertise) or eliminate pursuing clients desiring such services altogether. Even when dealing in areas that are not normally considered high-risk areas of practice, a firm may encounter a high level of risk if the firm does not have adequate experience. Firms that only dabble in a practice area accept higher liability risk in that area. Accordingly, exercising caution is appropriate when accepting engagements in areas where the firm has limited experience. Mitigating actions might include taking additional continuing education courses in the practice area or contracting the services of individuals outside the firm who have experience in handling that type of engagement.

Evaluating Higher Risk Practice Areas. It may come as a surprise that accountants' malpractice claim statistics historically show tax and accounting services representing the highest frequency of claims filed. However, the severity of damages per claim is higher for audit engagements and business/investment advisory services. Yet firms that perform only compilation and review work should not assume that their malpractice risk is inherently low, as it is not unusual for small CPA firms with no audit practice to be hit with claims seeking in excess of $1 million. Before accepting an engagement, CPA firms need to not only examine the economics of servicing the client but also the potential liability risks posed by the engagement. For example, with a compilation and review-only practice, completeness of prospective financial statements may present higher risk to the firm and the firm needs to take appropriate precautions.

Evaluating Industry Risk

The next step in the client acceptance and continuance process is to evaluate the risk of providing services in certain industries. Some industries pose higher than normal levels of risk. Such industries may vary with time and economic cycles, but industries such as the following historically tend to produce higher firm risk:

- Employee benefit plans.
- Financial services companies, including banks, savings and loans, credit unions, and insurance companies.
- Technology companies.
- Real estate or construction companies.
- Telecommunication companies.
- Health care institutions, including hospitals and nursing homes.
- Nonprofit organizations.

Companies in those industries tend to either invoke public trust or are held in suspicion as they can be, by nature, quite volatile and frequently suffer high rates of business failure. Selected industries listed in the previous paragraph have specialized accounting practices and may create financial reporting and tax exposure for firms that do not fully understand these accounting practices. In addition, the financial services and real estate industries have cyclical business trends and have greater liability exposure during economic turns. Industries expected to present higher risk to firms in the future include high-tech companies and companies with substantial e-commerce applications. Troubled industries can generally be identified by answering the following questions:

- Is the industry, as a whole, in recession?
- Has the industry been subject to increased regulatory scrutiny due to losses and insolvencies?
- Is the industry undergoing dramatic changes such as market growth or contraction, government deregulation, or intense foreign competition?
- Is the industry plagued by outdated technology that requires a significant infrastructure upgrade to remain viable or competitive?

Similar to the decision to provide services in a practice area, the decision to provide services within an industry also depends on the extent to which the CPA firm has expertise in serving businesses in that industry. In addition, it is generally safer for a CPA firm to perform services for an entity in a specialized industry if the firm already has several clients in that industry than to undertake an engagement of a sole company within an industry. Thus, the "critical mass" of the firm's practice becomes important in determining whether a firm considers accepting clients in a given industry.

Evaluating Engagement Risk

After a tentative decision regarding the client's acceptability has been made, the next step in the acceptance process is consideration of engagement or transaction risk. Engagement risk can often be identified when the firm answers questions such as—

- During inquiries with the prospective client's management, what work is to be performed and what does the client intend to do with the work? For instance, will other people, such as bonding companies or absentee owners, rely on the firm's work? If financial statements are to be issued, are the statements intended to meet regulatory, credit, or contractual requirements?

- Will the work be used to influence investment decisions? For instance, is this engagement critical to a pending purchase or sale, obtaining business financing, or investor funding?

- Will the work be used in conjunction with a new or risky enterprise or transaction?

A thorough analysis of the engagement generally indicates the experience level and industry competence needed to properly staff the engagement. (Furthermore, the analysis might indicate that more detailed monitoring of the client is needed in the future.)

Evaluating the Financial Reporting System and Financial Statements

Before accepting the engagement, the accounting firm may also make a preliminary evaluation of the prospective client's financial reporting system to determine whether the proposed engagement is feasible. The evaluation needs to be sufficient to determine if the firm can apply required procedures on a cost-effective basis. As part of that process, the firm generally evaluates the prospective client's prior years' financial statements and available current-year financial information with the following questions in mind:

- Is there adequate documentation to support the information presented in the financial statements?

- Are the books and records in good order?

- From a preliminary review of the current financial statements, are any dramatic accounting changes evident from the prior year?

- Do comparative financial statements indicate that the prospective client's financial condition is deteriorating?

- Are there obvious discrepancies among the various financial statements?

While this evaluation may not reveal a well-concealed problem, it may provide evidence of potential problems or risks.

Determining If Scope Limitations Exist

Consideration needs to be given to any limitations or restrictions the prospective client intends to place on the engagement. For instance, the timing of the fieldwork needs to allow the firm sufficient time to apply all necessary procedures. If there are obstacles to the firm being able to apply all necessary procedures, the firm should evaluate if there are any alternative procedures that can be performed or applied to overcome the restriction. However, in the event an engagement restriction makes it impossible or impracticable to apply necessary procedures (when alternative procedures are unavailable), a scope limitation exists.

EVALUATING COMPETENCE, CAPABILITIES, TIME, AND RESOURCES OF THE FIRM

Deciding whether to accept or continue an engagement also requires policies and procedures to determine whether the firm has personnel who possess the competence and capabilities and have scheduling availability to provide the desired services. SQCS No. 7 (QC 10.31) offers the following matters to consider:

- Do firm members have, or are they able to acquire, the requisite industry or subject matter knowledge?
- Do firm members have, or are they able to acquire, the requisite experience with regulatory or reporting requirements?
- Are there sufficient competent and capable firm personnel available to perform the engagement?
- If specialists are needed, are they available?
- For applicable engagements, are there individuals qualified to perform an engagement quality control review?
- Can the firm meet the reporting deadline required by the engagement?

Industry or Subject Matter Knowledge

The human resources QC element focuses on the general competence and capabilities of personnel. Within the context of the acceptance and continuance QC element, the focus is on whether the firm has, or is able to acquire, the specialized knowledge required for the specific engagement. Certain industries such as health care, banking, insurance, and petroleum have specific terminology, complex transactions, and specialized accounting requirements that are not encountered in general engagements.

Rule 201 of the AICPA's *Code of Professional Conduct* (ET 201.01) applies to all public accounting services and requires that members agree to perform only those professional services that the member or the firm can reasonably expect to complete with *professional competence*. While *competence* includes the ability to make sound decisions in the performance of an engagement, the most frequently assumed qualification of competence is technical proficiency. *Not having the specialized knowledge about the specific industry in which the client operates at the beginning of an engagement will not force a firm to decline an engagement if it is possible to obtain that knowledge during the course of the engagement.*

Methods of obtaining knowledge can include continuing education courses, self-study, and research. Consider the complexity of the material to be covered and whether there are relevant training classes and materials available, as well as whether there is sufficient time to develop the desired level of expertise required for the engagement. Where adequate time is not available to develop the needed expertise, the only option may be to engage the services of an outside specialist.

Special Considerations—Ethics Requirements When Using Third-party Service Providers. Members who outsource client work to third-party service providers are subject to specific requirements, which are detailed in three ethics rulings.

- Before engaging the services of a third-party service provider, members should enter into a contractual agreement with the third-party service provider requiring confidentiality of client information. In addition, members should obtain reasonable assurance that the appropriate procedures are in place at the third-party service provider to prevent the unauthorized release of confidential information to others. If the accountant does not enter into a confidentiality agreement with a third-party service provider, specific client consent should be obtained before the member discloses confidential client information to the third-party service provider. (See Ethics Ruling No. 1 under Rule 301—*Confidential Client Information* at ET 391.001–.002.)

- When using a third-party service provider to provide professional services for a client, the accountant has a duty to inform the client, preferably in writing, of the use of such a provider prior to sharing confidential client information with that provider. If the client objects to the use of a third-party service provider, the engagement would have to be performed without using third-party service providers, or the firm should decline the engagement. (See Ethics Ruling No. 112 under Rule 102—*Integrity and Objectivity* at ET 191.224–.225.)

- The accountant is responsible for all work performed, including the work performed by third-party service providers, and ensuring that the services meet the general standards and all other applicable technical standards. (See Ethics Ruling No. 12 under Rule 201—*General Standards* and Rule 202—*Compliance with Standards* at ET 291.023–.024.)

Regulatory or Reporting Requirements

For certain engagements, firm staff may be required to have a specialized background or be acquainted with additional standards beyond the attestation or compilation and review standards. For example, a specialized background will generally be required to perform accounting services for employee benefit plans, which are subject to ERISA and DOL requirements.

Meeting Reporting Deadlines

When the firm discusses the nature of the services requested, the firm generally also discusses the required timing. Even if the firm has the staff with the appropriate technical background, if those resources are not available to perform and complete the engagement within the deadline specified by the client, the firm should decline the engagement. For example, if an engagement is required to secure debt or satisfy debt covenants, submitting financial statements later than required may have severe consequences for the client. It is also important that the firm understand the nature of the deadline to determine if it is arbitrary or imposed by legal or regulatory entity. If the deadline is not imposed by a legal or regulatory entity, the firm might be able to negotiate a revised deadline compatible with availability of firm resources.

HOW TO COMPLY WITH LEGAL AND ETHICAL REQUIREMENTS

Another component when deciding whether to accept or continue an engagement requires the firm to develop policies and procedures to determine whether the firm can comply with the requisite legal and ethical requirements of the engagement.

Legal and Regulatory Requirements

Certain engagements require a firm to comply with specific legal and regulatory requirements. Those requirements may apply as a result of the type of industry in which the client operates, or whether the company is an issuer. For example, engagements that require the CPA to collect and examine the personal information of a client's customers, employees, or vendors may subject the accountant to federal and state privacy laws such as the Health Insurance Portability and Accountability Act (HIPPA). Also, many companies may be subject to Security Breach Notification Laws, which are now in effect in a significant number of states.

Ethical Requirements

Section 100 of the AICPA's *Code of Professional Conduct* requires that members in public practice be independent in fact and appearance, as well as maintain integrity and objectivity when performing professional services. Subject to mitigating factors, in cases where it appears that a firm's independence, integrity, or objectivity is likely to be impaired, the firm should decline to accept an engagement.

Statutory or Regulatory Appointment of Accountant

SQCS No. 7 (QC 10.36) indicates that, in situations where the firm has been appointed by statutory procedure or by law or regulation to perform the engagement, the acceptance and continuance considerations discussed herein may not apply.

HOW TO OBTAIN AN UNDERSTANDING WITH THE CLIENT

SQCS No. 7 (QC 10.28) states that the policies and procedures should direct the firm to obtain an understanding with the client about the nature, scope, and limitations of the services to be provided. Whether the understanding is oral or written depends on other applicable AICPA standards. Any discussions with the client regarding important terms or issues of an engagement should be documented.

As a general rule, the professional standards covering compilations and reviews of historical financial statements and attestations include requirements to establish an understanding with the client regarding the services to be rendered and to decline to accept or perform the engagement if the practitioner believes that an understanding with the client has not been established. The AICPA standards that address obtaining an understanding with the client are—

- SSARS No. 1 (AR 100.05 and AR 100.24), *Compilation and Review of Financial Statements*, indicates the firm should reach an understanding with the client regarding the compilation or review services—preferably, but not required, in writing. A written communication is required only when management-use-only compiled financial statements are submitted without an accompanying report.
- SSARS No. 19, *Compilation and Review Engagements*, was issued in December 2009 and supersedes AR 20, AR 50, and AR 100. The new standard is effective for compilations and reviews of financial statements for periods ending on or after December 15, 2010. Among the revisions resulting from SSARS No. 19 is a requirement that the understanding established with the client should be documented by using a written, signed engagement letter. Thus, once SSARS No. 19 becomes effective, engagement letters will be required for all compilation and review engagements.
- SSAE No. 10 (AT 101.46), *Attest Engagements*, requires accountants to document the understanding with the client in the workpapers when providing attestation services, preferably through a written communication with the client.
- Interpretation 101-3 to Rule 101 of the AICPA's *Code of Professional Conduct* requires a written understanding with the client when nonattest services are provided for an attest client.

Engagement Letters

Although engagement letters are only currently required for audit engagements and compilations of management-use-only financial statements in which a report is not issued, this course recommends the use of engagement letters in a firm's suggested quality control system because it is believed engagement letters are the most cost-effective means of providing quality services and minimizing engagement risk. However, SSARS No. 19 will require engagement letters for all compilation and review engagements.

As all authoritative literature does not require written engagement letters, a firm may decide that it will not require engagement letters on some or all types of engagements. If so, the firm can tailor that suggested procedure to meet the unique operations of its firm. However, firms need to be aware that authoritative standards do require that the firm reach an understanding with its clients as to the terms of all engagements and that peer reviewers will ask for documentation of a firm's understanding with its client. Also, if a SSARS No. 1 compilation of management-use-only financial statements in which a report is not issued is peer reviewed, the reviewer will ask for the engagement letter. In addition, many firms include the documentation required by Ethics Interpretation 101-3 in their engagement letters.

ADDITIONAL CONSIDERATIONS

Timing and Scope of Clients and Engagements Subject to SQCS No. 7

SQCS No. 7 (QC 10.27), indicates that the firm should gather all the information necessary about a client or an engagement before—

- A new client is accepted.

- Work on a continuing engagement begins.
- A new engagement with an existing client is accepted.

In addition, when making a decision about whether to continue an existing client relationship, SQCS No. 7 (QC 10.33) requires the firm to consider whether any significant issues have arisen during the course of the relationship with the client. Consideration should also be given to how those issues affect the ongoing client relationship. As an example, the client may have begun to expand its operations into an area that requires specialized accounting knowledge and the firm does not currently possess the necessary competence.

Evaluating the Acceptability of Existing Client Relationships. One of the major deficiencies of most acceptance and continuance QC systems is the failure to adequately evaluate the acceptability of existing clients and engagements. Some firms may be reluctant to adopt formal procedures for fear that they will be costly and time-consuming. Further, many firms view such an evaluation as a futile exercise because rarely can a firm afford to dismiss a marginal client. However, an annual evaluation program does not have to be an onerous task, and even if marginal clients cannot be dismissed, the continuance evaluation exercise is not futile. In fact, annual client and engagement evaluations make good business sense. One of the primary benefits of the evaluation is not the dismissal of clients, but the identification of problem clients and the development of strategies to mitigate the risk associated with those clients, for example, requiring down payments on fees before work commences, flexible fee arrangements, and expanded or alternative procedures to reduce risk.

Evaluating the Client List. There are two approaches to performing ongoing client and engagement evaluations. One approach is to annually reevaluate each client on the firm's client list in a meeting of all partners. To control the meeting time, partners may be asked in advance to specifically evaluate clients for which they have engagement responsibility. Reasons that might cause the firm to consider discontinuing services include—

- Significant changes in the client, for example, retirement of senior management, perceived integrity of management has declined, other ownership changes, decline in financial stability, or specific risks associated with the engagement.
- Changes in the nature or scope of the engagement, including requests for additional services the firm may not be adequately prepared to render.
- Significant changes in the composition of the firm, for example, a change in the firm's professional competence (expertise) in a particular industry.
- Significant unpaid fees that may cause an independence problem or create doubt about the collectibility of future fees.
- The existence of conditions that would have caused the firm to reject the client or engagement had such conditions existed at the time of the initial acceptance.
- The client is in the development stage or operates in a highly specialized or regulated industry (such as a financial institution, governmental entity, or employee benefit plan) that poses undue risk to the firm.
- More time is required to perform the engagement than the firm can provide.

Evaluating the Client during the Planning Stage of Each Engagement. A second approach to ongoing client and engagement evaluation is to require the engagement team to reevaluate the acceptability of the client during the planning stage of each engagement. This procedure requires the firm to add a program step to all of its engagement work programs to remind the engagement team of this responsibility.

Which Approach is Preferred? Either approach to evaluating the ongoing acceptability of a client is an effective technique. Adopting both procedures is preferred (a macro review of the client list and a micro review of each engagement) because the procedures are complementary and are not time-consuming. However, as performance of both approaches is not required by professional standards, firms need to establish policies and procedures that work best for their particular clients and circumstances.

Responsibility for Approval. Regardless of which of the approaches discussed above is used, the ultimate decision to dismiss a current client generally should be made by firm management in coordination with the engagement partner, unless specified otherwise by professional standards.

Documentation of Client and Engagement Evaluation. Documenting the annual evaluation in the minutes of the partners' meeting or with a memorandum is also recommended. The documentation might state that all clients and engagements were evaluated, list the general factors considered, identify any steps to be taken on marginal clients, and identify any clients who will be dismissed. An example of such minutes or memoranda is presented in Exhibit 2-2. Documentation of the acceptance and continuance evaluation made at the engagement level can be made by simply initialing this step on the engagement work program.

Exhibit 2-2

Minutes or Memorandum Documenting Annual Client and Engagement Acceptability Evaluation and Monitoring

On [Insert date.] , I (we) [Names of Partners in Attendance] considered the acceptability of continuing to provide all or certain professional services to each client on the firm's client list. Among the factors considered in evaluating each client were:

- Timely payment of fees.
- The firm's relationship with client's management or owners.
- Known instances of fraud or illegal acts, or allegations of fraud.
- Significant changes in one or more of the following:
  - Independence relationships.
  - Perceived integrity of management.
  - Directors or key management.
  - Legal counsel or litigation status.
  - Financial condition.
  - Litigation.
  - Nature of business or industry.
  - Ability to operate as a going concern.
  - Nature or scope of engagement.
  - System of internal control or reliability of financial records.
  - Risk associated with a particular engagement.
  - The firm's professional competence (expertise).
- Aggressive accounting or tax positions taken and/or related unresolved disagreements with management.

Based on this evaluation, the following clients and/or engagements have been categorized as requiring special monitoring or expanded procedures:

[List all clients and steps to be taken to mitigate risk to the firm.]

I (We) decided to discontinue relationships with the following clients:

[List clients' names and reason for discontinuing services.]

The appropriateness of the QC system over the acceptance and continuance of clients and engagements was also considered along with the firm's compliance with the system. Results of our ongoing monitoring activities as they relate to reviewing compliance with the acceptance and continuance system were reviewed and evaluated. I (We) determined that both the system and the firm's compliance with the system were acceptable (except as noted below).

[List any exceptions and corrective actions here.]

____ __________________
Partner Date

* * *

Conflicts of Interest

The discovery of any potential conflicts of interest should cause the firm to seriously consider whether an engagement with a new or existing client should be accepted. Moreover, SQCS No. 7 (QC 10.32) states that if the engagement is accepted, the ethical requirements under AICPA Interpretation No. 102-2 (ET 102.03), "Conflicts of Interest," under Rule 102, *Integrity and Objectivity*, should be considered.

> A conflict of interest may occur if a member performs a professional service for a client or employer and the member or his or her firm has a relationship with another person, entity, product, or service that could, in the member's professional judgment, be viewed by the client, employer, or other appropriate parties as impairing the member's objectivity. If the member believes that the professional service can be performed with objectivity, and the relationship is disclosed to and consent is obtained from such client, employer, or other appropriate parties, the rule shall not operate to prohibit the performance of the professional service. When making the disclosure, the member should consider Rule 301, *Confidential Client Information*.

Significant Issues Discovered after the Engagement Begins

SQCS No. 7 (QC 10.34) states that the firm's policies and procedures for accepting or continuing an engagement address the actions a firm should take if information comes to light that would have caused the firm to decline the engagement if such information had been previously known. If these circumstances apply, the firm should consider—

- Any professional or legal responsibilities of the firm to the client.
- The possibility of withdrawing from the engagement or even severing the client relationship.

Withdrawing from an Engagement or Ending a Client Relationship

When drafting policies and procedures for withdrawal from an engagement or a client relationship, SQCS No. 7 (QC 10.35) states that the following should be documented:

- Significant issues that result in a firm withdrawing from the engagement or client.
- Consultations.
- Conclusions.
- Basis for conclusions.

SQCS No. 7 (QC 10.35) also suggests that policies and procedures related to withdrawing from an engagement include the following additional issues that may be discussed with the appropriate level of client management and those charged with governance:

- Appropriate actions that the firm might take.
- The firm's decision to withdraw.

Further, QC 10.35 states that the firm may consider whether there are professional, regulatory, or legal requirements to—

- Remain associated with the client and the engagement.
- Report the withdrawal, including the reasons, to the appropriate regulatory authorities.

Determining When to Withdraw from an Existing Engagement. The suggested acceptance procedures in the previous paragraphs are designed to be performed before work commences on an engagement. Even with the best possible pre-engagement acceptance procedures, situations will sometimes occur in which the firm subsequently becomes aware of facts that cause the firm to consider withdrawing from the engagement after the engagement work has begun. Best practices indicate that an acceptance and continuance QC system should also provide guidance for situations that would cause a firm to withdraw.

Responsibility for Approving the Decision to Withdraw. The managing partner and the accounting partner are generally responsible for deciding when to withdraw from an engagement. A client may contend that the act of withdrawing from an engagement-in-process is a breach of contract. Such a contention could subject the firm to possible legal action. (As a result, firms need to consider consulting their legal counsel prior to withdrawing from an engagement.) The suggested engagement letters in PPC *Guides* contain the following sentence that informs the client that the firm has the right to withdraw:

> If, for any reason, we are unable to complete the [Type of Engagement] , we may not issue a report as a result of this engagement.

Documenting a Withdrawal. Any decision to withdraw from an engagement would require a major consultation among the partners of the firm. The QC system requires that major consultations be documented and filed in the engagement workpapers. It is believed that any decision to withdraw from an engagement would be subject to those same consultation documentation procedures.

Communicating the Decision to Withdraw or Discontinue Services. A decision to withdraw or discontinue services is a serious matter and, consequently, communication of this decision (especially to the client) needs to be carefully considered. It is believed that, in most cases, the communication should be in writing, and PPC's accounting guides include a form for drafting a resignation letter. In some cases, the firm may need to contact legal counsel to determine the most appropriate method of making this communication.

Special Considerations—Attestation Engagements. SSAE No. 10 requires the practitioner to withdraw from an attest engagement in the following circumstances:

- In a review engagement, if the practitioner's client is the responsible party (that is, the party responsible for the subject matter) and does not provide the practitioner with a written assertion (that is, a written declaration about whether the subject matter is based on or in conformity with the criteria against which it will be evaluated) (AT 101.58, footnote 11; AT 101.73; and AT 101.75).
- In a review engagement, if the responsible party refuses to provide all written representations the practitioner believes are necessary to issue a report (AT 101.62).
- In a review engagement, if the practitioner is unable to perform the inquiry and analytical or other procedures considered necessary for review (AT 101.75).
- If other information in a client-prepared document containing the practitioner's attest report is materially inconsistent with the information in the practitioner's report, and the client does not revise the information to eliminate the inconsistency. Withdrawal is one action that should be considered (revision of the report to describe the inconsistency or withholding use of the report in the document are other actions that should be considered) (AT 101.92).

Special Considerations—Compilation and Review Engagements. SSARS literature requires an accountant to withdraw from a compilation or review engagement in the following circumstances:

- The accountant becomes aware that information supplied by the client is incorrect, incomplete, or otherwise unsatisfactory, and the client refuses to provide additional or revised information (AR 100.10).
- In a review, the accountant is unable to apply the analytical and review procedures or the client refuses to provide a representation letter, and the accountant decides (as would ordinarily be the case) that it is not appropriate to issue a compilation report (AR 100.51 and AR 100.89).
- The client will not accept a modified report (AR 9100.22).
- A modification of the standard report will not adequately indicate the deficiencies in the financial statements taken as a whole (AR 100.58 and AR 9100.18–.22).

DRAFTING QUALITY CONTROL POLICIES AND PROCEDURES FOR THE FIRM

AICPA Practice Aid

After reviewing authoritative literature, the illustrative examples suggested by the AICPA for designing the acceptance and continuance element of the quality control system should be reviewed. Those examples are found in the AICPA Practice Aid, *Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (the AICPA Practice Aid).

While the AICPA's illustrative policies and procedures may provide a logical starting point for designing the acceptance and continuance quality control system, careful consideration of the firm's needs is urged before adopting them. Many firms will find that the suggested policies and procedures may not meet their firm's particular needs.

Developing Acceptance and Continuance Policies and Procedures

Quality control policies are designed to achieve the overall objectives of the QC system and the specific objectives of the individual QC elements. Quality control procedures are designed to provide the actions necessary to implement and monitor compliance with the stated policies. It is believed that factors such as the following can impact the QC policies and procedures for a given firm—

- Size of the firm.
- Operating characteristics of the firm.
- Knowledge and experience of firm personnel.
- Nature and complexity of the firm's practice.

There is more than one way to develop a firm's quality control policies and procedures. For example, the approach taken in this course is to develop one policy statement for each QC element and then design appropriate procedures for each element that implements that one policy. Alternatively, the AICPA Practice Aid illustrative policies and procedures include multiple policy statements for each QC element with procedures related to each policy. Firms need to choose an approach in developing their QC policies and procedures that meets the needs and desires of the firm.

The Firm's Quality Control Procedures

Once overall policy statements are formulated, the next step is to design the procedures needed to implement and monitor the policies. It is important for firms to design procedures that can be easily monitored by the firm and ultimately be assessed by a practice monitoring unit. Elaborate documentation is not necessarily required; instead, it should be based on the firm's size, structure, and nature of the firm's practice. Documentation should provide sufficient evidence that the quality control policies and procedures were followed.

Adopt a Standardized Checklist for Accepting a New Client. Most firms have found that an easy method for evaluating a new client is to adopt a standard acceptance checklist. This checklist can easily be formulated from the firm's acceptance and continuance policies and procedures.

MONITORING COMPLIANCE WITH ACCEPTANCE AND CONTINUANCE POLICIES AND PROCEDURES OF THE FIRM

The firm should review, on an ongoing basis, its client and engagement acceptance and continuance policies and procedures to determine if they continue to be appropriate for the firm. This review and assessment is normally accomplished in coordination with the monitoring phase of the firm's quality control system. Based on this review and assessment, the firm's policies and procedures should be revised as appropriate.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

15. Jody is an accountant assigned by the firm to consider the integrity of a client in order to determine whether the firm should continue a review engagement with that client for a period that will end on May 1, 2010. As part of his evaluation, Jody will be evaluating those charged with governance. Which AICPA standard should Jody consult for a definition of *those charged with governance*?

    a. SFAS No. 57.

    b. SSARS No. 17.

16. Bob wants to gather background information on a prospective client to determine the client's reputation in the community as a measure of integrity. Which of the following sources would provide Bob with the information he is seeking?

    a. National Association of Credit Management.

    b. PublicData.com

    c. Moody's Investors Service.

    d. Dun & Bradstreet.

17. Of the following statements, which one is accurate regarding compilation and review engagements?

    a. Under SSARS, an accountant must communicate with a predecessor accountant as a prerequisite to accepting an engagement.

    b. The accountant does not need permission from the client in order to make inquiries of the predecessor.

    c. The accountant should request that the client authorize the predecessor to respond fully to inquiries.

    d. The accountant must obtain a certain level of knowledge about the principles and practices of the industry the entity operates in prior to accepting the client.

18. When members outsource client work to third-party service providers, they are subject to specific requirements that are cited in three ethics rulings. When a member desires to use a third-party service provider and wants to know the requirements that must be met prior to sharing confidential client information with that provider, which of the following ethics rulings should be reviewed?

    a. Ethics Ruling No. 1 under Rule 301.

    b. Ethics Ruling No. 112 under Rule 102.

    c. Ethics Ruling No. 12 under Rule 201.

19. Which of the following factors will have the greatest impact on the firm's ability to meet the reporting deadline for an engagement?

    a. Having staff with appropriate technical background to perform the engagement.

    b. Having a deadline established by the client to meet internal requirements.

    c. Having an engagement deadline that has been imposed by a legal entity.

20. Robert is preparing to perform nonattest services for XYZ Company, an attest client. Which of the following AICPA standards describes the understanding that Robert should gain with XYZ Company regarding the services he will provide?

    a. Ethics Interpretation 101-3 to Rule 101 of the AICPA's *Code of Professional Conduct*.

    b. SSARS No. 1.

    c. SSAE No. 10.

21. Which of the following approaches to performing ongoing client and engagement evaluations is preferred?

    a. Annually reevaluate each client on the firm's client list in a meeting of all partners.

    b. Require the engagement team to reevaluate the acceptability of the client during the planning stage of each engagement.

    c. Adopting both approaches rather than just one is preferred.

22. Which of the following statements is accurate regarding documenting the annual client and engagement evaluation?

    a. Documenting the annual client and engagement evaluation is not required or recommended.

    b. Documenting the annual client and engagement evaluation is recommended.

23. If Aaron is performing an attest engagement and is unable to perform the inquiry and analytical procedures that are required for a review engagement, which of the following requires Aaron to withdraw from the engagement?

    a. SSAE No. 10, AT 101.92.

    b. SSAE No. 10, AT 101.75.

    c. SSAE No. 10, AT 101.58, footnote 11; AT 101.73; and AT 101.75.

    d. SSAE No. 10, AT 101.62.

24. If Aaron is performing a compilation or review engagement and a modification of the standard report will not sufficiently indicate the deficiencies in the financial statements taken as a whole, which of the following requires Aaron to withdraw from the engagement?

    a. SSARS (AR 100.51 and AR 100.89).

    b. SSARS (AR 9100.22).

    c. SSARS (AR 100.10).

    d. SSARS (AR 100.58 and AR 9100.18–.22).

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

15. Jody is an accountant assigned by the firm to consider the integrity of a client in order to determine whether the firm should continue a review engagement with that client for a period that will end on May 1, 2010. As part of his evaluation, Jody will be evaluating those charged with governance. Which AICPA standard should Jody consult for a definition of *those charged with governance*? **(Page 48)**

    a. SFAS No. 57. [This answer is incorrect. SFAS No. 57, *Related Party Disclosures*, as its title indicates is the AICPA standard that Jody would refer to for guidance concerning related party disclosures, not guidance on those charged with governance.]

    b. SSARS No. 17. [This answer is correct. SSARS No. 17, Omnibus Statement on Standards for Accounting and Review Services–2008, has added a definition of those charged with governance to AR 100.04 that is effective for compilations and reviews of financial statements for periods ending on or after December 15, 2008. Therefore, Jody would consult SSARS No. 17 for information regarding those charged with governance.]

16. Bob wants to gather background information on a prospective client to determine the client's reputation in the community as a measure of integrity. Which of the following sources would provide Bob with the information he is seeking? **(Page 51)**

    a. National Association of Credit Management. [This answer is incorrect. The National Association of Credit Management is a credit rating service that Bob could use to determine a prospective client's creditworthiness rather than to determine the client's reputation.]

    b. PublicData.com. [This answer is incorrect. PublicData.com is an online database service that can be used to compile background information on a prospective client such as professional licenses, property tax records and criminal records.]

    c. Moody's Investors Service. [This answer is incorrect. Moody's Investors Service is one of several credit rating services that would be used to assess a potential client's reliability in paying its creditors, and in a timely manner.]

    d. **Dun & Bradstreet. [This answer is correct. Dun & Bradstreet reports can be used in evaluating the client's reputation in the community since they provide information about timely payment of financial obligations.]**

17. Of the following statements, which one is accurate regarding compilation and review engagements? **(Page 53)**

    a. Under SSARS, an accountant must communicate with a predecessor accountant as a prerequisite to accepting an engagement. [This answer is incorrect. An accountant is not required to communicate with a predecessor accountant as a prerequisite to accepting an engagement according to AR 400.03.]

    b. The accountant does not need permission from the client in order to make inquiries of the predecessor. [This answer is incorrect. AR 400.03 emphasizes that the accountant should request permission from the client to make inquiries of the predecessor.]

    c. The accountant should request that the client authorize the predecessor to respond fully to inquiries. [This answer is correct. The accountant should request that the client authorize the predecessor to respond fully to the inquiries of the current accountant as cited in SSARS at 400.03. The client's permission is necessary because of the ethical requirement for confidentiality.]

    d. The accountant must obtain a certain level of knowledge about the principles and practices of the industry the entity operates in prior to accepting the engagement. [This answer is incorrect. AR 100.08 and AR 100.33 permits the accountant to obtain this level of knowledge *after* accepting the client.]

18. When members outsource client work to third-party service providers, they are subject to specific requirements that are cited in three ethics rulings. When a member desires to use a third-party service provider and wants to know the requirements that must be met prior to sharing confidential client information with that provider, which of the following ethics rulings should be reviewed? **(Page 57)**

    a. Ethics Ruling No. 1 under Rule 301. [This answer is correct. Ethics Ruling No. 1 under Rule 301–*Confidential Client Information* at ET391.001–.002 should be reviewed by members before engaging the services of a third-party service provider to learn how to enter into a contractual agreement with the third-party service provider requiring confidentiality of client information.]

    b. Ethics Ruling No. 112 under Rule 102. [This answer is incorrect. Ethics Ruling No. 112 under Rule 102–*Integrity and Objectivity* at ET191.224–.225 should be reviewed to learn how to inform the client of the use of a third-party service provider and gaining their approval prior to sharing confidential client information with that provider.]

    c. Ethics Ruling No. 12 under Rule 201. [This answer is incorrect. Ethics Ruling No. 12 under Rule 201–*General Standards* and Rule 202–*Compliance with Standards* at ET 291.023–.024 states that the accountant is responsible for all work performed, including the work performed by third-party service providers, and ensuring that the services meet the general standards and all other applicable technical standards.]

19. Which of the following factors will have the greatest impact on the firm's ability to meet the reporting deadline for an engagement? **(Page 58)**

    a. Having staff with appropriate technical background to perform the engagement. [This answer is incorrect. Unless the firm has staff with the appropriate technical background to perform the engagement, it should not undertake the engagement. Therefore, having staff with the appropriate technical background is a factor related to acceptance of the engagement, not of the firm's ability to meet the reporting deadline.]

    b. Having a deadline established by the client to meet internal requirements. [This answer is incorrect. If the firm is working on an engagement with a deadline that has been arbitrarily established by the client, the firm may be able to negotiate a revised deadline that makes meeting the deadline more compatible with the firm's ability to dedicate resources to the engagement.]

    c. Having an engagement deadline that has been imposed by a legal entity. [This answer is correct. When the firm is working on an engagement with a deadline that has been imposed by a legal or regulatory entity, the firm must meet that deadline. If firm resources are not available in the time needed to complete the engagement by the deadline, the firm may not be able to meet the reporting deadline and should decline the engagement.]

20. Robert is preparing to perform nonattest services for XYZ Company, an attest client. Which of the following AICPA standards describes the understanding that Robert should gain with XYZ Company regarding the services he will provide? **(Page 59)**

    a. Ethics Interpretation 101-3 to Rule 101 of the AICPA's *Code of Professional Conduct*. [This answer is correct. When Robert provides nonattest services for XYZ Company, an attest client, Interpretation 101-3 to Rule 101 of the Code requires Robert to obtain a written understanding with XYZ Company when providing them with nonattest services.]

    b. SSARS No. 1. [This answer is incorrect. SSARS No. 1 (AR 100.05 and AR 100.24), *Compilation and Review of Financial Statements*, recommends that Robert reach an understanding with XYZ Company regarding the compilation or review services in writing; however a written understanding is not required. The only time when the understanding must be in writing is when management-use-only compiled financial statements are submitted without an accompanying report.]

    c. SSAE No. 10. [This answer is incorrect. SSAE No. 10 (AT 101.46, *Attest Engagements*, requires that Robert document the understanding with XYZ Company in the workpapers when providing attestation services. A written communication with XYZ Company is preferred.]

21. Which of the following approaches to performing ongoing client and engagement evaluations is preferred? **(Page 60)**

    a. Annually reevaluate each client on the firm's client list in a meeting of all partners. [This answer is incorrect. Although an annual reevaluation of each client on the firm's client list is one approach to evaluate the ongoing acceptability of a client, using only this approach is not the preferred way to make the ultimate decision as to whether a current client should be dismissed.]

    b. Require the engagement team to reevaluate the acceptability of the client during the planning stage of each engagement. [This answer is incorrect. Requiring the engagement team to reevaluate the acceptability of the client during the planning stage of each engagement is one approach to determining whether a current client should be retained or dismissed; however, using only this approach is not the preferred method.]

    c. Adopting both approaches rather than just one is preferred. [This answer is correct. Adopting both procedures is preferred (a broad review of the client and a detailed review of each engagement) because the procedures are complementary and are not time-consuming.]

22. Which of the following statements is accurate regarding documenting the annual client and engagement evaluation? **(Page 61)**

    a. Documenting the annual client and engagement evaluation is not required or recommended. [This answer is incorrect. Documenting the annual client and engagement evaluation is not required; however it is recommended.]

    b. Documenting the annual client and engagement evaluation is recommended. [This answer is correct. Documenting the annual client and engagement evaluation is recommended in the minutes of the partners' meeting or with a memorandum. Such documentation might indicate any actions to be taken on marginal clients as well as identifying any clients who will be dismissed.]

23. If Aaron is performing an attest engagement and is unable to perform the inquiry and analytical procedures that are required for a review engagement, which of the following requires Aaron to withdraw from the engagement? **(Page 63)**

    a. SSAE No. 10, AT 101.92. [This answer is incorrect. AT 101.92 requires Aaron to withdraw from the engagement if other information in a client-prepared document that contains Aaron's attest report is materially inconsistent with the information in the report, and the client does not revise the information to eliminate the inconsistency.]

    b. SSAE No. 10, AT 101.75. [This answer is correct. If Aaron is unable to perform the inquiry and analytical or other procedures he considers necessary for review, AT 101.75 requires that he withdraw from the engagement.]

    c. SSAE No. 10, AT 101.58, footnote 11; AT 101.73; and AT 101.75. [This answer is incorrect. AT 101.58, footnote 11; AT 101.73; and AT 101.75 require Aaron to withdraw from the engagement if Aaron's client is the responsible party and does not provide Aaron with a written assertion about whether the subject matter is based on or in conformity with the criteria against which it will be evaluated.]

    d. SSAE No. 10, AT 101.62. [This answer is incorrect. AT 101.62 requires Aaron to withdraw from the engagement if the responsible party refuses to provide all written representations that Aaron believes are necessary to issue a report.]

24. If Aaron is performing a compilation or review engagement and a modification of the standard report will not sufficiently indicate the deficiencies in the financial statements taken as a whole, which of the following requires Aaron to withdraw from the engagement? **(Page 64)**

   a. SSARS (AR 100.51 and AR 100.89). [This answer is incorrect. If, in a review, Aaron is unable to apply the analytical and review procedures or the client refuses to provide a representation letter, and Aaron decides that it is not appropriate to issue a compilation report, AR 100.51 and AR 100.89 require Aaron to withdraw from the engagement.]

   b. SSARS (AR 9100.22). [This answer is incorrect. AR 9100.22 requires that Aaron withdraw from the compilation or review engagement in situations where the client will not accept a modified report.]

   c. SSARS (AR 100.10). [This answer is incorrect. AR 100.10 requires Aaron to withdraw from his compilation or review engagement if he becomes aware that information supplied by the client is incorrect, incomplete, or otherwise unsatisfactory, and the client refuses to provide additional or revised information.]

   d. SSARS (AR 100.58 and AR 9100.18–.22). [This answer is correct. When Aaron is performing a compilation or review engagement and he determines that a modification of the standard report will not adequately indicate the deficiencies in the financial statements taken as a whole, AR 100.58 and AR 9100.18–.22 require Aaron to withdraw from the engagement.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (GCRTG101)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

16. When a firm is considering the integrity of the client as part of its quality control system to evaluate the acceptance and continuance of the client and engagements with that client, numerous individuals should be evaluated. Which individuals listed below are **not** included in SQCS No. 7 as those that should be evaluated to assess the client's integrity?

    a. Key management personnel.

    b. Key employees with at least 3 years of service.

    c. Related parties.

    d. Individuals charged with governance.

17. Which of the following factors would be of the least use to the firm when performing client screenings to identify evidence of questionable behavior?

    a. Client's competition.

    b. Community reputation.

    c. Client's openness.

    d. Client's dealings with employees.

18. When an accountant is deciding in which areas of auditing and accounting to practice, he or she may want to know what area of accounting experiences the highest level of malpractice claims. Historically, the highest frequency of malpractice claims filed has been in which of the following areas?

    a. Audit engagements.

    b. Tax and accounting services.

    c. Business advisory services.

    d. Investment advisory services.

19. When evaluating risks associated with various industries, the rate of failure is a strong indicator of the risk involved. Based on that information, which of the following industries would generally have the lowest firm risk due to a relatively low rate of failure?

    a. Insurance companies.

    b. Construction companies.

    c. Nonprofit organizations.

    d. State and local governments.

20. When there is not adequate time to develop the expertise within the firm needed to perform the engagement, which of the following may be the best option to consider?

    a. Continuing education courses.

    b. Self-study.

    c. Research.

    d. Using an outside specialist.

21. The firm should obtain an understanding with the client concerning the nature, scope, and limitations of the services to be provided. Which of the following statements accurately describes the form the understanding should take?

    a. The understanding should always be in writing.

    b. The understanding can be either written or oral at the firm's discretion.

    c. The understanding can be either written or oral depending on other applicable AICPA standards.

    d. Do not select this answer choice.

22. Although not required, engagement letters are recommended for which of the following?

    a. In compilations of management-use-only financial statements when a report is not issued.

    b. In a firm's suggested quality control system.

    c. In audit engagements in which a report is not issued.

    d. Do not select this answer choice.

23. Which of the following statements concerning the documentation required by Ethics Interpretation 101-3 is accurate?

    a. All firms include such documentation in their engagement letters.

    b. Many firms include such documentation in their engagement letters.

    c. Rarely do firms include such documentation in their engagement letters.

    d. Engagement letters are not the appropriate place to include documentation required by Ethics Interpretation 101-3.

24. Of the following statements concerning the decision to withdraw from an engagement, which one best describes how such a decision should be reached?

    a. The firm performing the engagement needs to rely on recommendations from the client.

    b. The firm's managing partner and the accounting partner need to make the decision without further input.

    c. The firm needs to consider advice from their legal counsel prior to making a final decision.

    d. The firm's legal counsel and the client's ownership need to make a mutually acceptable decision.

Lesson 3: Proper Performance of Engagements and Issuance of Reports

INTRODUCTION

SQCS No. 7

SQCS No. 7 includes guidance on engagement performance, supervision, and review responsibilities, consultation, differences of opinion, engagement quality control review, and engagement documentation as part of the engagement performance element. SQCS No. 7 (QC 10.57) summarizes the requirements for the engagement performance element and states:

> The firm should establish policies and procedures designed to provide it with reasonable assurance that engagements are consistently performed in accordance with professional standards and regulatory and legal requirements, and that the firm or the engagement partner issues reports that are appropriate in the circumstances.

Required engagement performance policies and procedures should address—

- Engagement performance.
- Supervision responsibilities.
- Review responsibilities.

The primary goal of establishing engagement performance policies and procedures is to design a standardized engagement approach that provides reasonable assurance that each engagement conforms to professional standards and regulatory and legal requirements. A standardized engagement approach is not intended to be a substitute for the exercise of professional judgment. An engagement performance quality control (QC) system encompasses the unique planning, performing, supervising, reviewing, documenting, and communicating decisions that occur on each engagement. There is no differentiation of service level in SQCS No. 7 regarding the requirements for engagement quality control review, documentation, consultation, and resolution of differences, so those requirements are relevant for compilation and review engagements as well as audit and attestation engagements. Accordingly, the engagement performance quality control system needs to be flexible enough to address all of those different types of engagements.

Upcoming Changes to SQCS No. 7

In June 2009, the ASB released for exposure a revised version of SQCS No. 7, *A Firm's System of Quality Control (Redrafted)*, which would supersede SQCS No. 7. The QC standard is being redrafted to apply the ASB's clarity drafting conventions and to converge with the international quality control standard, ISQC 1. The proposed SQCS is expected to be applicable to a firm's system of quality control for its accounting and auditing practice as of January 1, 2011. The proposed SQCS does not change or expand SQCS No. 7 in any significant respect.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine the engagement performance, supervision, and review requirements of SQCS No. 7.
- Summarize consultation and engagement quality control review requirements under SQCS No. 7.
- Identify the firm's quality control policies and procedures and their impact.

PERFORMANCE, SUPERVISION, AND REVIEW REQUIREMENTS OF ENGAGEMENTS

Due to its complexity, designing the engagement performance element of a QC system may be the most difficult aspect of preparing a QC document. For example, engagement performance covers all types of accounting engagements and needs to interface with the accounting manuals used by the firm. Additionally, engagement performance considers the policies and procedures found in other QC elements. To be most effective, the firm will want to design its engagement performance component of the quality control system based upon the size of the firm and the nature of the firm's engagements. The difficulty of designing appropriate engagement performance policies and procedures is supported by the knowledge that the majority of peer review comments relate to engagement performance.

Before beginning the process of designing engagement performance, supervision, and review policies and procedures that fit the firm's practice, it is advisable to become familiar with the authoritative guidance under which engagements must be conducted. A review of accounting, attestation, and ethics literature is appropriate to determine if there are particular requirements that need to be considered during the design and execution of the engagement performance quality control element. The AICPA and its senior technical bodies such as the Auditing Standards Board and the Accounting Review and Services Committee issue most of the authoritative guidance under which CPAs must perform engagements. That authoritative guidance can generally be found in the Statements on Quality Control Standards (SQCSs), *Code of Professional Conduct*, Statements on Standards for Accounting and Review Services (SSARS), Statements on Auditing Standards (SASs), and Statements on Standards for Attestation Engagements (SSAEs). Those requirements that affect engagement performance, supervision, and review are discussed in the remainder of this section.

SQCS Requirements

SQCS No. 7 (QC 10.58) indicates that effective policies and procedures facilitate consistency in the quality of engagement performance. Achieving consistency may be accomplished by using written or electronic manuals, software tools, or other forms of standardized documentation, as well as industry-specific or other subject-matter-specific guidance materials. Examples of processes the firm may address include:

- How engagement teams are briefed to obtain an understanding of the objectives of their work.
- Processes for complying with applicable engagement standards.
- Processes for engagement supervision, staff training, and mentoring.
- Methods of reviewing work performed, significant judgments made, and the form of report being issued.
- Appropriate documentation of the work performed, and the timing and extent of the review.
- Appropriate communication of the results of the engagement.
- Processes to keep policies and procedures current.

SQCS No. 7 (QC 10.59) states that firms might consider the following as appropriate policies and procedures for engagement supervision:

- Tracking engagement progress.
- Considering the capabilities and competence of individual engagement team members, whether they have sufficient time to perform their work, whether they understand their instructions, and whether their work is carried out in accordance with the planned engagement approach.
- Addressing significant issues that arise during the engagement, considering the significance of the issues, and modifying the planned approach as appropriate.

- Identifying matters for consultation with or consideration by engagement team members with more experience.

When determining review responsibilities, SQCS No. 7 indicates that qualified engagement team members, which may include the engagement partner, should review work performed by other team members on a timely basis.

SQCS No. 7 (QC 10.61) lists examples of the following considerations when performing review:

- The work is performed in accordance with professional standards and regulatory and legal requirements.
- Significant findings and issues are raised for further consideration.
- Appropriate consultations take place and resulting conclusions are documented and implemented.
- The nature, timing, and extent of work performed is appropriate and without need for revision.
- The procedures performed support the conclusions reached and are properly documented.
- Evidence obtained is sufficient and appropriate to support the report.
- The objectives of the procedures performed are achieved.

Upcoming QC Changes

The ASB has issued an exposure draft that would supersede SQCS No. 7. The proposed SQCS will move existing paragraphs QC 10.58, QC 10.59, and QC 10.61 to the application and other explanatory material section of the standard. The only real change for those paragraphs in the proposed standard is removal of the words might and may from existing paragraphs QC 10.58 and QC 10.59, respectively. Additionally, the guidance related to how teamwork and training assist less experienced members of the engagement team (QC 10.53) has been moved from the human resources quality control element discussion to be included in the engagement performance QC element guidance of the proposed standard.

Ethical Requirements

Ethical requirements over CPA engagement performance and behavior are set out in the AICPA *Code of Professional Conduct* (the *Code*). Many state licensing organizations require compliance with the ethical standards issued by the AICPA, even for CPAs who are not AICPA members. Six articles describe the general conduct required by CPAs:

- Article I—Responsibilities.
- Article II—The Public Interest.
- Article III—Integrity.
- Article IV—Objectivity and Independence.
- Article V—Due Care.
- Article VI—Scope and Nature of Services.

The articles can be found in the *Code* at ET sections 52–57.

Interpretations of the *Code* provide guidelines as to the scope and application of the rules within the *Code of Professional Conduct*. Members who depart from those guidelines must justify such departure in any disciplinary hearing.

Since 2003, changes to Ethics Interpretation 101-3 have caused significant changes to how practitioners administer the performance and documentation of nonattest services to attest clients. Ethics Interpretation 101-3, "Performance of Nonattest Services," requires that before practitioners perform nonattest services for attest clients, they should determine that the requirements of Interpretation 101-3 have been met. One of those requirements states that practitioners must document in writing their understanding with the client regarding the nonattest services and the client's responsibilities. That documentation requirement creates an engagement performance step that should be included in a firm's quality control policies and procedures.

Compilation and Review Requirements

Rule 201 of the *Code* states that a member shall "adequately plan and supervise the performance of professional services." While SSARS No. 1 (AR 100) does not provide specific guidance on how to plan and supervise engagements, an interpretation of SSARS No. 1 found in AICPA Professional Standards (AR 9100.16–.17) suggests that the guidance in auditing literature at SAS No. 22 (AU 311) be considered. This interpretation is reproduced below:

> **Question—** . . . Rule 201C (ET 201.01C) states: "Adequately plan and supervise the performance of professional services." Although SAS No. 22 (AU 311), *Planning and Supervision*, deals with these matters in the context of an audit in accordance with generally accepted auditing standards, SSARS No. 1 (AR 100) does not provide specific guidance for the planning and supervision of a compilation or review engagement. In the absence of specific guidance on planning and supervision in SSARS No. 1 (AR 100), is an accountant required to follow the guidance provided in SAS No. 22 (AU 311) in the context of a compilation or review engagement for a nonissuer?
>
> **Interpretation—**No. SASs do not govern engagements to compile or review financial statements of a nonissuer. However, an accountant may wish to consider SAS No. 22 (AU 311) or other reference sources, such as textbooks and articles, when he needs additional information on planning and supervision.

Compilation Performance Requirements. Although SSARS No. 1 does not provide specific guidance on how to plan and supervise engagements, it does provide specific compilation performance requirements. SSARS No. 1 (AR 100.05–.11) requires the following in a compilation:

- Establish an understanding with the entity regarding the services to be performed, including a description of the nature and limitations of the services to be performed and a description of the report to be issued, if any. The understanding should also include the accountant's responsibility regarding errors, fraud, or illegal acts.

- Knowledge of the accounting principles and practices of the entity's industry and a general understanding of certain matters related to the entity itself, including the nature of the entity's business transactions, the form of its accounting records, the stated qualifications of its accounting personnel, the accounting basis of the financial statements to be presented, and the form and content of the financial statements.

- Consider whether it will be necessary to perform other accounting services such as assistance in adjusting the books of account or consult on accounting matters.

- Take certain actions when the accountant becomes aware that information supplied by the entity is incorrect, incomplete, or otherwise unsatisfactory.

- Read the compiled financial statements and consider whether they appear to be appropriate in form and free from obvious material errors.

<u>New SSARS Requirements.</u> ARSC has issued SSARS No. 19, which includes new performance and documentation requirements for compilation and review engagements. Those new requirements will generally be effective for compilations and reviews of financial statements for periods ending on or after December 15, 2010. Accordingly, firms performing compilation and review engagements for 2010 year-end periods should follow the SSARS No. 19 guidance.

Compilation Documentation Requirements. Compilations are subject to documentation requirements as part of engagement performance. Those requirements include:

- Documenting the required step-down considerations if the engagement was originally intended to be a higher level of service.
- Documenting communications, whether oral or written, to the appropriate level of management regarding fraud or illegal acts.
- Properly documenting any significant situations that required consultation.
- Documenting differences of professional opinion, if any, including the considerations involved in the resolution.
- Documenting the accountant's understanding with the client if he or she performs nonattest services for that client.

Review Performance Requirements. SSARS No. 1 (AR 100.33–.38) requires the following in a review:

- Establish an understanding with the entity regarding the services to be performed, including a description of the nature and limitations of the services to be performed and a description of the report to be issued, if any. The understanding should also include the accountant's responsibility regarding errors, fraud, or illegal acts.
- Knowledge of the accounting principles and practices of the industry in which the client operates and an understanding of the entity's business.
- Understanding of the entity's organization and operating characteristics and the nature of its assets, liabilities, revenues, and expenses. This would ordinarily involve a general knowledge of the entity's production, distribution, and compensation methods, types of products and services, operating locations, and material transactions with related parties.
- Application of analytical procedures to the financial statements, including developing expectations and comparing recorded amounts to those expectations.
- Inquiries of members of management having responsibility for financial and accounting matters, including—
  - Whether the financial statements have been prepared in conformity with GAAP (or an OCBOA) consistently applied.
  - The entity's accounting principles, practices, and the methods followed in applying them, and procedures for recording, classifying, and summarizing transactions and accumulating information for disclosure in the financial statements.
  - Unusual or complex situations that may have an effect on the financial statements.
  - Significant transactions occurring or recognized near the end of the reporting period.
  - The status of uncorrected misstatements identified during the previous engagement.
  - Questions that have arisen in the course of applying the review procedures.
  - Events subsequent to the date of the financial statements that could have a material effect on the financial statements.
  - Their knowledge of any fraud or suspected fraud affecting the entity involving management or others where the fraud could have a material effect on the financial statements, for example, communications received from employees, former employees, or others.

    - Significant journal entries and other adjustments.

    - Communications from regulatory agencies.

- Inquiries concerning actions taken at meetings of stockholders, board of directors, committees of the board of directors, or comparable meetings that may affect the financial statements.

- Obtaining reports from other accountants, if any, who have been engaged to audit or review the financial statements of significant components of the reporting entity, its subsidiaries, and other investees.

- Reading the financial statements to consider, on the basis of information coming to the accountant's attention, whether the financial statements appear to conform with generally accepted accounting principles.

- Obtaining a management representation letter. This includes the consideration of obtaining an updated representation letter based upon events that may have occurred.

New SSARS Requirements. ARSC has issued SSARS No. 19, which includes new performance and documentation requirements for compilation and review engagements. Those new requirements will generally be effective for compilations and reviews of financial statements for periods ending on or after December 15, 2010. Accordingly, firms performing compilation and review engagements for 2010 year-end periods should follow the SSARS No. 19 guidance.

Review Documentation Requirements. SSARS No. 1 (AR 100.43–.45) states that the following should be documented:

a. Any findings or issues that in the accountant's judgment are significant.

b. The matters covered in the accountant's inquiry procedures.

c. The analytical procedures performed.

d. The expectations, where significant expectations are not otherwise readily determinable from the documentation of the work performed, and factors considered in the development of those expectations.

e. Results of the comparison of the expectations to the recorded amounts or ratios developed from recorded amounts.

f. Any additional procedures performed in response to the significant unexpected differences arising from the analytical procedure and the results of such additional procedures.

g. Unusual matters that the accountant considered during the performance of the review procedures, including their disposition.

h. Communications, whether oral or written, to the appropriate level of management regarding fraud or illegal acts that come to the accountant's attention.

i. The representation letter.

SSARS No. 19. The Accounting and Review Services Committee issued SSARS No. 19, Compilation and Review Engagements, in December 2009. SSARS No. 19 supersedes AR 20, *Defining Professional Requirements in Statements on Standards for Accounting and Review Services*; AR 50, Standards for Accounting and Review Services; and AR 100, *Compilation and Review of Financial Statements*. The new standard is generally effective for compilations and reviews of financial statements for periods ending on or after December 15, 2010. Early implementation is permitted only for the optional disclosure in the compilation report of the reasons for an independence impairment. The following paragraphs discuss the most significant changes from the existing performance and documentation requirements previously discussed.

Effect on Compilation Engagements. In addition to the performance and documentation requirements discussed above, SSARS No. 19 makes the following additional requirements:

- Documenting the understanding established with the entity by using a written, signed engagement letter. The information required in that understanding is expanded, as further explained below.

- Documenting any findings or issues that, in the accountant's judgment, are significant, whether consultation occurred or not. Documentation should include disposition of the matter.

- Allowing the accountant to include a description in the accountant's compilation report as to the reasons for an independence impairment. If one reason is disclosed, all of the reasons must be disclosed.

- Changing the reporting language for compilation reports.

The expanded understanding with management regarding a compilation of financial statements should include the following:

- The objective of a compilation is to assist management in presenting financial information in the form of financial statements.

- The accountant uses information that is the representation of management without undertaking to obtain any assurance that there are no material modifications that should be made to the financial statements in order for them to be in conformity with the applicable financial reporting framework.

- Management is responsible for—

  - the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework.

  - designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

  - preventing and detecting fraud.

  - identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.

  - making all financial records and related information available to the accountant.

- The accountant is responsible for conducting the compilation engagement in accordance with SSARS issued by the AICPA

- A compilation differs significantly from a review or audit of financial statements. A compilation does not contemplate performing inquiry, analytical procedures, or other procedures performed in a review. Additionally, a compilation does not contemplate obtaining an understanding of the entity's internal control; assessing fraud risk; testing accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents; or other procedures ordinarily performed in an audit. Accordingly, the accountant will not express an opinion or provide any assurance regarding the financial statements.

- The compilation engagement cannot be relied upon to disclose errors, fraud, or illegal acts.

- The accountant will inform the appropriate level of management of any material errors and of any evidence or information that comes to the accountant's attention during the performance of the compilation procedures that fraud or an illegal act may have occurred (unless the illegal acts are clearly inconsequential).

- The effect of any independence impairments on the expected form of the accountant's report, if applicable.

Effect on Review Engagements. In addition to the performance and documentation requirements discussed above, SSARS No. 19 makes the following additional requirements:

- The understanding established with the entity should be documented by using a written, signed engagement letter. The information required in that understanding is expanded as further explained below.
- Expanded guidance with respect to the performance of analytical procedures.
- Documenting management's responses to (a) the accountant's inquiries regarding fluctuations or relationships that are inconsistent with other information or that differ from expectations by a significant amount, and (b) significant matters covered in the accountant's inquiry procedures.
- Changing the reporting language for review reports.

The expanded understanding with management regarding a review of financial statements should include the following:

- The objective of a review is to obtain limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework.
- Management is responsible for—
  - the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework.
  - designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.
  - preventing and detecting fraud
  - identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.
  - making all financial records and related information available to the accountant.
- Management will provide the accountant, at the conclusion of the engagement, with a letter that confirms certain representations made during the review.
- The accountant is responsible for conducting the review engagement in accordance with SSARS issued by the AICPA.
- A review includes primarily applying analytical procedures to management's financial data and making inquiries of company management.
- A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. A review does not contemplate obtaining an understanding of the entity's internal control; assessing fraud risk; testing accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents; or other procedures ordinarily performed in an audit. Accordingly, the accountant will not express an opinion regarding the financial statements as a whole.
- The review engagement cannot be relied upon to disclose errors, fraud, or illegal acts.
- The accountant will inform the appropriate level of management of any material errors and of any evidence or information that comes to the accountant's attention during the performance of the review procedures that fraud or an illegal act may have occurred (unless the illegal acts are clearly inconsequential).

Additional information about SSARS No. 19 is available in the 2010 edition of *PPC's Guide to Compilation and Review Engagements*. SSARS No. 19 is available for purchase at **www.cpa2biz.com**. Readers who subscribe to the AICPA materials on Checkpoint have access to SSARS No. 19 for no additional cost.

Attestation Requirements

The definition of an *accounting and auditing practice* for quality control purposes also includes engagements performed under the Statements on Standards for Attestation Engagements. SSAEs apply whenever a firm is engaged to issue or does issue a review or agreed-upon procedures report on subject matter (or an assertion about the subject matter) that is the responsibility of another party. Accordingly, firms that perform attestation engagements should include policies and procedures that address such engagements in the design of their QC systems. SSAE No. 10, *Attest Engagements* (AT 101.42–.50), discusses planning and supervision for attestation engagements. AT 101.42 presents the first standard of fieldwork for attestation engagements and states, "The practitioner must adequately plan the work and must properly supervise any assistants."

The remaining paragraphs of the planning and supervision discussion of AT 101 provide guidance on the considerations necessary to properly plan and supervise an attestation engagement. Some of those requirements include (not intended to be all-inclusive):

- Developing an overall strategy for the expected conduct and scope of the engagement (AT 101.44).
- Considering, among other things, the following matters (AT 101.45):
  - The criteria to be used.
  - Preliminary judgments about attestation risk and materiality for attest purposes.
  - The nature of the subject matter or the items within the assertion that is likely to require revision or adjustment.
  - Conditions that may require extension or modification of attest procedures.
  - The nature of the report expected to be issued.
- Establishing an understanding with the client regarding the services to be performed for each engagement (AT 101.46).
- Considering the nature, extent, and timing of the work to be performed to accomplish the objectives of the attest engagement, including changed conditions that may make it necessary to modify planned procedures (AT 101.47).
- Directing the efforts of assistants who participate in accomplishing the objectives of the attest engagement and determining whether those objectives were accomplished (AT 101.48).
- Reviewing each assistant's work to determine whether it was adequately performed and to evaluate whether the results are consistent with the conclusion to be presented in the practitioner's report (AT 101.50).

Attestation Documentation Requirements. SSAE No. 10 (AT 101.100–.107) provides information on attest documentation. Some of those requirements include (not intended to be all-inclusive):

- Preparing and maintaining attest documentation, the form and content of which should be designed to meet the circumstances of the particular attest engagement (AT 101.100).
- Preparing attest documentation sufficient to enable members of the engagement team with supervision and review responsibilities to understand the nature, timing, extent, and results of attest procedures performed and the information obtained. This includes indicating the engagement team members who performed and reviewed the work (AT 101.103).

- Adopting reasonable procedures to prevent unauthorized access to attest documentation (AT 101.106).

Specific Types of Attestation Engagements. SSAE No. 10 also covers guidance for specific types of attestation engagements such as agreed-upon procedures engagements, financial forecasts and projections, reporting on pro forma financial information compliance attestation, and management's discussion and analysis engagements. Sections 201, 301, 401, 601, and 701 of SSAE No. 10 may include additional engagement performance and documentation requirements for specific types of attestation engagements.

Other Considerations

Cover All Types of Accounting Engagements. Engagement performance policies and procedures should be developed for compilation, review, and attestation engagements (to the extent the firm provides or plans to provide those services). Accordingly, the engagement performance component of the quality control system needs to be flexible enough to address types of engagements performed by the firm.

Consider Procedures Found in Other QC Elements. SQCS No. 7 is written as if each of the elements of quality control are distinctly separate, each with its own policies and procedures. In reality, however, several of the elements are interrelated and cannot be viewed in isolation. The engagement performance element deals with every aspect of an engagement from start to finish and thus encompasses many of the policies and procedures that are part of the other elements of quality control. Exhibit 3-1 helps to illustrate this point.

Exhibit 3-1

Relationship of Engagement Performance to Other QC Elements
(Compilation and Review Engagements)

Leadership Responsibilities for Quality	Relevant Ethical Requirements	Acceptance and Continuance of Clients and Engagements	Human Resources	Engagement Performance	Monitoring	TYPICAL ENGAGEMENT PERFORMANCE QUALITY CONTROL STEPS
Yes	Yes	Yes	Yes	Yes		1. Evaluate whether to accept/continue the engagement considering the client's integrity and the firm's capabilities.
				Yes		2. Evaluate the propriety of a step down to a lower level of service.
Yes			Yes	Yes		3. Communicate the partner's identity and role to the client.
		Yes		Yes		4. Obtain an engagement letter.
Yes			Yes	Yes		5. Assign staff based on capabilities, competence, and availability.
				Yes		6. Plan the work and obtain background information about the entity, officers, accounting practices, etc.
				Yes		7. Consider potential fraud implications.
				Yes		8. Prepare an engagement plan.
			Opt[a]	Opt[a]		9. Develop a time estimate.
	Yes		Yes	Yes		10. Obtain partner approval of engagement plan and staff assignments, and, if applicable, time estimates.
				Yes		11. Perform and document analytical procedures.
				Yes		12. Perform and document inquiries of management.
				Yes		13. Document significant, unusual matters, including disposition.
				Yes		14. Document management's response to inquiries about unexpected/inconsistent fluctuations or relationships and significant matters.
				Yes		15. Perform and document other procedures.

Leadership Responsibilities for Quality	Relevant Ethical Requirements	Acceptance and Continuance of Clients and Engagements	Human Resources	Engagement Performance	Monitoring	TYPICAL ENGAGEMENT PERFORMANCE QUALITY CONTROL STEPS
			Yes	Yes		16. Supervise procedures (including work of other accountants).
	Yes			Yes		17. Draft (or assist in drafting) the financial statements.
				Yes		18. Complete a presentation and disclosure checklist and read the financial statements.
				Yes		19. Obtain a management representation letter.
Yes	Yes			Yes		20. Draft the report.
Yes			Yes	Yes	Yes	21. Review the workpapers.
				Yes		22. Determine that all review points and open items have been cleared.
Yes	Yes		Yes	Yes	Yes	23. Obtain an engagement quality control review, if required by firm policy.
Yes			Yes	Yes		24. Obtain consultation when appropriate and document and implement conclusions.
Yes			Yes	Yes		25. Resolve any differences of opinion and document and implement conclusions.
Yes				Yes		26. Have the partner sign the report or transmittal letter.
Yes			Yes	Yes		27. Evaluate the staff's performance.
	Yes			Yes		28. Maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of the workpapers.
				Yes	Yes	29. Assemble and retain the workpapers for a sufficient period of time (subject to monitoring review).

Note:

[a] Opt—Optional.

* * *

The engagement performance system in Exhibit 3-1 is typical of that used by firms that perform compilation and review engagements. Note that a number of the steps in this system are procedures found in one of the other elements of a QC system. For example, the relevant ethical requirements element of the quality control system may be viewed as an administrative system designed to monitor items such as client lists, employee relationships, past due receivables, and such. However, the relevant ethical requirements element also considers the engagement level by asking, "Is the firm independent with respect to this client?"

Likewise, a client and engagement acceptance and continuance QC system should contain overall policies and procedures about whether to accept a new client (or a new engagement) or to continue a relationship with an existing client. The system of acceptance and continuance procedures is also implemented at the engagement level as a part of the engagement performance system.

Interface the System with the Firm's Accounting Manuals. Most firms have some type of engagement performance system. Occasionally, these systems are comprised of accounting manuals including practice aids such as checklists, programs, confirmation letters, etc., accumulated from various sources. Many firms also adopt accounting manuals purchased from other publishers or firms. The engagement performance QC policies and procedures the firm adopts for its quality control system needs to be interfaced with those found in its manuals and practice aids, whether developed internally, purchased by the firm, or a combination of the two.

Consider Firm Size. Many of the examples of engagement performance systems found in QC literature or in accounting manuals are designed for large firms that need complex systems because of their practice size. Those systems are difficult to adapt to small firms because:

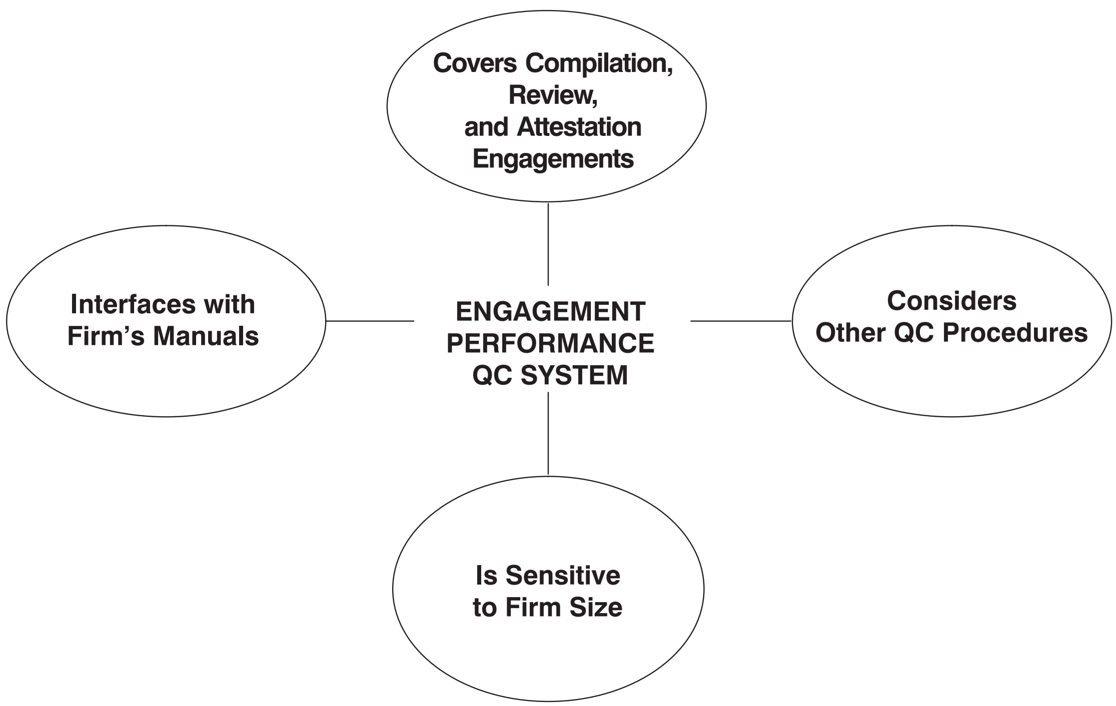
- A smaller firm ordinarily does not have the many levels of staff found in larger firms. Consequently, the small firm does not need as elaborate an engagement performance system.

- Many financial statement engagements in a small firm are compilations or reviews that require fewer than 40 hours; smaller engagements do not ordinarily demand a complex system. In fact, a complex system could consume a valuable portion of the engagement time that would better be allotted to providing the service.

Summary. Exhibit 3-2 summarizes the considerations discussed above.

Exhibit 3-2

Design Considerations for an Engagement Performance QC System



* * *

HOW TO MAINTAIN ENGAGEMENT DOCUMENTATION

Assembly of Engagement Documentation

SQCS No. 7 (QC 10.62) specifies that firms "should establish policies and procedures for engagement teams to complete the assembly of final engagement files on a timely basis, as appropriate for the nature of the engagement, after the engagement reports have been released." Those policies and procedures should comply with any time limits established by professional standards, laws, or regulations that address the assembly of final engagement files for specific types of engagements.

Timely completion of engagement documentation is important to ensure engagement quality. As a practical matter, firms that strive to prepare engagement documentation as the engagement progresses are more likely to avoid inadvertently omitting critical information or incorrectly recording aspects of the procedures that were completed or the evidence obtained. Additionally, striving to assemble and maintain engagement documentation as the engagement progresses serves to make assembly of the engagement documentation more efficient.

Proposed SQCS Changes. The ASB has issued an exposure draft that would supersede SQCS No. 7. The proposed standard provides additional information related to assembly of final engagement documentation. The additional information addresses the appropriate completion time for final engagement documentation assembly when completion time is not prescribed by professional standards, laws, or regulations. Additional guidance is also provided to address time limits for final engagement documentation assembly in the situation when two or more different reports are issued regarding the same subject matter information.

Compilation and Review Requirements. No specific documentation assembly requirements exist in the SSARS. However, the engagement documentation assembly requirements of SQCS No. 7 impose such requirements on accountants performing compilation and review engagements. While a firm may have developed procedures over the assembly of compilation and review documentation, a firm should now include such policies and procedures in their QC system.

Retention of Engagement Documentation

SQCS No. 7 (QC 10.69) states that firms "should establish policies and procedures for the retention of engagement documentation for a period sufficient to meet the needs of the firm, professional standards, laws, and regulations." SQCS No. 7 provides examples of procedures that firms may adopt for retention of engagement documentation. The procedures include those that—

- Enable the retrieval of and access to engagement documentation during the retention period (particularly in the case of electronic documentation), as the underlying technology may need to be upgraded or revised over time.
- Where necessary, provide a record of changes made to engagement documentation after the assembly process is complete.
- Enable authorized external parties to access and review specific engagement documentation for quality control or other purposes.

Additionally, various states have enacted legislation or regulations that may require a stipulated retention period. In some cases, government agencies have specific record retention requirements that are made part of the contract for the specified engagement performance. Additionally, there may exist generally accepted retention periods in the absence of specific legal or regulatory requirements. Firms might consider consulting their attorneys and liability insurance carriers when establishing their retention policies.

Recognizing the need for exceptions in extenuating circumstances is also important when documenting retention policies. Most notably, when engagement documentation is the subject of a subpoena, or contemplated or threatened subpoena or summons, no file or document destruction should occur until the related issues have been fully settled.

Compilation and Review Requirements. SSARS does not address or establish requirements for the retention of compilation or review workpapers. As is the case with document assembly, the new engagement documentation retention requirements of SQCS No. 7 impose requirements on accountants performing compilation and review engagements where none existed before. While a firm may have developed procedures over the retention of compilation and review documentation, a firm should now include such policies and procedures in their QC system. Additionally, some states have enacted legislation or regulations that address the retention of compilation and/or review workpapers and may require a stipulated retention period. For example, the state of Washington requires seven-year retention of both audit and review files.

Proposed SQCS Changes. The ASB has issued an exposure draft that would supersede SQCS No. 7. The proposed standard provides additional guidance that addresses the ownership of engagement documentation. Basically, the exposure draft indicates that unless otherwise specified by law or regulation, engagement documentation belongs to the firm.

Confidentiality, Custody, Integrity, Accessibility, and Retrievability of Engagement Documentation

SQCS No. 7 (QC 10.63) indicates that "firms should establish policies and procedures designed to maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation."

Confidentiality. The need to maintain a confidential relationship with a client is expressed in Rule 301 of the *Code*, which states, "A member in public practice shall not disclose any confidential client information without the specific consent of the client." Ordinarily, engagement documentation can be shown outside of the firm only with the client's explicit permission. This is true even if a practitioner sells their practice to another firm, and it also applies to a predecessor communicating with a successor accountant. Specific laws or regulations may impose additional obligations on the firm to maintain client confidentiality, particularly when data of a personal nature are concerned.

There are some limited exceptions to engagement documentation confidentiality. For example, explicit client permission is not necessary for making engagement workpapers available if subpoenaed in connection with a legal proceeding, if requested in an ethical disciplinary proceeding, or if submitted in an AICPA or state CPA society authorized quality or peer review program. Also, Ethics Ruling No. 20 under Rule 301 clarifies the firm's responsibility when providing confidential client information to the firm's professional liability insurance carrier; the firm is not required to obtain a client's permission if the information is provided solely to assist in the defense against an actual or potential claim against the firm.

Custody, Integrity, Accessibility, and Retrievability. Engagement documentation may exist on paper, electronically, or in some other media. Regardless of how it exists, the integrity, accessibility, and retrievability of the underlying data may be compromised if the documentation could be altered, added to, or deleted without the firm's knowledge. Accordingly, controls are necessary to prevent engagement documentation from unauthorized use or alteration, or from becoming lost or damaged. SQCS No. 7 indicates that some appropriate and reasonable controls over engagement documentation may include controls that enable the firm to—

- Clearly determine when and by whom engagement documentation was prepared and reviewed.
- Protect the integrity of information at all stages of the engagement, especially when information is shared within the engagement team or transmitted to other parties via electronic means.
- Prevent unauthorized changes to engagement documentation.
- Allow access to engagement documentation by the engagement team and other authorized parties as necessary to properly discharge their responsibilities.

Electronic Engagement Documentation. Many firms have transitioned to using paperless engagement software. As a result, the firm may scan engagement documents or otherwise convert original paper documentation to another media for inclusion in the engagement files. When that is the case, SQCS No. 7 (QC 10.67) states that, "the firm should establish procedures designed to maintain the integrity, accessibility, and retrievability of the documentation." Procedures may include steps such as the following:

- Generating scanned copies that reflect a complete copy of the document (such as both sides of two-sided documents) and capture manual signatures, cross-references, and annotations.
- Integrating the scanned copies into the electronic engagement files, including indexing and signing off on the copies as necessary.
- Enabling the scanned copies to be retrieved and printed as needed.

Even firms that have completely achieved the *paperless office* concept for their engagements may have legal, regulatory, or other reasons to retain some original paper documentation. Accordingly, those firms should ensure that the policies and procedures over engagement documentation confidentiality, safe custody, integrity, accessibility, and retrievability encompass hard copy documents as well.

Additional controls that firms design and implement to maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation may include controls such as the following:

- The use of data encryption and passwords by engagement team members to restrict access to electronic engagement documentation to authorized users.
- Back-up routines for electronic engagement documentation at appropriate stages during the engagement.
- Procedures for distributing engagement documentation to the team members at the beginning of the engagement, processing it during the engagement, and collating it at the end of the engagement.
- Procedures to restrict access to, and enable proper distribution and confidential storage of, hard copy engagement documentation.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

25. As part of engagement performance, compilations are subject to which of the following documentation requirements?

    a. If the engagement was originally intended to be a higher level of service, documenting the required step-down considerations.

    b. Documenting the results of the comparison of expectations to recorded amounts or ratios developed from recorded amounts.

    c. Documenting any additional procedures that are performed due to significant unexpected differences resulting from the analytical procedure as well as the results of those additional procedures.

    d. Documenting all communications to proper level of management concerning fraud or illegal acts that the accountant discovers.

26. Which of the following is required by SSARS No. 1 (AR 100.33–.38) in a review?

    a. Inquiries related to actions taken at meetings of the board of directors, committees of the board of directors, etc that may impact the financial statements.

    b. Take certain actions when it becomes apparent to the accountant that information supplied by the entity is unsatisfactory.

    c. Consider whether performing other accounting services such as assistance in adjusting the books of account will be necessary.

    d. Read the compiled financial statements and assess whether they appear to be appropriate in form and without obvious material errors.

27. SSAE No. 10, *Attest Engagements* (AT 101.50) provides guidance concerning a number of requirements necessary to properly plan/supervise an attestation engagement. Which of the following accurately reflects one of those requirements?

    a. Directing the efforts of assistants who are participants in accomplishing attest engagement objectives is required, while confirming whether those objectives were accomplished is optional.

    b. Establishing with the client an understanding regarding general services that will be performed for all engagements.

    c. Reviewing the work of each assistant to ascertain whether it was properly performed and to evaluate the results for consistency with the conclusion to be presented in the report.

    d. Taking into account only the nature and extent of the work necessary to accomplish the objectives of the attest engagement. Consideration of the timing of the work is not a requirement.

28. Alex is performing a compilation engagement. As a part of engagement performance, Alex has completed a quality control step involving maintaining the confidentiality, safe custody, integrity, accessibility, and retrievability of the workpapers. Which of the following quality control (QC) elements are also being satisfied by Alex's actions?

    a. Human resources.

    b. Leadership responsibilities for quality.

    c. Acceptance and continuance of clients and engagements.

    d. Relevant ethical requirements.

29. Alex is performing a review engagement. As a part of engagement performance, Alex has completed a quality control step involving supervising procedures (including work of other accountants). Which of the following quality control (QC) elements are also satisfied by completion of this step?

    a. Relevant ethical requirements.

    b. Human resources.

    c. Leadership responsibilities for quality.

    d. Monitoring.

30. Disclosing confidential client information requires the specific consent of the client in which of the following circumstances?

    a. When making engagement workpapers available if subpoenaed in connection with a legal proceeding.

    b. When requested in an ethical disciplinary proceeding.

    c. When a predecessor is communicating with a successor accountant.

    d. When submitted in an AICPA or state CPA society authorized quality or peer review program.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

25. As part of engagement performance, compilations are subject to which of the following documentation requirements? **(Page 79)**

    a. **If the engagement was originally intended to be a higher level of service, documenting the required step-down considerations. [This answer is correct. AR 100.05–.11 requires a variety of documentation requirements for compilations as part of engagement performance. One such requirement is the documenting of required step-down considerations in cases where the engagement was originally intended to be a higher level of service.]**

    b. Documenting the results of the comparison of expectations to recorded amounts or ratios developed from recorded amounts. [This answer is incorrect. Documenting the results of the comparison of expectations to recorded amounts or ratios developed from recorded amounts is a documentation requirement for a *review* as stated in AR 100.43–.45.]

    c. Documenting any additional procedures that are performed due to significant unexpected differences resulting from the analytical procedures as well as the results of those additional procedures. [This answer is incorrect. AR 100.43–.45 requires a *review* to document any additional procedures that are performed due to significant unexpected differences resulting from the analytical procedures as well as the results of those additional procedures.]

    d. Documenting all communications to the proper level of management concerning fraud or illegal acts that the accountant discovers. [This answer is incorrect. Documenting all communications to proper level of management concerning fraud or illegal acts that the accountant discovers is a documentation requirement of all *reviews* as cited in AR 100.43–.45.]

26. Which of the following is required by SSARS No. 1 (AR 100.33–.38) in a *review*? **(Page 79)**

    a. **Inquiries related to actions taken at meetings of the board of directors, committees of the board of directors, etc that may impact the financial statements. [This answer is correct. One of the performance requirements set forth in SSARS No. 1 (AR 100.33–.38) when conducting a review is to make inquiries concerning actions taken at meetings of the board of directors, committees of the board of directors, stockholders, or comparable meetings that may affect the financial statements. Other requirements include the application of analytical procedures to the financial statements, and obtaining a management representation letter, among others.]**

    b. Take certain actions when it becomes apparent to the accountant that information supplied by the entity is unsatisfactory. [This answer is incorrect. Taking specified actions when the accountant becomes aware that information supplied by the entity is incorrect. incomplete, or otherwise unsatisfactory is required in a *compilation* by SSARS No. 1 (AR 100.05–.11).]

    c. Consider whether performing other accounting services such as assistance in adjusting the books of account will be necessary. [This answer is incorrect. SSARS No. 1 (AR 100.05–.11) requires the accountant to consider whether it will be necessary to perform other accounting services such as assistance in adjusting the books of account or consult on accounting matters in a compilation.]

    d. Read the compiled financial statements and assess whether they appear to be appropriate in form and without obvious material errors. [This answer is incorrect. Reading the compiled financial statements and considering whether they appear to be appropriate in form and free from obvious material errors is required by SSARS No. 1 (AR 100.05–.11) in a *compilation*.]

27. SSAE No. 10, *Attest Engagements* (AT 101.50) provides guidance concerning a number of requirements necessary to properly plan/supervise an attestation engagement. Which of the following accurately reflects one of those requirements? **(Page 83)**

    a. Directing the efforts of assistants who are participants in accomplishing attest engagement objectives is required, while confirming whether those objectives were accomplished is optional. [This answer is incorrect. Directing the efforts of assistants who participate in accomplishing the objectives of the attest engagement and determining whether those objectives were accomplished are required by SSAE No. 10 (AT 101.48).]

    b. Establishing with the client an understanding regarding general services that will be performed for all engagements. [This answer is incorrect. SSAE No. 10 (AT 101.46) requires the firm to establish with the client an understanding regarding the specific services to be performed for *each* engagement.]

    c. Reviewing the work of each assistant to ascertain whether it was properly performed and to evaluate the results for consistency with the conclusion to be presented in the report. [This answer is correct. SSAE No. 10 (AT 101.50) provides guidance regarding the reviewing of each assistant's work to determine whether it was adequately performed and to evaluate whether the results are consistent with the conclusion to be presented in the practitioner's report.]

    d. Taking into account only the nature and extent of the work necessary to accomplish the objectives of the attest engagement. Consideration of the timing of the work is not a requirement. [This answer is incorrect. SSAE No. 10 (AT 101.47) provides guidance regarding considering the nature, extent, *and timing* of the work to be performed to accomplish the objectives of the attest engagement, including changed conditions that may make it necessary to modify planned procedures.]

28. Alex is performing a compilation engagement. As a part of engagement performance, Alex has completed a quality control step involving maintaining the confidentiality, safe custody, integrity, accessibility, and retrievability of the workpapers. Which of the following quality control (QC) elements are also being satisfied by Alex's actions? **(Page 84)**

    a. Human resources. [This answer is incorrect. Human resources is a QC element that is also being satisfied when quality control steps such as communicating the partner's identity and role to the client, or reviewing the workpapers have been completed by Alex as spelled out in SQCS No. 7, but *not* completion of the QC step involving maintaining the confidentiality, safe custody, integrity, accessibility, and retrievability of the workpapers.]

    b. Leadership responsibilities for quality. [This answer is incorrect. SQCS No. 7 indicates that leadership responsibilities for quality is a QC element that is also being satisfied when quality control steps such as drafting the report, or obtaining an engagement quality control review (if required by firm policy) have been completed by Alex, but *not* completion of the QC step involving maintaining the confidentiality, safe custody, integrity, accessibility, and retrievability of the workpapers.]

    c. Acceptance and continuance of clients and engagements. [This answer is incorrect. Per SQCS No. 7, acceptance and continuance of clients and engagements is a QC element that is also being satisfied when the quality control step involving evaluating whether to accept/continue the engagement considering the client's integrity and the firm's capabilities has been accomplished by Alex, but *not* completion of the QC step involving maintaining the confidentiality, safe custody, integrity, accessibility, and retrievability of the workpapers.]

    d. Relevant ethical requirements. [This answer is correct. Relevant ethical requirements is a QC element that is also being satisfied when the quality control step involving maintaining the confidentiality, safe custody, integrity, accessibility, and retrievability of the workpapers has been completed by Alex as indicated in SQCS No. 7.]

29. Alex is performing a review engagement. As a part of engagement performance, Alex has completed a quality control step involving supervising procedures (including work of other accountants). Which of the following quality control (QC) elements are also satisfied by completion of this step? **(Page 84)**

    a. Relevant ethical requirements. [This answer is incorrect. Relevant ethical requirements is a QC element that is also being satisfied when the quality control step involving obtaining partner approval of engagement plan and staff assignments, and, if applicable, time estimates has been accomplished by Alex as stated in SQCS No. 7, but not completion of the QC step involving supervising procedures (including work of other accountants).]

    b. Human resources. [This answer is correct. Human resources is a QC element that is also satisfied when the quality control step involving supervising procedures (including work of other accountants) has been accomplished by Alex per SQCS No. 7.]

    c. Leadership responsibilities for quality. [This answer is incorrect. Leadership responsibilities for quality is a QC element that is also satisfied when the quality control step involving assigning staff based on capabilities, competence, and availability has been accomplished by Alex as cited in SQCS No. 7, but *not* completion of the QC step involving supervising procedures (including work of other accountants).]

    d. Monitoring. [This answer is incorrect. SQCS No. 7 states that monitoring is a QC element that is also satisfied when the quality control step involving assembling and retaining the workpapers for a sufficient period of time has been accomplished, but *not* completion of the QC step involving supervising procedures (including work of other accountants).]

30. Disclosing confidential client information requires the specific consent of the client in which of the following circumstances? **(Page 88)**

    a. When making engagement workpapers available if subpoenaed in connection with a legal proceeding. [This answer is incorrect. Making engagement workpapers (confidential client information) available if subpoenaed in connection with a legal proceeding does not require the specific consent of the client per Ethics Ruling No. 20 under Rule 301 of the *AICPA Code of Professional Conduct (Code)*.]

    b. When requested in an ethical disciplinary proceeding. [This answer is incorrect. Confidential client information, when requested in an ethical disciplinary proceeding, does not require the specific consent of the client as cited in Ethics Ruling No. 20 under Rule 301 of the *Code*.]

    c. When a predecessor is communicating with a successor accountant. [This answer is correct. Rule 301 of the Code states that a member in public practice shall not disclose any confidential client information without the specific consent of the client. Generally, engagement documentation can be shown outside of the firm only with the client's explicit permission, even in cases where a practitioner sells their practice to another firm or to a predecessor communicating with a successor accountant.]

    d. When submitted in an AICPA or state CPA society authorized quality or peer review program. [This answer is incorrect. Ethics Ruling No. 20 under Rule 301 of the Code states that confidential client information does not require specific consent of the client when it is submitted in an AICPA or state CPA society authorized quality or peer review program.]

CONSULTATION AND DIFFERENCES OF OPINION FOR COMPLEX TECHNICAL ISSUES OR UNIQUE INDUSTRY SITUATIONS IN AN ENGAGEMENT

Consultation

When an engagement team encounters complex technical issues or unique industry situations in an engagement that they have never encountered before, the engagement team may need to consult with someone not involved in the engagement. Consultation on such matters may be with individuals, at the appropriate professional level, within or outside the firm who have relevant specialized expertise.

Some firms designate specialists in particular industries. Some firms designate a particular person to become expert in unusually complex areas such as leases or pension plans. Many firms have specialists in income taxes. The extent of specialization varies with firm size and individual firm preference. Naturally, the smaller a firm is, the less likely the firm will have in-house specialists available for consultation. Additionally, on particularly complex matters, outside consultation may be necessary, even for large firms.

Other than the guidance found in the quality control standards, authoritative guidance addressing consultation is found only in auditing literature, and that guidance is limited primarily to situations involving the use of specialists. However, SSARS No. 1 requires that accountants possess or obtain a level of knowledge of the accounting principles and practices of the client's industry to appropriately compile or review the client's financial statements. Such knowledge may be obtained, among other ways, by consulting in-firm or outside firm individuals. Additionally, Rule 201 of the *Code* recognizes that consultation with others may be necessary during the performance of professional services. Accordingly, firms may need to resolve complex technical issues through consultation when performing compilation and review engagements.

SQCS No. 7 (QC 10.72) indicates that firms should establish policies and procedures over consultation to provide the firm with reasonable assurance that—

- Appropriate consultation takes place (such as when dealing with complex, unusual, unfamiliar, difficult, or contentious issues).
- Sufficient and appropriate resources are available to enable appropriate consultation to take place.
- The engagement team provides all the known relevant facts to individuals consulted.
- The nature and scope of such consultations are documented and are understood by both those seeking consultation and the individual consulted.
- The consultation conclusions reached are documented and implemented.

Consultation within the firm includes making use of appropriate technical reference materials in the firm's library as well as using the collective experience and technical expertise of the firm. Consultation aids in promoting engagement quality and improves the application of professional judgment. Appropriate recognition of consultation in the firm's policies and procedures helps to promote a culture in which consultation is recognized as an asset and encourages personnel to consult on complex, unusual, unfamiliar, difficult, or contentious issues.

Consultation outside the firm might be the appropriate resolution if the firm does not have the relevant experience or technical expertise necessary or the firm believes that additional consultation is needed, for example, on particularly complex matters. Some firms prepare a list of outside specialists that may be consulted regarding an accounting or SSARS issue. Those outside specialists could be advisory services provided by other firms, professional and regulatory bodies, or commercial organizations that provide relevant quality control services. Before contracting for such services, the firm should evaluate the external provider's qualification for that purpose. (The proposed SQCS indicates that considering the competence and capabilities of the external provider help in determining whether that provider is qualified.) Additionally, some firms may have policies that require advance approval by firm management (such as the managing partner) before outside consultation is initiated. Some firms may also specify that the outside consultant's views and conclusions are considered by the firm, but are not binding on the final decision made by the firm.

The firm's consultation procedures should provide for consultation with those having appropriate knowledge, seniority, and experience within the firm, on significant technical, ethical, and other matters. Such procedures should also provide for appropriate documentation and implementation of conclusions resulting from consultations. SQCS No. 7 (QC 10.77) states that the appropriate documentation of consultations that is sufficiently complete and detailed contributes to an understanding of the issue on which consultation was sought. It also needs to be complete and detailed to provide understanding of the results of the consultation, including decisions taken, the basis for those decisions, and how the decisions were implemented.

Documentation of consultation should include the conclusions reached and the reasons supporting the conclusion. Although the documentation can be by memorandum, it is suggested that a standard form be used. It is usually helpful to request that the preparers of the consultation documentation attach copies of authoritative literature used to reach their conclusions.

Proposed SQCS Changes. The ASB has issued an exposure draft that would supersede SQCS No. 7. The proposed standard makes certain revisions to paragraph QC 10.72, including:

- The removal of the presumptively mandatory requirement regarding the engagement team providing all known relevant facts to those consulted. That guidance has been moved to the application and other explanatory materials section of the proposed standard. (See the discussion in Chapter 1 regarding the new clarified format.)

- The elimination of the terms complex, unusual, and unfamiliar in describing the types of situations that may result in consultation. Issues requiring consultation are merely described as difficult or contentious in the proposed standard.

- The clarification that consultation conclusions should be understood by the individual seeking consultation and the individual providing the consultation.

Maintaining an Adequate and Up-to-date Professional Reference Library. The firm library is an essential tool that enables a firm's personnel to stay current with professional standards and regulatory and legal requirements that are constantly changing. Having ready access to such information may help minimize the need for some external consultation and resolve any potential differences of opinion. Having adequate and up-to-date technical reference materials (whether paper or electronic media) may allow personnel to resolve some issues more efficiently without the involvement of supervisory personnel. In fact, the firm may encourage staff to initially perform their own research to answer technical questions, as this process provides more in-depth knowledge and understanding of the matter and a learning opportunity for the individuals.

Firms need to identify the resources required to answer the types of questions that personnel frequently face. Generally, the resources vary by firm based upon the types of engagements performed. The firm's clients, the expertise of the firm's personnel, the availability of outside libraries, and staff usage levels also affect the firm's library needs. To maintain current and adequate libraries, firms also need to periodically consider whether new resources are required to cover any current professional standards changes or new areas of service.

A suggested professional accounting library is presented below:

a. *AICPA Pronouncements*. The AICPA, through its senior and technical committees and task forces, issues pronouncements that govern a wide range of topics including accounting, auditing, compilation, review, and other professional services; professional ethics; and quality control. Its pronouncements can be found in the following resources.

   (1) *AICPA Professional Standards*. This resource contains all of the currently effective pronouncements on professional standards issued by the AICPA, the International Federation of Accountants, and the International Accounting Standards Board. Consequently, it includes Statements on Auditing Standards, Statements on Standards for Attestation Engagements, Statements on Standards for

Accounting and Review Services, and the Interpretations related to those Statements. It also includes the AICPA *Code of Professional Conduct*, AICPA Bylaws, Statement on Standards for Consulting Services, Statements on Quality Control Standards, Standards for Performing and Reporting on Quality Reviews and related Interpretations, Statements on Standards for Tax Services and related Interpretations, Statements on Responsibilities in Personal Financial Planning Practice, and Statement on Standards for CPE Programs and related Policies and Forms. Finally, the resource includes Statements of International Accounting Standards, Statements of International Standards on Auditing, and International Statements on Auditing.

(2) *Industry Audit and Accounting Guides*. These guides include recommendations for applying GAAP to financial statements of entities in specific industries and on applying certain audit methods to all financial statement audits.

(3) *Technical Practice Aids*. This resource includes selected Technical Information Service Questions and Answers, Accounting Statements of Position, Audit and Attest Statements of Position, Practice Bulletins, Issues Papers of the Accounting Standards Division, Practice Alerts, Suitable Trust Services Criteria and Illustrations, and PCAOB Staff Questions and Answers and Other Implementation Guidance.

(4) *AICPA Risk Alerts*. Although most small firms do not need all of the alerts, each firm needs the alerts that are applicable to its practice.

The preceding publications are available in bound or loose-leaf format and can be ordered by calling the AICPA Order Department at (888) 777-7077 or online at **www.cpa2biz.com**. They are also available via CD-ROM or online through PPC by calling (800) 431-9025 or at the website **ppc.thomsonreuters.com**, in conjunction with ownership of PPC *Guides*.

b. *FASB Codification.* The *FASB Accounting Standards Codification* (FASB Codification) is the single source of authoritative U.S. generally accepted accounting principles (GAAP) to be applied by nongovernmental entities. The FASB Codification became authoritative for periods ending after September 15, 2009, superseding accounting guidance included in Accounting Principles Board Opinions, Accounting Research Bulletins, FASB Statements, FASB Staff Positions, FASB Interpretations, AICPA Interpretations, AICPA Statement of Positions, EITF Abstracts, AICPA Practice Bulletins, and AICPA Audit and Accounting Guides. The FASB Codification is available in two online versions (professional or basic). The basic online version is available at no charge and provides browsing by topic, basic print functionality, and utility to identify the location of the original standards. The professional online version, while not free, provides more extensive functionality and features. The FASB currently continues to provide bound volumes of certain pre-FASB Codification products, such as the Current Text, EITF Abstracts, and Original Pronouncements. The pre-FASB Codification products do not include authoritative guidance issued since the FASB codification became effective.

The FASB Codification on Checkpoint is available as an add-on with a subscription to any PPC product on Checkpoint. The FASB Codification on Checkpoint provides enhanced functionality and advanced navigation related to the FASB Codification material and also accesses the complete library of prior statements, standards, and other supporting material. Contact PPC at (800) 431-9025 or at the website **ppc.thomsonreuters.com**.

All of the FASB publications can be ordered from the FASB by calling their Order Department at (800) 748-0659 or via their website, **www.fasb.org**. Many of the pre-FASB Codification pronouncements are still available at no charge as originally issued on the FASB's website at **www.fasb.org**.

c. *Pronouncements of the Governmental Accounting Standards Board (GASB)*. Similar to the FASB, the GASB is the primary standards-setting body for governmental accounting. Its pronouncements include Statements of the Governmental Accounting Standards Board, GASB Interpretations, GASB Technical Bulletins, consensus positions of the GASB Emerging Issues Task Force, and implementation guides prepared by the GASB's staff. Further information about GASB publications can be obtained by calling the GASB Order Department at (800) 748-0659 or online at **www.gasb.org**.

d. *Accounting and Auditing Manuals*. There are several sources that provide accounting and auditing manuals for local firms. Thomson Reuters' PPC brand of manuals are recommended because they are interfaced with this course and generally have been peer reviewed. For more information and a list of all accounting and auditing manuals available, visit Thomson Reuters' website at **ppc.thomsonreuters.com** or call (800) 431-9025.

e. *Industry and Specialty Reference Sources*. It is recommended the firm's library include reference manuals that provide specialized guidance relating to the types of industries served by the firm.

Attestation Requirements for Using Specialists. AT 101.22 recognizes that specialists may need to be consulted on attestation engagements. Specialists, when used in that literature, are individuals possessing special skill or knowledge in a particular field other than accounting, for example, actuaries, appraisers, attorneys, engineers, geologists, environmental consultants, etc. Normally, when one thinks of the term *specialists* in the context of a firm's QC system, one is not referring to the nonaccounting specialists discussed in the context of attestation literature. Rather, one is referring to an individual with special knowledge or expertise in accounting. This is especially true of small firms that only provide traditional services or whose clients' financial statements are not subject to the special FASB disclosures that require the use of nonaccounting specialists.

While most illustrations of consulting QC systems make no mention of consulting with nonaccounting specialists, it is generally appropriate to include special procedures for those types of consultation in the QC system.

Specifying Situations That Require Consultation. It is impossible to identify every situation that could require consultation; therefore, many firms may question the practicality of specifying such situations. However, the consultation component of the QC document normally should contain a list of common situations that generally indicate consultation may be necessary. The list might include the following:

- Any engagement in which a modified or nonstandard report is likely.
- An engagement involving material litigation.
- Application, for the first time, of new or complex technical pronouncements.
- Industries with special accounting or reporting requirements.
- Accounting for complex or unusual transactions.
- Emerging practice problems.
- Choices among alternative generally accepted accounting principles upon initial adoption or when an accounting change is made.
- Uncertainty exists at the financial statement date regarding a significant accounting estimate, such as asset impairment (for example, recovery of a revenue producing asset or goodwill), asset realization (for example, deferred tax asset valuation allowances), liability recognition (for example, environmental cleanup obligations), or other contingencies.
- Reissuance of a report, consideration of omitted procedures after a report has been issued, or subsequent discovery of facts that existed at the time a report was issued.
- Filing requirements of regulatory agencies.
- Meetings with regulators at which the firm is to be called on to support the application of generally accepted accounting principles that have been questioned.

The types of engagement services performed, the industries serviced, and other unique firm criteria will impact the list of common consultation situations encountered for each firm.

When firms specify situations that require consultation and documentation in the firm's quality control policies and procedures, it is important that the firm ensure its personnel are aware of, and recognize, the situations in which firm policy requires consultation and documentation.

Differences of Opinion

Prior to the issuance of SQCS No. 7, the quality control standards did not address differences of opinion policies and procedures in the firm's quality control system. The right to document disagreements only resided in the auditing literature. However, the new QC standard has incorporated dealing with and resolving differences of opinion as part of the engagement performance element.

Occasionally, differences of opinion concerning accounting issues may arise among—

- Firm personnel within the engagement team.
- The firm and individuals consulted.
- The engagement partner and the engagement quality control reviewer.

SQCS No. 7 (QC 10.78) states that firms should establish policies and procedures for dealing with and resolving differences of opinion. Those policies and procedures should require that (a) conclusions reached be documented and implemented, and (b) the report not be released until the difference of opinion is resolved.

If procedures are effective, they will encourage identification of differences of opinion at an early stage. They will also provide clear guidelines about the successive steps to be taken thereafter. In addition, procedures should require documentation regarding the resolution of the differences and the implementation of the conclusions reached. Procedures to resolve such differences may include consulting with another practitioner, firm, or professional or regulatory body.

As stated above, conclusions reached when dealing with differences of opinion should be documented. Specific guidance regarding this documentation is not provided in SQCS No. 7. Care should be exercised in establishing policies and procedures for documenting differences of opinion. If the firm establishes documentation procedures that are too stringent, staff personnel may be discouraged from initiating general discussions of technical questions or issues for fear that these exchanges of ideas demand too much documentation time and effort.

It is suggested that matters of a material nature be documented, but that the firm's QC policies and procedures not require matters of a general nature or of minor technical importance to be documented. The decision of whether a question is of a general nature or of minor technical importance versus one that is material would ordinarily be made by the engagement partner. Once the determination has been made that the issue is material, the firm should follow its documentation procedures. It is usually helpful to request that the preparers of the consultation documentation attach copies of authoritative literature used to reach their conclusions.

QUALITY CONTROL REVIEW OF THE ENGAGEMENT

SQCS No. 7 includes a requirement for the firm to establish criteria against which all engagements are to be evaluated to determine whether an engagement quality control review should be performed. An *engagement quality control review* is defined as "a process designed to provide an objective evaluation, by an individual or individuals who are not members of the engagement team, of the significant judgments the engagement team made and the conclusions reached in formulating the report."

General Requirements

SQCS No. 7 (QC 10.81–.82) states that if an engagement meets specified criteria established by the firm, an engagement quality control review (EQCR) should be performed for that engagement and completed before the report is released. Additionally, firm policies and procedures should indicate that the engagement partner is still responsible for the engagement and its performance, notwithstanding involvement of the engagement quality control reviewer. The engagement quality control reviewer may be a firm partner, another person in the firm, a qualified external person, or a team comprised of such individuals, none of whom is part of the engagement team. The reviewer(s) should possess sufficient and appropriate experience and authority to perform the EQCR.

Proposed SQCS Changes. The ASB has issued an exposure draft that would supersede SQCS No. 7. The proposed standard modifies the following items previously discussed as general requirements of EQCR:

- The presumptively mandatory requirement stating that firm policies and procedures should indicate that the engagement partner is still responsible for the engagement and its performance has been removed. However, the replaced guidance has been included in the application and other explanatory material section of the proposed SQCS and revised to indicate that the performance of EQCR on an engagement does not reduce the responsibilities of the engagement partner.

- A new presumptively mandatory requirement has been added indicating that the firm should establish policies and procedures setting out the nature, timing, and extent of an EQCR.

- The definition of *engagement quality control reviewer* has been modified. Instead of stating that the reviewer should possess sufficient and appropriate experience and authority to perform the EQCR, the proposed standard indicates that the reviewer should be a person with sufficient and appropriate experience and authority to objectively evaluate the significant judgments the engagement team made and the conclusions it reached in formulating the report.

Establishing Criteria for Engagement Quality Control Reviews

In establishing criteria for performance of an EQCR, the structure and nature of the firm's practice are important. Such criteria may include considerations such as the following:

- The nature of the engagement, including whether it involves a matter of public interest.

- Whether unusual circumstances or risks have been identified relating to the engagement, engagement service type, or industry.

- Whether laws or regulations require an engagement quality control review to be performed.

While firms are required to establish criteria as part of their QC policies and procedures for determining when an EQCR should be performed, if no engagements meet the criteria established by the firm for review, no EQCRs are required to be performed.

The structure and nature of the firm's practice are important factors in establishing criteria to consider when determining which engagements are to be subject to an EQCR. Accordingly, it is recommended that the firm begin the process of developing EQCR policies and procedures by considering its unique structure and nature. Firm structure includes the size of the firm, the number of partners in the firm, etc. The nature of the firm includes the types of services the firm performs and how those services make up the total engagements of the firm. For example, does the firm provide an extensive line of services including reviews, compilations, and attest engagements?

Firms define engagement quality control review criteria based upon the firm's unique circumstances (that is, structure and nature). Accordingly, some firms may establish criteria that result in more EQCRs being performed than other firms. For example, a compilation and review firm with a larger tax practice and a smaller accounting practice may designate that all reviews exceeding an 80-hour time budget have an EQCR performed. For that particular firm, since the firm offers a variety of services overseen by multiple partners, some of whom perform both review and tax services, there may be a more pressing need to have EQCRs performed on a larger number of review engagements. Alternatively, a firm that performs a significant number of reviews may feel more confident in its ability to follow established review guidance because all of its partners routinely perform reviews as a matter of course. Thus, that firm may designate only review engagements that it considers to be high-risk (as defined by the firm) for EQCR. The preceding discussion indicates that firms may treat the same engagement differently for purposes of establishing engagement quality control review criteria. The key point is that EQCR criteria are as unique as the firm.

For each type of service provided, the firm may consider a different set of EQCR criteria. In other words, the criteria established for review engagements may differ significantly than for other types of attest engagements. SQCS No. 7 suggests that when establishing criteria for EQCRs, firms may consider the nature of the engagement, unusual circumstances or risks of the engagement, and whether other laws or regulations impact EQCR requirements. The following list represents the types of situations that may be considered in establishing EQCR criteria:

- Third-party use of the report, such as to the client's lender for financing purposes.
- High profile clients, for example, well-known individuals or entities in the local community.
- Entities subject to governmental regulations.
- New types of service for the firm.
- New or complex specialized industries.
- Client entities without competent or experienced accounting personnel.
- Client entities with substantial fraud risk factors.
- Client entities with significant related party transactions.
- Clients that have experienced material misstatements during the current or previous engagements.
- Engagements where the acceptance and continuance decision caused reason for concern (even though the firm resolved the initial concern).
- First-time clients.
- New firm partners.

It is recommended that any circumstance that creates an unusual or a higher level of engagement risk be considered in establishing EQCR criteria. Whenever an engagement is subject to a heightened level of risk, the firm may consider it prudent to have a second pair of eyes review the engagement. Regardless of whether a particular engagement meets the firm's stipulated EQCR criteria, it may be selected for EQCR based upon current year risk during engagement performance. However, the reverse situation does not hold true. That is, a firm may not choose to opt-out of performing an EQCR when an engagement meets the established EQCR criteria.

Since EQCR criteria is based upon the firm's unique circumstances, a firm's established EQCR criteria need to change when firm circumstances change. It is important for the firm's quality control system to be a dynamic system that changes as the firm changes.

Proposed SQCS Changes. The ASB has issued an exposure draft that would supersede SQCS No. 7. The proposed SQCS makes no real change to the criteria for EQCR listed above other than to move the information to the application and other explanatory material section of the proposed standard.

However, the proposed SQCS has added discussion in the application and other explanatory material section of the standard regarding considerations specific to governmental entities. The guidance indicates that certain governmental entities may be of sufficient significance to warrant the performance of EQCR. Additionally, other entities may be significant for a variety of reasons. Furthermore, while no specific criteria exist to categorize an entity as significant, the firm may determine whether an entity is sufficiently significant to warrant performance of EQCR.

Example of Establishing EQCR Performance Criteria. SQCS No. 7 does not describe the process a firm should go through to determine its unique EQCR performance criteria. Exhibit 3-3 provides some scenarios for developing engagement quality control review criteria based upon a firm's unique nature and structure. Thus, *if* the firm situation warrants it, EQCR may be limited. The illustrations in Exhibit 3-3 represent suggestions given a specific set of circumstances and are not meant to indicate that the selected engagement quality control review criteria are the only appropriate EQCR criteria. No right or wrong answers exist because no two firms are the same. Once a firm has established its EQCR criteria, it is important for firms to reevaluate whether their EQCR policy is still appropriate when changes occur in the firm's compilation and review practice. It is recommended that firms reevaluate the appropriateness of their EQCR criteria when changes occur in the firm's risk-related circumstances, or at least annually.

Exhibit 3-3

Example of Establishing EQCR Performance Criteria

Scenario #1 (Sole Practitioner)

A sole practitioner firm performed the following attest services during its last fiscal year:

23 compilations (both interim and annual, including two full-disclosure GAAP)

6 reviews (three of which are required by client banks)

The firm's clients have been with the firm for many years and are primarily in the hospitality and retail industries. A&A personnel have experience in those industries. The manager handles all reviews and full-disclosure compilation engagements, as well as the majority of the other compilation engagements. The partner supervises four of the other compilation engagements. The firm received a peer review report with a rating of pass and had no findings during its most recent peer review.

A&A personnel include:

Partner (primarily tax)	20 years experience
Manager (strong A&A experience)	12 years experience
Senior (A&A and tax)	4 years experience

Firm EQCR Policy—

Based on its services, client base, personnel, and most recent peer review, the firm has established a policy that EQCR be performed on compilation engagements supervised by the partner. The EQCR is performed by the manager. Due to the strong A&A experience of the manager, no EQCR is considered necessary for the engagements supervised by the manager.

Scenario #2 (Sole Practitioner)

Assume the same fact pattern in Scenario #1, except that the senior manager was promoted to New Partner, effective 1/1/20X1. The firm revises its EQCR policy as follows (revision in **bold**):

Firm EQCR Policy—

Based on its services, client base, personnel, and most recent peer review, the firm has established a policy that EQCR be performed on compilation engagements supervised by the partner. The EQCR is performed by the manager. Due to the strong A&A experience of the manager, no EQCR is considered necessary for the engagements supervised by the manager. **Additionally, if the firm accepts a new level of A&A service, the firm will evaluate whether in-house expertise is available to perform EQCR. If in-house expertise is not available, the firm will consider whether EQCR should be performed by an outside individual who has the appropriate engagement experience.**

Scenario #3 (Sole Practitioner)

Assume the same fact pattern in Scenario #1, except that the manager with the strong A&A experience leaves the firm. After several months of searching for a replacement, a new manager with A&A experience is hired. The firm revises its EQCR policy as follows (revision in **bold**):

Firm EQCR Policy—

Based on its services, client base, personnel, and most recent peer review, the firm has established a policy that EQCR be performed on compilation engagements supervised by the partner. The EQCR is performed by the manager. Because of the A&A experience of the manager, no EQCR is considered necessary for the engagements supervised by the manager. **During the time that the firm is seeking a replacement for the manager, the partner supervises all A&A engagements. The partner considers whether EQCR is necessary based upon each engagement's level of risk. If EQCR is considered necessary, the partner contracts with an outside individual who has appropriate experience. Once the new manager is hired, the partner reviews all engagements supervised by the manager, and based upon engagement risk, determines whether EQCR will be performed by an outside individual who has appropriate experience.**

Scenario #4 (Sole Practitioner)

A sole practitioner firm performed the following attest services during its last fiscal year:

18 tax basis compilations (both interim and annual, no disclosure)

The firm's clients are in the medical professional service field and have experienced minimal change over the years. The firm's practice is primarily tax-oriented. All personnel perform both tax and accounting work. The firm received a peer review report with a rating of pass and had no findings during its most recent peer review.

A&A personnel include:

Partner	16 years experience
Senior	8 years experience
Staff	4 years experience

Firm EQCR Policy—

Based on its services, client base, personnel, and most recent peer review, the firm has established a policy that EQCR is not required on its current A&A engagements. If the firms accepts a new level of A&A service or an A&A client in a new industry, the firm will reconsider its EQCR criteria.

Scenario #5 (Multi-partner Firm)

A two-partner firm performed the following attest services during its last fiscal year:

18 compilations (both interim and annual, including three full-disclosure GAAP)

12 reviews (six of which are required by client banks)

The firm's clients have been stable and are primarily in construction and construction-related industries. All firm personnel have experience in those industries. The firm received a peer review report with a rating of *pass* and had no findings during its most recent peer review.

A&A personnel include:

Partner 1	20 years experience
Partner 2	15 years experience
Staff 1	7 years experience
Staff 2	4 years experience

Firm EQCR Policy—

Based on its services, client base, personnel, and most recent peer review, the firm has established a policy that EQCR be performed on the six reviews required by the client banks and the three full-disclosure compilation engagements. Partner 1 performs EQCR for engagements supervised by Partner 2, and vice versa.

Scenario #6 (Multi-partner Firm)

A two partner firm performed the following attest services during its last fiscal year:

12 compilations (both interim and annual, including four full-disclosure GAAP)
8 reviews (3 of which are required by client banks)

The firm's clients have been stable, but represent various industries. All firm personnel have multiple years of experience with the firm's clients. During the firm's most recent peer review, the firm had no matters or findings on the compilations it performed, but did receive a Finding for Further Consideration form (FFC) relating to its review engagement documentation.

A&A personnel include:

Partner 1	18 years experience
Partner 2	12 years experience
Staff 1	5 years experience
Staff 2	3 years experience

Firm EQCR Policy—

Based on its services, client base, personnel, and most recent peer review, the firm has established a policy that EQCR be performed on all review and full-disclosure compilation engagements. Due to receipt of the FFC relating to review engagement documentation, the firm has EQCR performed on all review engagements by an outside individual with appropriate experience. Partner 1 performs EQCR for full-disclosure compilation engagements supervised by Partner 2, and vice versa.

* * *

Establishing Qualifications for Appointment and Replacement of Engagement Quality Control Reviewers

SQCS No. 7 (QC 10.92) indicates that firms should establish policies and procedures to address the appointment of engagement quality control reviewers and the technical qualifications required to perform the role, including the necessary experience and authority. (The proposed SQCS adds that establishing policies and procedures that address the appointment of engagement quality control reviewers should also establish the reviewers' eligibility.)

Technical Qualifications. The firm's policies and procedures on the technical qualifications of engagement quality control reviewers may address the experience, technical expertise, and authority needed to fulfill the role. What represents sufficient and appropriate experience, technical expertise, and authority depends on the circumstances of the engagement. For example, when determining the engagement quality control reviewer for the compilation of a forecast of a construction contractor client, the engagement quality control reviewer should have technical expertise and experience with that specialized industry. Alternatively, if an engagement quality control reviewer is needed for a first-time review of a new manufacturing client, the individual chosen needs technical expertise and experience in the manufacturing industry as well as knowledge of issues that commonly occur when performing the initial review of any client.

Objectivity. The firm should establish policies and procedures designed to maintain the objectivity of the engagement quality control reviewer. Accordingly, while the engagement quality control reviewer is not a member of the engagement team, the engagement quality control reviewer should satisfy the independence requirements relating to the engagements reviewed. (The proposed SQCS adds application guidance indicating that policies and procedures designed to maintain objectivity of the engagement quality control reviewer also provide for consideration of whether the reviewer's ability to perform an objective review has been impaired, and if so, for replacement of the reviewer. Consideration of impairment to the engagement quality control reviewer's objectivity can be judged by personnel other than the engagement quality control reviewer or the engagement partner.)

<u>Not Selected by Engagement Partner.</u> SQCS No. 7 (QC 10.95) suggests that firms, where practical, include a requirement in their QC policies and procedures that the engagement quality control reviewer not be selected by the engagement partner. Such a requirement is designed to help maintain the objectivity of the engagement quality control reviewer. However, since many compilation and review-only firms have few accounting partners, it may not be practical for the engagement partner not to be involved in selecting the engagement quality control reviewer.

<u>No Participation in Engagement Performance Other Than Consultation.</u> To maintain the objectivity of the engagement quality control reviewer, the firm's policies and procedures may include a requirement that the reviewer may not participate in the performance of the engagement except in a consulting role. The engagement partner may consult the engagement quality control reviewer at any time during the engagement, for example, to establish that a judgment made by the engagement partner will be acceptable to the engagement quality control reviewer. Consultation of such nature need not impair the engagement quality control reviewer's eligibility to perform his or her role. However, if the nature and extent of the consultations become significant, the reviewer's objectivity may become impaired unless both the engagement team and the reviewer are careful to maintain the reviewer's objectivity. [The proposed SQCS indicates that in addition to such consultation not impairing the engagement quality control reviewer's eligibility to perform his or her role, it also avoids differences of opinion being identified at a late stage of the engagement. The exposure draft also adds that when it is not possible to maintain the reviewer's objectivity, another individual within the firm or a suitably qualified external person may be designated to take on the role of the engagement quality control reviewer or the individual to be consulted on the engagement.]

<u>No Engagement Team Decisions.</u> To maintain the objectivity of the engagement quality control reviewer, policies and procedures may include a requirement that the engagement quality control reviewer not make decisions for the engagement team. Otherwise, the reviewer's objectivity on the engagement is threatened.

<u>Additional Proposed SQCS Changes.</u> The proposed SQCS also indicates that policies and procedures designed to maintain the engagement quality control reviewer's objectivity provide that the engagement quality control reviewer is not subject to other considerations that would threaten the reviewer's objectivity. In all circumstances associated with the role of engagement quality control reviewer, the person performing the EQCR should maintain his or her objectivity.

Replacement of Reviewers. The firm's policies and procedures should include a provision for the replacement of the engagement quality control reviewer if the reviewer's ability to perform an objective review becomes impaired. For example, if the relative positions in the firm of the engagement partner and the engagement quality control reviewer keep the engagement quality control reviewer from maintaining their objectivity in carrying out their responsibilities, then a different engagement quality control reviewer needs to be selected. In such a situation, the firm may determine the relationships that create those objectivity issues and assign engagement quality control reviewers differently. [The proposed SQCS has modified slightly the requirements for when an engagement quality control reviewer is replaced. Currently, SQCS No. 7 indicates that such a replacement should occur when the reviewer's ability to perform an objective review *has* been impaired. The exposure draft indicates that reviewer replacement should occur when the reviewer's ability to perform an objective review is likely to have been impaired.]

Contracting Engagement Quality Control Review. When sole practitioners or small firms identify engagements requiring EQCRs, a qualified individual may not be available within the firm to perform the EQCRs. In such cases, qualified external individuals or firms may be contracted to perform the function.

Performing Engagement Quality Control Reviews

SQCS No. 7 (beginning at QC 10.85) states that engagement quality control review procedures should ordinarily include—

- An objective evaluation of significant judgments made and the conclusions reached in formulating the report.
- Reading the financial statements or other subject matter information and the report and considering whether the report is appropriate.
- A review of selected engagement documentation relating to the significant judgments and the conclusions reached.
- A discussion with the engagement partner about significant findings and issues.
- Requiring the engagement quality control reviewer to conduct the review in a timely fashion so significant issues may be resolved to the reviewer's satisfaction before the report is released. As a result, the review may be conducted at various stages throughout the engagement.

The extent of the EQCR may depend upon, among other things, the complexity of the engagement and the risk that the report might not be appropriate in the circumstances.

Engagement quality control reviews may include consideration of—

- The engagement team's evaluation of the firm's independence relating to the engagement.
- Whether consultation has taken place relating to matters regarding differences of opinion or other difficult or contentious matters, and the conclusions reached as a result of such consultation.
- Whether the workpapers selected for review reflect the work performed and the conclusions reached relating to significant judgments.

Significant judgments made by the engagement team may include the following:

- Significant risks identified and responses to those risks.
- Judgments made, particularly with respect to significant risks and materiality.
- The significance of identified corrected and uncorrected misstatements and the disposition of such misstatements.

If the engagement quality control reviewer makes recommendations and the engagement partner does not accept those recommendations, the firm's procedures for resolving differences of opinion should be followed if the matter is not resolved to the reviewer's satisfaction. Additionally, the report cannot be released until the matter is resolved.

Documenting Engagement Quality Control Review

SQCS No. 7 (QC 10.99) indicates that firms should establish policies and procedures for preparing appropriate documentation of the engagement quality control review, including documentation that reflects—

- The engagement quality control review procedures required by firm policies have been performed.
- The engagement quality control review has been completed before the report is released.
- The reviewer is not aware of any unresolved matters that would cause him or her to believe that significant judgments the engagement team made and conclusions they reached were not appropriate.

Documentation supporting performance of the EQCR should indicate that the review was completed prior to the issuance of the engagement report.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

31. Bill is a practitioner in a firm and is seeking answers to questions he has regarding his responsibilities in a personal financial planning practice. AICPA *Pronouncements* are available to provide a wide range of guidance such as accounting, auditing, compilation, review, and other professional services. Which of the following resources will Bill need to consult to find the pronouncement that addresses personal financial planning practice?

    a. Technical practice aids.

    b. Industry audit and accounting guides.

    c. AICPA professional standards.

    d. AICPA risk alerts.

32. Differences of opinion policies and procedures in a firm's quality control system should be documented. What is the source of guidance regarding this documentation?

    a. SQCS No. 7.

    b. Procedures established by the firm.

33. According to SQCS No. 7 (QC 10.81–.82), an engagement quality control review (EQCR) is required for which of the following?

    a. All engagements the firm is responsible for performing.

    b. Only engagements that meet the criteria established by SQCS No. 7 for review.

    c. Only engagements that meet the criteria established by the firm for review.

    d. EQCRs are an optional quality control tool.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

31. Bill is a practitioner in a local firm and is seeking answers to questions he has regarding his responsibilities in a personal financial planning practice. AICPA *Pronouncements* are available to provide a wide range of guidance such as accounting, auditing, compilation, review, and other professional services. Which of the following resources will Bill need to consult to find the pronouncement that addresses personal financial planning practice? **(Page 97)**

    a. Technical practice aids. [This answer is incorrect. AICPA *Pronouncements* that address personal financial planning practice are not found in technical practice aids. Technical practice aids include selected Technical Information Service Questions and Answers, Practice Bulletins, Practice Alerts, Accounting Statements of Position, among others.]

    b. Industry audit and accounting guides. [This answer is incorrect. Bill will not find answers to his questions regarding personal financial planning practice in industry audit and accounting guides. These guides include recommendations for applying GAAP to financial statements of entities in specific industries and on applying certain audit methods to all financial statement audits.]

    c. AICPA professional standards. [This answer is correct. AICPA professional standards include all current pronouncements on professional standards issued by the AICPA including Statements on Responsibilities in Personal Financial Planning Service for which Bill is seeking answers. Other pronouncements in AICPA professional standards include Statements on Quality Control Standards, AICPA bylaws, statements on auditing standards, and a variety of other pronouncements.]

    d. AICPA risk alerts. [This answer is incorrect. AICPA risk alerts are all alerts that could possibly apply, and each firm should use those alerts that are applicable to its practice; however, such alerts will not provide answers to Bill's questions regarding personal financial planning practice.]

32. Differences of opinion policies and procedures in a firm's quality control system should be documented. What is the source of guidance regarding this documentation? **(Page 100)**

    a. SQCS No. 7. [This answer is incorrect. SQCS No. 7 does not provide any specific guidance regarding differences of opinion policies and procedures.]

    b. Procedures established by the firm. [This answer is correct. The firm is responsible for establishing its documentation procedures. Generally, matters of a material nature should be documented. However, matters of a general nature or of minor technical importance generally need not be documented.]

33. According to SQCS No. 7 (QC 10.81–.82), an engagement quality control review (EQCR) is required for which of the following? **(Page 101)**

    a. All engagements the firm is responsible for performing. [This answer is incorrect. SQCS No. 7 does not require firms to conduct an EQCR for *all* engagements since firms define EQCR criteria based on the firm's unique circumstances, such as structure and nature.]

    b. Only engagements that meet the criteria established by SQCS No. 7 for review. [This answer is incorrect. The criteria for determining which engagements require an EQCR is not established by SQCS No. 7. Some firms may establish criteria that result in more EQCR's being performed than other firms. For example, a compilation and review firm with a larger tax practice and a smaller accounting practice may designate that all reviews exceeding an 80-hour time budget have an EQCR performed. By the same token, a firm that performs a significant number of reviews may feel more confident in its ability to follow established review guidance because all of its partners routinely perform reviews as a matter of course. Thus, that firm may designate only review engagements that it considers to be high-risk for EQCR.]

c. **Only engagements that meet the criteria established by the firm for review. [This answer is correct. SQCS No. 7 (QC 10.81–.82) states that an EQCR should be performed for any engagement that meets specified criteria established by the firm.]**

d. EQCRs are an optional quality control tool. [This answer is incorrect. EQCRs are not optional. They are required for engagements based on specified criteria.]

HOW TO DRAFT THE FIRM'S QUALITY CONTROL POLICIES AND PROCEDURES

For some of the elements of quality control, professional standards will contain considerations or requirements that need to be incorporated into the design of the quality control system. Therefore, it is always important to begin the design of any of the quality control elements with a review of the authoritative literature.

AICPA Practice Aid

After reviewing authoritative literature, the illustrative examples suggested by the AICPA for designing the engagement performance element of the quality control system should be reviewed. Those examples are found in the AICPA Practice Aid, *Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (the AICPA Practice Aid).

While the AICPA's illustrative policies and procedures may provide a logical starting point for designing the engagement performance quality control system, careful consideration of the firm's needs before adopting them is recommended. Many firms will find that the suggested policies and procedures may not meet their firm's particular needs.

Developing Engagement Performance Policies and Procedures

Quality control policies are designed to achieve the overall objectives of the QC system and the specific objectives of the individual QC elements. Quality control procedures are designed to provide the actions necessary to implement and monitor compliance with the stated policies. It is believed that factors such as the size of the firm, operating characteristics of the firm, the knowledge and experience of firm personnel, and the nature and complexity of the firm's practice can impact the QC policies and procedures for a given firm.

There is more than one way to develop a firm's quality control policies and procedures. For example, the approach taken in this course is to develop one policy statement for each QC element and then design appropriate procedures for each element that implements that one policy. Alternatively, the AICPA Practice Aid provides illustrative policies and procedures that include multiple policy statements for each QC element, with procedures related to each policy. Firms need to choose an approach in developing their QC policies and procedures that meets the needs and desires of the firm.

Developing Engagement Level Quality Control Steps

Developing the actual engagement performance quality control system is a very difficult task. Referring back to Exhibit 3-2, the following considerations should enter into the design of the procedures:

- The procedures should cover all types of accounting and attest engagements performed by the firm (compilation, review, and attestation).
- Procedures from other QC elements should be incorporated into the procedures.
- The procedures should interface with the accounting manuals used by the firm.
- The procedures should be flexible and reasonable, in relation to the firm's size and number of employees.

The challenge comes in determining how to incorporate the preceding considerations, into a concise, organized format. There are several approaches, each of which is discussed in the following paragraphs.

Presenting the Detailed Procedures in the Body of the QC Document. Some firms choose to include in the body of their engagement performance QC procedures every quality control step the firm follows on a typical engagement. Such a format, while comprehensive, tends to be very lengthy and difficult to understand because the nuances of each type of engagement (compilation, review, and attestation) are difficult to capture in a concise narrative.

Referencing to Engagement Procedures Located in the Firm's Accounting Manuals. Another widely used approach is to make reference in the QC document to the engagement procedures and checklists located in the accounting manuals used by the firm. This approach avoids the problem of incorporating the numerous procedures into the QC document; however, it has one major disadvantage—rarely does a firm follow every procedure in its accounting manuals verbatim (especially if manuals are purchased from a third party).

Building a Bridging Document. A compromise to the two previously discussed approaches is to build a bridging document. A bridging document is the term used herein to describe a worksheet that shows the engagement performance QC steps performed by the firm for each type of engagement. Such a worksheet allows the firm to tailor its procedures to fit the type of engagement and to interface its QC document into the checklists, forms, and practice aids used by the firm. (Such practice aids may be those adopted from a purchased set of accounting manuals, those designed by the firm, or a combination of both.) Exhibit 3-4 illustrates a bridging document for compilation and review engagements. Exhibit 3-5 illustrates a bridging document for attestation engagements.

Exhibit 3-4

Illustration of an Engagement Performance Bridging Document (Compilation and Review Engagements)

	Person or Group Responsible for Completing Step		Historical Financial Statements[a]	
Engagement Performance Quality Control Steps	**Primary Responsibility**	**Secondary Responsibility**	**Compilations**	**Reviews**
1. Evaluate whether to accept/continue the engagement, considering the client's integrity and the firm's capabilities.	Partner (P)	Engagement Team (ET)	Yes	Yes
2. Evaluate the propriety of a step down to a lower level of service.	P	ET	Yes	Yes
3. Communicate the partner's identity and role to the client.	P	ET	Yes	Yes
4. Obtain an engagement letter.	P	ET	Yes	Yes
5. Assign staff based on capabilities, competence, and availability.	P	ET	Yes	Yes
6. Plan the work and obtain background information about the entity, officers, accounting practices, etc.	ET	P	Yes	Yes
7. Consider potential fraud implications.	ET	P	Yes	Yes
8. Prepare an engagement plan.	ET	P	Yes	Yes
9. Develop a time estimate.	ET	P	Opt	Opt
10. Obtain partner approval of engagement plan and staff assignments, and, if applicable, time estimates.	P	ET	Opt	Yes
11. Perform and document analytical procedures.	ET	P	No	Yes
12. Perform and document inquiries of management.	ET	P	No	Yes
13. Document significant, unusual matters, including disposition.[b]	P	ET	Yes	Yes
14. Document management's response to inquiries about unexpected/inconsistent fluctuations or relationships and significant matters.[b]	P	ET	No	Yes
15. Perform and document the procedures.	ET	P	Yes	Yes
16. Supervise procedures (including work of other accountants).	ET	P	Yes	Yes
17. Draft (or assist in drafting) the financial statements.	ET	P	Yes	Yes
18. Complete a presentation and disclosure checklist and read the financial statements.	ET	P	Yes	Yes
19. Obtain a management representation letter.	ET	P	Opt	Yes
20. Draft the report.	ET	P	Yes	Yes
21. Review the workpapers.	P & ET	—	Yes	Yes
22. Determine that all review points and open items have been cleared.	ET	P	Yes	Yes
23. Obtain an engagement quality control review, if required by firm policy.	P	ET	Yes	Yes

	Person or Group Responsible for Completing Step		Historical Financial Statements[a]	
Engagement Performance Quality Control Steps	Primary Responsibility	Secondary Responsibility	Compilations	Reviews
24. Obtain consultation when appropriate and document and implement conclusions.	P	ET	Yes	Yes
25. Resolve any differences of opinion and document and implement conclusions.	P	ET	Yes	Yes
26. Have the partner sign the report or transmittal letter.	P	ET	Yes	Yes
27. Evaluate the staff's performance.	ET	P	Opt	Opt
28. Maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of the workpapers.	ET	P	Yes	Yes
29. Assemble and retain the workpapers for a sufficient period of time (subject to monitoring review).	ET	P	Yes	Yes

Notes:

[a] Opt—Optional.

[b] This procedure is a new requirement under SSARS No. 19. SSARS No. 19, Compilation and Review Engagements, supersedes AR 20, AR 50, and AR 100, and is effective for compilations and reviews of financial statements for periods ending on or after December 15, 2010.

* * *

Exhibit 3-5

Illustration of an Engagement Performance Bridging Document (Attestation Engagements)

	Person or Group Responsible for Completing Step		Engagements Subject to QC Standards[a]				
			Forecasts and Projections		Other Attestations		
Engagement Performance Quality Control Steps	Primary Responsibility	Secondary Responsibility	Compilations	Agreed-upon Procedures	Reviews	Examinations	Agreed-upon Procedures
1. Evaluate whether to accept/continue the engagement, considering the client's integrity and the firm's capabilities.	Partner (P)	Engagement Team (ET)	Yes	Yes	Yes	Yes	Yes
2. Communicate the partner's identity and role to the client.	P	ET	Yes	Yes	Yes	Yes	Yes
3. Obtain an engagement letter.	P	ET	Yes	Yes	Yes	Yes	Yes
4. Assign staff based on capabilities, competence, and availability.	P	ET	Yes	Yes	Yes	Yes	Yes
5. Plan the work and obtain background information about the entity, officers, accounting practices, etc.	ET	P	Yes	Yes	Yes	Yes	Yes
6. Evaluate and document materiality and tolerable misstatement.	ET	P	No	No	Yes	Yes	No
7. Consider potential fraud implications.	ET	P	No	No	Yes	Yes	No
8. Identify and assess risks of material misstatement and develop responses to identified risks.	ET	P	No	No	Opt	Opt	No
9. Prepare an engagement plan.	ET	P	Yes	Yes	Yes	Yes	Yes
10. Develop a time estimate.	ET	P	Opt	Opt	Opt	Opt	Opt
11. Obtain partner approval of engagement plan and staff assignments, and, if applicable, time estimates.	P	ET	Opt	Yes	Yes	Yes	Yes

Engagement Performance Quality Control Steps	Person or Group Responsible for Completing Step		Engagements Subject to QC Standards[a]				
			Forecasts and Projections		Other Attestations		
	Primary Responsibility	Secondary Responsibility	Compilations	Agreed-upon Procedures	Reviews	Examinations	Agreed-upon Procedures
12. Perform and document the procedures.	ET	P	Yes	Yes	Yes	Yes	Yes
13. Supervise procedures (including work of other accountants).	ET	P	Yes	Yes	Yes	Yes	Yes
14. Evaluate the propriety of a step down to a lower level of service.	ET	P	Opt	Opt	Opt	N/A	Yes
15. Obtain legal representation letters.	ET	P	No	No	No	Opt	No
16. Draft (or assist in drafting) the financial information or subject matter.	ET	P	Yes	Yes	Opt	Opt	Opt
17. Perform analytical procedures.	ET	P	No	No	Yes	Opt	No
18. Complete a presentation and disclosure checklist and read the financial information.	ET	P	Yes	Opt	N/A	N/A	N/A
19. Obtain a management representation letter.	ET	P	Yes	Yes	Yes	Yes	Yes
20. Draft the report.	ET	P	Yes	Yes	Yes	Yes	Yes
21. Review the workpapers.	P & ET	—	Yes	Yes	Yes	Yes	Yes
22. Determine that all review points and open items have been cleared.	ET	P	Yes	Yes	Yes	Yes	Yes
23. Obtain an engagement quality control review, if required by firm policy.	P	ET	Yes	Yes	Yes	Yes	Yes
24. Obtain consultation when appropriate and document and implement conclusions.	P	ET	Yes	Yes	Yes	Yes	Yes
25. Resolve any differences of opinion and document and implement conclusions.	P	ET	Yes	Yes	Yes	Yes	Yes
26. Have the partner sign the report or transmittal letter.	P	ET	Yes	Yes	Yes	Yes	Yes
27. Evaluate the staff's performance.	ET	P	Opt	Opt	Opt	Opt	Opt
28. Maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of the workpapers.	ET	P	Yes	Yes	Yes	Yes	Yes
29. Assemble and retain the workpapers for a sufficient period of time (subject to monitoring review).	ET	P	Yes	Yes	Yes	Yes	Yes

Notes:

[a] Opt—Optional.

* * *

Interfacing the Bridging Document with the Firm's Accounting Manuals. Rarely does a firm follow every procedure in its accounting manuals verbatim (especially if the manuals are purchased from a third party). For firms that choose to adapt the accounting manuals developed by a third party into its practice, the following paragraph is suggested which can be added to the engagement performance section of a firm's QC document. (In the following illustration the firm uses Thomson Tax & Accounting's PPC brand engagement manuals and practice aids.)

> The firm adopts and integrates within its quality control system the use of PPC accounting manuals and practice aids as more fully described in the attached engagement performance bridging documents. This QC document, the PPC manuals, and any other practice aids used by the firm are intended solely to assist us in achieving compliance with professional standards. Accordingly, nothing within this QC document should be construed as (a) requiring a higher level

of performance or documentation than the minimum specifically required by our firm's QC policies and procedures, or (b) overriding the exercise of professional judgment.

This additional paragraph, along with an engagement performance bridging document should allow a firm to tailor its procedures to fit each type of engagement and to interface its QC document into the checklists, forms, and practice aids used by the firm.

Documenting the Quality Control Steps in the Bridging Document. As is illustrated in Exhibits 3-4 and 3-5, specific steps have been established in the engagement performance QC system. These steps generally are necessary for firms, regardless of size, to enable them to:

- Comply with the engagement performance requirements of the authoritative literature.
- Meet peer review requirements.
- Interface the firm's engagement performance QC system into the QC procedures found in the other elements of the QC system (see Exhibit 3-1).

These generally are the minimum steps necessary for a QC engagement performance system, some firms may desire even a more comprehensive system and, accordingly, may choose to expand the steps in Exhibits 3-4 and 3-5 to provide greater detail.

Additionally, the use of bridging documents, practice aids, and monitoring memoranda are recommended to document compliance with a firm's engagement performance quality control component.

Assigning Responsibilities for Completion of the Engagement Level QC Steps

Referring to the bridging documents in Exhibits 3-4 and 3-5, it is obvious that some of the quality control steps are ordinarily performed by a partner, while others can be delegated to a manager, supervisor, senior, or in-charge person. There are various levels of staff classifications that can be adopted by a firm. The responsibilities of each staff level can vary depending on the qualifications and maturity of personnel and the difficulties of each job. For these reasons, it is best not to specify the staff title that should be responsible for completing a QC step. Instead, the term *engagement team* (ET) is used in Exhibits 3-4 and 3-5, to refer to all nonpartner staff assigned to an engagement team. This approach gives the firm flexibility in delegating completion of the step to any qualified member of the engagement team. Also, it is recommended that the bridging document indicate whether a partner (P) or another member of the engagement team (ET) should have primary or secondary responsibility for completing the step.

Indicating the Applicability of Steps to Each Type of Engagement

Some of the quality control steps illustrated in Exhibits 3-4 and 3-5 are not applicable to every engagement covered by SQCS No. 7. One of the disadvantages of many engagement performance QC systems is that they make no distinction as to the applicability of the procedure to each type of engagement. For example, a requirement to prepare a time estimate and budget for each engagement might be appropriate for a review, but inappropriate for a compilation. Bridging documents like those illustrated in Exhibits 3-4 and 3-5 allow the firm to tailor its QC steps to fit each type of engagement.

How to Tailor the Bridging Document. In the bridging documents in Exhibits 3-4 and 3-5 the steps are marked with a "Yes" response as necessary for that engagement either because of peer review considerations or professional literature requirements. Steps that indicate a "No" or "Optional" answer can be changed to a "Yes" at the discretion of the user.

In reviewing the bridging document, you may note that certain "Yes" responses are more than the minimum required by professional standards. For example, authoritative literature does not require written engagement letters, except for audits and compilations of management-use-only financial statements in which a report is not issued and for the documented understanding with an attest client about nonattest services to be provided required by Ethics Interpretation 101-3. (See discussion earlier in this lesson about upcoming changes in SSARS requirements, which, among other things, require that accountants establish an understanding with management through a written engagement letter for both compilation and review engagements.) Neither does authoritative literature require engagement quality control reviews for all engagements. However, these steps are required in the PPC quality control system because it is thought these procedures are the most cost-effective means of providing quality services and minimizing engagement risk.

If a firm decides that it will not issue engagement letters on some engagements, for example, on non-management-use-only compilations and reviews, it is important that the firm be aware that authoritative standards do require that practitioners reach an understanding with clients as to the terms of all engagements. Also, attestation standards require documentation of the understanding, and peer reviewers may ask for documentation of any oral understandings. Additionally, the *Code of Professional Conduct* (ET 101-3) requires practitioners who provide nonattest services to their attest clients to document in writing the understanding with the client they obtained regarding the nonattest services and the client's responsibilities. While, as a general rule, engagement quality control reviews are desirable for most engagements, it may be appropriate for a firm to require EQCRs only for high-risk compilation or review engagements. Also, it may be appropriate for a firm to exempt compiled financial statements that omit substantially all disclosures from such a review. A firm might even choose to exempt all compiled financial statements from the review. However, each firm makes such decisions based on its own client base and circumstances.

Describing the QCM Used by the Firm

An integral part of a firm's QC system is its engagement work programs, checklists, sample confirmations and letters, and other practice aids. Such a system of practice aids is often referred to as *quality control materials* (QCM). When designing the engagement performance QC system, the firm should indicate the QCM that are used in the system or make reference to the firm's accounting manuals that contain the firm's QCM.

As previously mentioned, a bridging document allows the firm to tailor its engagement performance procedures to fit a specific type of engagement and to interface its QC document into the checklists, forms, and practice aids used by the firm for that specific type of engagement. Accordingly, if firms are not following their bridging document(s) as written, it is important for the firm to modify their bridging document(s) to fit the firm's actual procedures.

Incorporate the Applicable QC Engagement Performance Steps Into the Engagement Work Program. To ensure that the firm's QC steps are actually performed on each engagement, the firm's work programs for each type of engagement generally should contain the quality control steps adopted by the firm. In other words, the engagement work program is the vehicle that enables the firm to comply with its stated quality control procedures. The use of standardized work programs to ensure that the procedures are performed on each engagement is recommended.

Unique Engagement Performance Issues for Compilation Engagements. Firms may provide a variety of types of compilation services. For example, compilation engagements can include interim and year-end financial statements, computer and manually prepared statements, management-use-only financial statements, GAAP and other comprehensive basis of accounting statements, and those with and without full disclosures. Additionally, compiled financial statements may be prepared by professional accountants, paraprofessionals, or bookkeepers. Preparation of compiled financial statements may involve creating the statements from source documents (including complete bookkeeping services), creating the statements from client-provided ledgers (including a limited number of adjustments), adding disclosures to client-prepared statements, adjusting and finalizing client-prepared statements, or some combination of any of those tasks. So much variety for one type of engagement can make it challenging to establish engagement performance quality control steps for compilation engagements.

It is suggested that appropriate procedures be in place and followed for each type of compilation engagement. Obviously, it is not necessary for the procedures to be the same for each engagement type. For example, some firms use abbreviated checklists for interim engagements. Also, some firms may require an engagement quality control review for all full disclosure compilation engagements, but not for compilation engagements with financial statements without full disclosure. It is important that firms specify in their bridging document or elsewhere the differing QC procedures related to the particular types of compilation engagements.

Developing Policies and Procedures for Maintaining Engagement Documentation

Document Retention. When firms establish document retention policies, various considerations enter into the decision of how long to maintain records:

- Authoritative, legal, and regulatory requirements, if any, must be considered. Certain types of records may have specific requirements.
- Advice from legal liability insurance carriers and/or attorneys may be factored into the decision.
- Firms that have not embraced the paperless office concept will want to consider the cost of storage space and the administrative burden of maintaining paper records.
- For all firms, keeping records indefinitely is both costly and unnecessary.

But, how long should the firm keep its files? The answer varies depending on the above considerations.

Firms often base how long they keep workpapers on the length of the statute of limitations for breach of contract, breach of fiduciary duty, and professional liability claims. Example retention periods for engagement documentation are presented in Exhibit 3-6; however, the retention periods are only examples. The firm should consider consulting its attorney and insurance carrier when establishing a document retention policy. In addition, reviewing the policy annually and updating it as necessary, considering changes in governmental and professional requirements and the cost of retaining records is recommended.

Exhibit 3-6

Example Engagement Document Retention Policy

	Retention Period[a]	
	Current Client	Former Client
Engagement files		
Client correspondence files	7 years	7 years
Draft financial statements and reports	Until engagement completion	N/A
Compiled or reviewed financial statements and reports	Indefinitely	7 years
Special reports	Indefinitely	7 years
Workpaper files:		
Compilation or review workpapers	7 years	2 years
Attestation workpapers (other than examinations of prospective financial statements)	7 years	2 years
Special reports workpapers	7 years	2 years
Tax return workpapers	7 years	2 years
Special tax report workpapers	7 years	2 years
Permanent files	Indefinitely	7 years

Note:

[a] These are example document retention periods only. Document retention policies should generally correspond with the longest statute of limitations that prevails in states in which the firm does business.

Records related to pending legal proceedings must be kept until the proceedings are completed. Individual state boards of accountancy can provide applicable requirements for their state.

* * *

Confidentiality, Custody, Integrity, Accessibility, and Retrievability of Engagement Documentation. It is recommended that firms develop consistent policies, procedures, and underlying controls for all engagements that address confidentiality, safe custody, integrity, accessibility, and retrievability. Such controls may need flexibility based on the stage of the engagement (e.g., fieldwork still in progress, after fieldwork but before the report is issued, and after the report has been issued and the engagement documentation has been assembled) as well as the nature of the engagement documentation media (e.g., paper or electronic).

Developing Policies and Procedures for Consultation and Resolving Differences of Opinion

SQCS No. 7 has broadened the requirements beyond just auditing engagements for performing consultation and resolving differences of opinion. Firms now need to consider those requirements for all accounting engagements.

Consultation Considerations. In designing the firm's engagement performance QC system, consider the following key considerations related to consultation:

- *Encourage Consultation.* The myriad of professional standards and regulatory and legal requirements, as well as the recent changes in many of those standards and requirements, have resulted in an increased need for consultation on technical issues. In today's environment, no one is expected to know all the answers. As a result, the firm's policies and procedures are best drafted in a way so as to encourage, rather than discourage, the use of consultation.

- *Allow a Voice for Minority Opinion.* Consultations are serious matters, and at stake, among other things, is potential legal liability to the firm if a wrong decision is made. Consequently, it is important to carefully consider the opinions of all parties to a consultation, even if the opinion is unpopular. Furthermore, it is recommended that consultation systems include a procedure to allow someone who disagrees with the resolution to a consultation to document their disagreement in the engagement documentation.

- *Provide Documentation.* Designing a policy for documenting consultations can be troublesome because it is often difficult to determine when an issue is worthy of documentation. Many consultations initially seem to deal with unusual or complex issues that turn out to be inconsequential. Other consultations deal with issues that are so important they should always be documented. As a result, the firm's documentation requirements generally should be specific enough for engagement personnel to understand what types of consultation issues warrant documentation, but flexible enough to allow engagement personnel to exercise their professional judgment. Documenting consultations should be sufficiently complete and detailed to provide an understanding of (a) the issue that triggered the need for consultation and (b) the results of the consultation, including decisions made, the reasons for those decisions, and how they were implemented.

Establishing Steps to Perform a Consultation. The consultation process generally evolves through the following stages:

a. Establish policies and procedures to ensure that consultation occurs when appropriate (that is, when confronted with complex, unusual, unfamiliar, difficult, or contentious issues).

b. Once a situation requiring consultation is identified, discuss the issue creating the need for consultation with members of the engagement team (including the engagement partner if necessary).

c. Ensure that sufficient and appropriate resources are available to allow meaningful consultation to occur.

d. If the issue cannot be resolved at the engagement team level, consult with an in-firm specialist who has the experience and technical expertise to provide appropriate professional judgment to facilitate solving the situation requiring consultation.

e. If the issue cannot be resolved within the firm, consult outside of the firm with an individual or other firm with the relevant specialized expertise to provide appropriate professional judgment to facilitate solving the situation requiring consultation.

f. Provide all relevant facts known to the engagement team to the in-firm specialist and/or the external specialist.

g. Document the nature and scope of consultations and the conclusions reached and implement the decision.

Those steps can be used by any size firm and will help minimize research time and the cost of using an outside specialist by giving staff direction on how to resolve an issue that requires consultation.

Designating In-firm Specialists. Some large firms may include a consultation procedure whereby specific individuals within the firm are designated as specialists for an array of possible industries, types of engagements, new or complex accounting requirements, etc. While it may be necessary to designate various individuals within a large firm, in a sole proprietorship it is obviously not necessary to make such designations. Such designations may also not be necessary in a small firm because the particular expertise or specialty of each staff member is generally common knowledge. Therefore, in lieu of designating specialists and preparing a list of firm specialists, stating in the QC procedures that the accounting partner will be consulted if the engagement team is not aware of the name of a specialist within the firm is preferable.

Designating Outside Specialists. Some firms elect to state in their quality control policies the name of outside specialists that the firm wants engagement teams to consult with when an issue requiring consultation is encountered. Specialists outside the firm may include advisory services provided by other firms, professional and regulatory bodies, and commercial organizations that provide relevant quality control services. Advisory services provided by other firms may be, for example, the technical arm of an association of firms or a specific CPA that has established a consulting relationship with the firm. One professional body that provides advisory services to its members is the AICPA, who has a technical information service that answers inquiries on complex accounting, auditing, attestation, and accounting and review issues. The toll-free number for this service is (877) 242-7212. Inquiries may also be submitted electronically to the AICPA at the website **www.aicpa.org/members/div/infohot/form.asp**. Before using an outside specialist's services, SCQS No. 7 indicates that the firm should evaluate whether the external provider is qualified for that purpose.

Assigning Responsibility for Resolving Differences of Opinion. Throughout the engagement process, disagreement among parties involved as to the proper answer or course of action for resolving a difference of opinion issue may occur. Generally when such a difference of opinion occurs, it can be resolved through adequate library research, or by obtaining the opinion of in-house or outside specialists. In the infrequent situation where a disagreement still exists after those steps have been taken, a firm's quality control procedures may appoint a person in the firm to mediate the difference of opinion and make a final determination of the firm's resolution to the issue. In a compilation and review-only firm, the managing partner is ordinarily the appropriate individual to make the final determination, although the accounting partner will generally be involved throughout the consultation and resolution process regarding any accounting-related or quality control-related difference of opinion.

Even after a final determination has been made, one or more members of the engagement team may disagree with the chosen resolution. It is recommended that the firm's QC document include a procedure allowing individuals who disagree with the final resolution to document their disagreement.

SQCS No. 7 requires that differences of opinion be resolved before the engagement report is released. However, normally it is acceptable to have dissenting opinions about the final resolution to the difference of opinion (as discussed in the preceding paragraph) and still consider that the issue has been resolved and the report can be released.

Developing Engagement Quality Control Review Policies and Procedures

In developing policies and procedures over engagement quality control review (EQCR), the firm should initially establish criteria against which all engagements subject to SQCS No. 7 are to be evaluated. If an engagement meets the criteria the firm has established, an EQCR is to be performed. The EQCR is to be performed before the engagement report is issued. If an engagement does not meet the firm's criteria, then no engagement quality control review is performed.

Once the EQCR criteria have been developed, the firm should establish a procedure to ensure that all appropriate engagements are compared to the EQCR criteria. It is suggested that such a step be included in all work programs used by the firm. Alternatively, firms may choose to consider earlier in the engagement whether an EQCR will be performed, and thus, firms may add a step to the firm's pre-engagement planning checklist. In any given engagement, events may occur after the engagement has begun that prompt the engagement partner or managing partner to have an EQCR performed, although the engagement did not initially meet the EQCR criteria. Accordingly, the firm may need to reconsider whether an engagement meets EQCR criteria near the end of the engagement.

The need to consider whether an EQCR is necessary more than once during an engagement could be the result of the EQCR criteria developed by the firm. Thus, firms may want to strive to develop EQCR criteria that are easy, rather than complex, to evaluate against, bearing in mind that the objective of establishing EQCR criteria is to identify engagements that need review.

Addressing Nature, Timing, Extent, and Documentation of EQCR. The firm should establish quality control procedures that address how an EQCR will be performed for those engagements that meet the EQCR criteria.

Timing of Review. Such procedures address the timing of the review while complying with the SQCS No. 7 requirement to complete the review before the report is released. Thus, firms may determine that reviews be conducted at appropriate stages throughout the engagement. Alternatively, procedures may be established to allow for reviews to be conducted after the report date, but before the report is released. Such a procedure should recognize that when additional engagement procedures are required as a result of the review, the date of the report may need to change.

Nature and Extent of Review. SQCS No. 7 provides requirements for procedures that firms should perform as part of conducting an EQCR. Firms may choose to include additional procedures when performing EQCRs. The specific situation, such as the complexity of the engagement and/or the risk that the report might not be appropriate, may expand the extent of the review.

Documenting the Review. SQCS No. 7 (QC 10.99) provides the documentation requirements for EQCRs.

Establishing the Eligibility of Engagement Quality Control Reviewers. In general, the firm's policies and procedures for eligible engagement quality control reviewers should address the appointment of such individuals and what technical qualifications the firm requires for individuals to perform that role, including necessary experience and authority within the firm. If firms do not have a suitably qualified individual to perform the review, the firm may contract with such an external individual or firm. Those contracted with should meet SQCS No. 7 requirements for engagement quality control reviewers.

HOW TO EVALUATE THE OVERALL ADEQUACY OF THE QUALITY CONTROL SYSTEM'S DESIGN

The ideas, recommendations, and suggestions in this lesson can assist the firm in designing a practical engagement performance quality control system. The ultimate responsibility for the system, however, resides with the firm.

As previously mentioned in this lesson, the majority of deficiencies noted by peer reviewers arise during their review of specific engagements, and most relate to the engagement performance element. It is suggested that the firm consider common engagement performance deficiencies noted in peer reviews in making a final evaluation of its QC system. Exhibit 3-7 provides examples of the significant common deficiencies noted in peer reviews. The information included in Exhibit 3-7 is based upon examples of noncompliance with applicable professional standards provided by the AICPA Peer Review Board in its Annual Report on Oversight available at **www.aicpa.org/members/div/practmon/index.htm**.

Exhibit 3-7

Common Engagement Performance Deficiencies Noted in Peer Reviews

<u>Engagement Deficiencies</u>

Reports:

- Failure to appropriately qualify an accountant's report for a departure from the basis of accounting used for the financial statements.
- Departures from standard wording where the report does not contain the critical elements of the applicable standards.
- Issuance of a review report when the accountant is not independent.
- Failure to disclose the lack of independence in a compilation report.
- Failure to disclose the omission of substantially all disclosures (in a compilation without disclosures).
- Failure to disclose the omission of the statement of cash flows in financial statements prepared in accordance with GAAP.
- Failure to disclose an "other comprehensive basis of accounting" (OCBOA) for financial statements compiled without disclosures, where the basis of accounting is not readily determinable from reading the report.
- Failure to disclose, in the accountant's report, a material departure from professional standards [examples include omission of significant income tax provision on interim financial statements; omission of significant disclosures related to defined employee benefit plans; or omission of required supplemental information for a unique industry].
- Inappropriate references to GAAP in the accountant's report on financial statements in conformity with an OCBOA.
- Reports dated incorrectly, issued without a date, or without appropriate reference to all time periods covered by the financial statements.
- Reports reflecting financial statement titles and terminology not in accordance with professional standards.
- Failure to explain the degree of responsibility the accountant is taking with respect to supplementary information.

Financial Statement Measurements and Presentations:

- Inclusion of material balances that are not appropriate for the basis of accounting used.
- Failure to include a material amount or balance necessary for the basis of accounting used (examples include omission of material accruals, failure to amortize a significant intangible asset, failure to provide for material losses or doubtful accounts, or failure to provide for material deferred income taxes).
- Significant departures from the financial statement formats prescribed by industry and audit and accounting guides.
- Improper accounting of a material transaction (for example, recording a capital lease as an operating lease).
- Misclassification of a material transaction or balance.
- Failure to segregate the statement of cash flows into the components of operating, investing, and financing.
- Omission of statement of income and retained earnings when referred to in the report.

- Investments in marketable securities presented at cost and not fair market value resulting in a material misstatement to the balance sheet.
- Failure to segregate the current portion of long-term debt.
- Failure to refer to the accountant's report on each page of the financial statements and financial statements inconsistently titled with the applicable reports.
- Supplementary information not clearly segregated or marked as supplementary and departs from standard report presentation.

Disclosures:

- Omission of the disclosure(s) related to significant accounting policies applied (GAAP or OCBOA).
- Omission of significant matters related to the understanding of the financial statements (the cumulative material effect of a number of deficiencies).
- Failure to include a summary of significant assumptions in a financial forecast or projection.
- Omission of significant required disclosures related to material financial statement balances or transactions.
- Failure to disclose the cumulative effect of a change in accounting principle.
- Omitted or inadequate disclosures (for example: disclosure deficiencies related to inventory valuation allowances, method of income recognition, significant advertising costs, long-term debt, significant related party transactions, concentrations of credit risk).
- Failure to disclose the omission of the statement of cash flows in financial statements prepared in accordance with GAAP.
- Failure to disclose the omission of substantially all disclosures (in a compilation without disclosures).
- Missing disclosures in the financial statements where the item to be disclosed was included in a disclosure checklist used in preparing the financial statements.

SSARS Procedures and Documentation:

- Failure to perform and document analytical and inquiry procedures for a review engagement.
- Engagement letters on SSARS No. 8 engagements that omit the required descriptions or statements documenting the understanding with the client.
- Failure to obtain a client management representation letter for a review engagement.
- Failure to document the matters covered in the accountant's inquiry and analytical procedures on a review engagement.
- Failure to segregate the current portion of long-term debt in a review engagement.
- The engagement letter on a SSARS No. 8 engagement did not refer to supplementary information, which was presented along with the basic financial statements.
- Reference to the accountant's compilation report was not present on the financial statements.
- Failure to include a summary of significant assumptions in a financial forecast or projection.

Attestation Procedures and Documentation:

- Failure to clearly identify the responsible party and/or failure to have the responsible party accept responsibility for its assertions or subject matter.
- Failure to appropriately label pro forma information to distinguish it from historical financial information.

Financial Statement Deficiencies

Assets:

- Improper classification between current and long-term assets.
- Investment in majority owned or controlled subsidiary not consolidated.
- Bank overdrafts shown as a negative asset balance.
- Improper recording of capital leases as operating leases.
- Incorrect or inadequate disclosure of the basis of accounting for trade receivables.
- Accounts receivable shown on cash basis financial statements.
- Investments in debt and equity securities not classified or measured correctly.
- Presentation of investments in marketable securities at cost instead of fair market value.

Liabilities:

- Improper classification of deferred income taxes and/or failure to accrue income taxes.

- Improper classifications between current and long-term debt.
- Demand liabilities classified as long-term.
- Nonrecognition of a liability for compensated absences.
- Nonrecognition of capital leases.
- Improper recognition of deferred revenue.

Statement of Income:

- Income tax provision, where applicable, not recorded in interim financial statements.
- Accountant's report did not cover all periods.
- Income tax expense presented as an operating expense rather than as a separate line item.
- Use of an inappropriate method of revenue recognition.

Statement of Cash Flows:

- Cash flow statement not categorized by operating, investing, and financing activities.
- Misclassification of activities, especially between investing and financing activities.
- No disclosure of noncash investing and financing activities.
- No disclosure of interest and income taxes paid for indirect statement of cash flows (may be in the notes).
- Cash flow statement not presented for each period for which a statement of income is presented.
- Material errors on interim period presentations of the statement of cash flows.
- No reconciliation between net income and net cash flow from operations.

* * *

All PPC accounting and auditing manuals provide engagement programs, disclosure checklists, and other practice aids that address each of the engagement areas noted in Exhibit 3-7. Use of bridging documents will aid the firm in ensuring that all necessary procedures are performed and adequately documented.

HOW TO MONITOR COMPLIANCE WITH THE FIRM'S ENGAGEMENT PERFORMANCE POLICIES AND PROCEDURES

The firm should review, on an ongoing basis, its engagement performance policies and procedures to determine if they continue to be appropriate for the firm. This review and assessment is normally accomplished in coordination with the inspection/review phase of the firm's quality control system. Based on this review and assessment, the firm's policies and procedures should be revised as appropriate.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

34. When developing the engagement performance quality control system, a number of considerations should be made when designing the procedures. There are several approaches that may be used to incorporate considerations in a concise and organized format. Which of the following approaches generally is most effective in accomplishing this goal?

    a. In the body of the QC document, presenting the detailed procedures.

    b. In the firm's accounting manuals, referencing engagement procedures.

    c. Constructing a bridging document.

35. The *engagement team* has *secondary* responsibility for accomplishing which of the following engagement performance quality control steps when utilizing a bridging document in the illustration developed by PPC for *review* engagements?

    a. Assign staff based on availability, competence, and capabilities.

    b. Draft/assist in drafting financial statements.

    c. Develop a time estimate.

36. The *partner* has *secondary* responsibility for accomplishing which of the following engagement performance quality control steps when utilizing a bridging document in the illustration developed by PPC for *review* engagements?

    a. Evaluate whether to accept or continue the engagement.

    b. Prepare an engagement plan.

    c. Obtain engagement quality control review.

    d. Resolve differences of opinion, if any.

37. The *engagement team* has *primary* responsibility for accomplishing which of the following engagement performance quality control steps when utilizing a bridging document in the illustration developed by PPC for *attestation* engagements?

    a. Obtain approval of partner for engagement plan.

    b. Have the partner sign the transmittal letter.

    c. Obtain an engagement letter.

    d. Consider implications of potential fraud.

38. The partner has *primary* responsibility for accomplishing which of the following engagement performance quality control steps when utilizing a bridging document in the illustration developed by PPC for *attestation* engagements?

    a. Prepare an engagement plan.

    b. Perform/document the procedures.

    c. Assign staff based on availability, competence, and capabilities.

    d. Assemble/retain workpapers for an adequate period of time.

39. Of the following common *engagement deficiencies* that are noted in peer reviews, which one applies to deficiencies in *financial statement measurements and presentations*?

    a. Failure to disclose the omission of substantially all disclosures in a compilation that does not include disclosures.

    b. Failure to separate the current portion of long-term debt.

    c. Failure to include the cumulative material effect of a number of deficiencies.

    d. Failure to document analytical procedures for a review engagement.

40. Of the following common *financial statement deficiencies* that are noted in peer reviews, which one applies to deficiencies in the *statement of cash flows*?

    a. Where applicable, income tax provision not recorded in interim financial statements.

    b. Improper classification between current and long-term assets.

    c. No disclosure of noncash investing and financing activities.

    d. Improper classification between current and long-term debt.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

34. When developing the engagement performance quality control system, a number of considerations should be made when designing the procedures. There are several approaches that may be used to incorporate considerations in a concise and organized format. Which of the following approaches generally is most effective in accomplishing this goal? **(Page 113)**

    a. In the body of the QC document, presenting the detailed procedures. [This answer is incorrect. Including every quality control step the firm follows on a typical engagement in the body of their engagement performance QC procedures is a thorough approach; however, it tends to be very lengthy and hard to understand due to the fact that the subtle differences among compilation, review, and attestation engagements are difficult to differentiate in a concise way. As a result, this approach is less successful in incorporating considerations into the engagement performance quality control system.]

    b. In the firm's accounting manuals, referencing engagement procedures. [This answer is incorrect. Making reference in the QC document to the engagement procedures and checklists located in the accounting manuals used by the firm avoids having to incorporate the numerous procedures into the QC document. However, rarely is every procedure in a firm's accounting manuals followed verbatim. Therefore, such a drawback makes this approach to incorporating considerations into the engagement performance quality control system less effective.]

    c. Constructing a bridging document. [This answer is correct. Building a bridging document, that is, a worksheet that shows the engagement performance QC steps performed by the firm for each type of engagement, allows the firm to tailor its procedures to fit the type of engagement and to interface its QC document into the checklists, forms, and practice aids used by the firm thereby making this approach the most effective in accomplishing the stated goal.]

35. The engagement team has secondary responsibility for accomplishing which of the following engagement performance quality control steps when utilizing a bridging document in the illustration developed by PPC for *review* engagements? **(Page 113)**

    a. Assign staff based on availability, competence, and capabilities. [This answer is correct. Assigning staff based on availability, competence, and capabilities is the primary responsibility of the *partner* for a review engagement. The engagement team has secondary responsibility for this action.]

    b. Draft/assist in drafting financial statements. [This answer is incorrect. The engagement team has *primary* responsibility for drafting, or assisting in drafting the financial statements for a review engagement. The partner has secondary responsibility for this action.]

    c. Develop a time estimate. [This answer is incorrect. The engagement team has *primary* responsibility for developing a time estimate for a review engagement. The partner has secondary responsibility for this action.]

36. The *partner* has *secondary* responsibility for accomplishing which of the following engagement performance quality control steps when utilizing a bridging document in the illustration developed by PPC for *review* engagements? **(Page 113)**

    a. Evaluate whether to accept or continue the engagement. [This answer is incorrect. The partner has *primary* responsibility for evaluating whether to accept or continue the engagement for a review engagement. The engagement team has secondary responsibility for this action.]

    b. Prepare an engagement plan. [This answer is correct. Preparing an engagement plan is the *primary* responsibility of the *engagement team* for a review engagement. The partner has secondary responsibility for this action.]

c. Obtain engagement quality control review. [This answer is incorrect. The partner has *primary* responsibility for obtaining an engagement quality control review for a review engagement. The engagement team has secondary responsibility for this action.]

d. Resolve differences of opinion, if any. [This answer is incorrect. Resolving differences of opinion, if any, as well as documenting and implementing the conclusions, is the *primary* responsibility of the partner for a review engagement. The engagement team has secondary responsibility for this action.]

37. The *engagement team* has *primary* responsibility for accomplishing which of the following engagement performance quality control steps when utilizing a bridging document in the illustration developed by PPC for *attestation* engagements? **(Page 114)**

   a. Obtain approval of partner for engagement plan. [This answer is incorrect. Obtaining approval of the partner for the engagement plan is the primary responsibility of the *partner* for an attestation engagement. The engagement team has secondary responsibility for this action.]

   b. Have the partner sign the transmittal letter. [This answer is incorrect. Signing the transmittal letter is the primary responsibility of the *partner* for an attestation engagement. The engagement team has secondary responsibility for this action.]

   c. Obtain an engagement letter. [This answer is incorrect. The engagement team has *secondary* responsibility for obtaining an engagement letter for an attestation engagement. The partner has primary responsibility for this action.]

   d. Consider implications of potential fraud. [This answer is correct. For an attestation engagement, the engagement team has primary responsibility for considering potential fraud implications for an attestation engagement. The partner has secondary responsibility for this action.]

38. The *partner* has *primary* responsibility for accomplishing which of the following engagement performance quality control steps when utilizing a bridging document in the illustration developed by PPC for *attestation* engagements? **(Page 114)**

   a. Prepare an engagement plan. [This answer is incorrect. Preparing an engagement letter is the primary responsibility of the *engagement team* for an attestation engagement. The partner has secondary responsibility for this action.]

   b. Perform/document the procedures. [This answer is incorrect. The *engagement team* has primary responsibility for performing and documenting the procedures for an attestation engagement. The partner has secondary responsibility.]

   c. Assign staff based on availability, competence, and capabilities. [This answer is correct. The partner has primary responsibility for assigning staff based on availability, competence, and capabilities for an attestation engagement. The engagement team has secondary responsibility for this action.]

   d. Assemble/retain workpapers for an adequate period of time. [This answer is incorrect. Assembling and retaining workpapers for a sufficient period of time (subject to monitoring review) is the primary responsibility of the *engagement team* for an attestation engagement; thus, the partner has secondary responsibility.

39. Of the following common *engagement deficiencies* that are noted in peer reviews, which one applies to deficiencies in *financial statement measurements and presentations*? **(Page 122)**

    a. Failure to disclose the omission of substantially all disclosures in a compilation that does not include disclosures. [This answer is incorrect. This is an example of a common engagement deficiency related to *reports*, and *disclosures*, rather than in financial statement measurements and presentations, noted in peer reviews.]

    b. Failure to separate the current portion of long-term debt. [This answer is correct. Failure to segregate the current portion of long-term debt is one of a number of examples of common engagement deficiencies in financial statement measurements and presentations that are noted in peer reviews, per the AICPA Annual report on Oversight.]

    c. Failure to include the cumulative material effect of a number of deficiencies. [This answer is incorrect. Omissions of significant matters related to the understanding of the financial statements, for example, the cumulative effect of deficiencies, is an example of an engagement deficiency related to *disclosures*, not reports.]

    d. Failure to document analytical procedures for a review engagement. [This answer is incorrect. Failure to perform and document analytical and inquiry procedures for a review engagement is an example of an engagement deficiency related to *SSARS procedures and documentation*.]

40. Of the following common *financial statement deficiencies* that are noted in peer reviews, which one applies to deficiencies in the *statement of cash flows*? **(Page 122)**

    a. Where applicable, income tax provision not recorded in interim financial statements. [This answer is incorrect. This is an example of a financial statement deficiency noted in peer reviews that applies to deficiencies in *statement of income*.]

    b. Improper classification between current and long-term assets. [This answer is incorrect. This is an example of a financial statement deficiency noted in peer reviews that applies to deficiencies related to assets, not statement of cash flows.]

    c. No disclosure of noncash investing and financing activities. [This answer is correct. This is one of several examples of a financial statement deficiency noted in peer reviews that applies to deficiencies in the statement of cash flows, per the AICPA Annual Report on Oversight.]

    d. Improper classification between current and long-term debt. [This answer is incorrect. Use of an inappropriate method of revenue recognition is an example of a financial statement deficiency noted in peer reviews that applies to deficiencies related to liabilities.]

EXAMINATION FOR CPE CREDIT

Lesson 3 (GCRTG101)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

25. Jim, CPA, who is not an AICPA member, is beginning a new engagement with a client, and wants to know what ethical standards in the AICPA *Code of Professional Conduct* have to say regarding his conduct regarding honesty in the performance of the engagement. Where will Jim find the information he is seeking?

    a. Article II.

    b. Article III.

    c. Article IV.

    d. Article V.

26. If an AICPA member departs from guidelines set forth in interpretations of the *Code of Professional Conduct*, which of the following actions by the AICPA will result?

    a. AICPA membership will be terminated.

    b. The member will be put on probation by the AICPA.

    c. The member must justify such departure in any disciplinary hearing.

    d. The member will receive one warning prior to any action being taken by the AICPA.

27. Bill is a practitioner who wants to ensure that he has procedures in place to prevent unauthorized individuals from gaining access to his attest documentation. Where can Bill find the requirements regarding this issue?

    a. SSAE No. 10 (AT 101.100).

    b. SSAE No. 10 (AT 101.103).

    c. SSAE No. 10 (AT 101.106).

    d. SSAE No. 10 (AT 201).

28. Jared is performing a review engagement. As a part of the quality control element of engagement performance, Jared has completed a quality control step involving drafting (or assisting in drafting) the financial statements. Which of the following quality control (QC) elements are also addressed by Jared's actions?

    a. Relevant ethical requirements.

    b. Monitoring.

    c. Leadership responsibilities for quality.

    d. Acceptance and continuance of clients and engagements.

29. Jared is performing a compilation engagement. As a part of the quality control element of engagement performance, Jared has completed a step involving obtaining an engagement letter. Which of the following quality control (QC) elements are also addressed by Jared's actions?

    a. Leadership responsibilities for quality.

    b. Relevant ethical requirements.

    c. Monitoring.

    d. Acceptance and continuance of clients and engagements.

30. Which of the following imposes requirements on accountants for the retention of compilation or review workpapers?

    a. SSAEs.

    b. SSARS.

    c. SQCS No. 7.

    d. No requirements currently exist.

31. An engagement team may need to consult someone outside the engagement when they encounter complex technical issues or unique industry situations in an engagement that they have not previously encountered. Documentation of such consultation should include the conclusions arrived at and the reasons supporting the conclusions. The preferred documentation method is:

    a. Memorandum.

    b. Standard form.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

32. The quality control standards did not address differences of opinion policies and procedures in the firm's quality control system prior to the issuance of SQCS No. 7. Once issued, SQCS No. 7 (QC 10.78) indicates that several actions be taken. Which of the following is an **inaccurate** statement regarding those actions?

    a. Policies/procedures to deal with and resolve differences of opinion should be established by the firm.

    b. Policies/procedures established should require conclusions reached to be documented/implemented.

    c. Report may be released prior to resolution of any differences of opinion, with exceptions noted.

    d. Do not select this answer choice.

33. If an engagement meets the firm's specified criteria, SQCS No. 7 (QC 10.81–.82) states that an engagement quality control review (EQCR) should be performed for that engagement. When should the EQCR be completed?

    a. Prior to the report being released.

    b. Concurrent with release of the report.

    c. Within 30 days of release of the report.

    d. At the firm's discretion.

34. Which of the following statements regarding the development of a firm's quality control policies and procedures is accurate?

    a. There is consensus that there is one basic approach for a firm to use in developing their quality control policies and procedures.

    b. A firm should choose an approach in developing their quality control policies and procedures that meets the firms' desires and needs.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

35. The *engagement team* has *primary* responsibility for accomplishing which of the following engagement performance quality control steps when utilizing a bridging document in the illustration develped by PPC for *compilation* engagements?

    a. Obtain engagement letter.

    b. Obtain partner approval of engagement plan/staff assignments.

    c. Supervise procedures, including the work of other accountants.

    d. Evaluate the appropriateness of a step down to a lower level of service.

36. The *partner* has *primary* responsibility for accomplishing which of the following engagement performance quality control steps when utilizing a bridging document in the illustration develped by PPC for *compilation* engagements?

    a. Consider potential fraud implications.

    b. Communicate the identity and role of the partner to the client.

    c. Evaluate the performance of the staff.

    d. Confirm that all open items and review points have been cleared.

37. The *engagement team* has *secondary* responsibility for accomplishing which of the following engagement performance quality control steps when utilizing a bridging document in the illustration develped by PPC for *attestation* engagements?

    a. Plan the work and obtain background information about accounting practices.

    b. Supervise procedures, including the work of other accountants.

    c. Evaluate the staff's performance.

    d. Communicate the identity and role of the partner to the client.

38. The *partner* has *secondary* responsibility for accomplishing which of the following engagement performance quality control steps when utilizing a bridging document in the illustration develped by PPC for *attestation* engagements?

    a. Evaluate/document materiality and tolerable misstatement.

    b. When appropriate, obtain consultation, and document/implement conclusions.

    c. If required, obtain an engagement quality control review.

    d. Resolve differences of opinion, if any, and document/implement conclusions.

39. Of the following common *engagement deficiencies* that are noted in peer reviews, which one applies to deficiencies in *financial statement measurements and presentations*?

    a. Failure to explain the degree of responsibility being taken by the accountant regarding supplementary information.

    b. Supplementary information is not clearly set apart or marked as supplementary and deviates from standard report presentation.

    c. Inappropriate references to GAAP in the accountant's report on financial statements that are in conformity with an OCBOA.

    d. Failure to disclose that the statement of cash flows are omitted in financial statements prepared in accordance with GAAP.

40. Of the following common *financial statement deficiencies* that are noted in peer reviews, which one applies to deficiencies in the *statement of income*?

    a. Accountant's report did not cover all periods.

    b. No disclosure of noncash investing and financing activities.

    c. No reconciliation between net income and net cash flow from operations.

    d. Cash flow statement not presented for each period for which a statement of income is presented.

Lesson 4: Monitoring Quality Control Systems for Proper Design and Effective Operation

INTRODUCTION

SQCS No. 7

Performing monitoring is a crucial part of maintaining the effectiveness of a firm's system of quality control (QC), and it is required by SQCS No. 7. In addition to meeting the QC standard requirement that a firm monitor the operating effectiveness of its quality control system, there are also sound business reasons for monitoring a firm's quality control system. Implicit in the monitoring concept is (a) the firm's quality control system is kept up-to-date for changes in professional standards and (b) appropriate changes are made to keep the system current with changes in the nature of the firm's practice and its personnel. Those changes serve to improve the quality of the firm's accounting services and to increase its efficiency in delivering those services.

SQCS No. 7 (QC 10.05) defines *monitoring* as "a process comprising an ongoing consideration and evaluation of the firm's system of quality control, the objective of which is to enable the firm to obtain reasonable assurance that its system of quality control is designed appropriately and operating effectively." When designing the monitoring component of its quality control system, the firm should choose monitoring policies and procedures that will provide reasonable assurance the policies and procedures over all other elements of the quality control system are relevant, adequate, operating effectively, and complied with in practice as required by SQCS No. 7 (QC 10.100).

SQCS No. 7 (QC 10.101) provides guidance about the purpose of monitoring compliance with the firm's quality control policies and procedures. Monitoring is performed to provide evaluation of—

- Whether the firm is complying with professional standards and regulatory and legal requirements.
- Whether the firm's quality control system appears to be appropriately designed and effectively implemented.
- Whether the firm's quality control policies and procedures are operating effectively so reports issued by the firm are appropriate in the circumstances.

Evaluating the firm's quality control system may indicate that changes are necessary, or there is a need to improve compliance with, the firm's policies and procedures to provide the firm with reasonable assurance that its system of quality control is effective. For instance, when evaluating its QC system, the firm may discover that certain policies and procedures are not meeting their intended objectives. Accordingly, those policies and procedures need to be changed. Alternatively, the firm may discover that its QC polices and procedures seem appropriate, but firm personnel are not complying with them. By determining why its policies and procedures are not being followed, the firm may take corrective action, either with firm personnel or by changing the policies and procedures.

Upcoming Changes to SQCS No. 7

In June 2009, the ASB released for exposure a revised version of SQCS No. 7, *A Firm's System of Quality Control (Redrafted)*, which would supersede SQCS No. 7. The QC standard is being redrafted to apply the ASB's clarity drafting conventions and to converge with the international quality control standard, ISQC 1. The proposed SQCS is expected to be applicable to a firm's system of quality control for its accounting and auditing practice as of January 1, 2011. The proposed SQCS does not change or expand SQCS No. 7 in any significant respect.

Learning Objectives:

Completion of this lesson will enable you to:

- Describe various aspects of monitoring including types of monitoring activities, monitoring procedures, and documentation.

VARIOUS TYPES OF MONITORING ACTIVITIES

Monitoring is a process that includes an ongoing consideration and evaluation of the firm's quality control system in order to determine that a firm's quality control policies and procedures are properly designed and operating effectively. Additionally, monitoring ensures that the firm's guidance material and practice aids continue to be appropriate, that professional development programs continue to be effective, and that the firm's policies and procedures are being complied with. Accordingly, after the firm has developed and implemented its quality control system, the system is monitored to ensure it continues to meet the requirements of a QC system.

SQCS No. 7 (QC 10.104) indicates that monitoring procedures may be accomplished through the performance of three types of monitoring activities—

- Engagement quality control review (EQCR).
- Postissuance review of engagement documentation, reports, and clients' financial statements for selected engagements.
- Inspection.

The first two monitoring activities are considered engagement monitoring procedures and they primarily focus on reviewing documentation related to client engagements, such as engagement documentation, client financial statements, and the related reports issued. Decisions made specific to the engagement, such as acceptance and continuance and independence considerations, are also part of engagement monitoring.

While the two first types of monitoring activities can accomplish *some* of the monitoring procedures, comprehensive and compliant monitoring requires more than engagement monitoring procedures. The monitoring component of the QC system should reflect an ongoing consideration and evaluation of the firm's system of quality control to determine that the entire system has been designed appropriately and is operating effectively. As a result, firms also should perform monitoring procedures related to administrative or other functions of the firm, as well as engagement monitoring. The remaining paragraphs in this section discuss the three types of monitoring activities in more detail.

Preissuance Review versus Engagement Quality Control Review

Prior to the issuance of SQCS No. 7, one of the types of monitoring activities commonly used by firms was preissuance review. Prior to SQCS No. 7, performance of preissuance review could be considered part of the firm's monitoring procedures, provided that certain specified procedures were performed and that the individuals performing or supervising the procedures were not directly associated with the performance of the engagement.

With the implementation of SQCS No. 7, preissuance review is no longer referred to in the Standard as a monitoring activity. Instead, the Standard introduces a new type of monitoring activity referred to as *engagement quality control review*, which is somewhat similar to concurring review. Engagement quality control review has essentially replaced preissuance review as the preferred monitoring activity, although there is nothing specifically stated in SQCS No. 7 that precludes firms from performing procedures similar to those previously encompassed within preissuance review.

Engagement Quality Control Review

QC 10.100 of SQCS No. 7 states that monitoring policies and procedures should include ongoing consideration and evaluation of the firm's QC system. In addition to serving as an engagement performance QC procedure, performing an EQCR helps to satisfy the ongoing evaluation monitoring requirement of SQCS No. 7. Since an EQCR evaluates the significant judgments made by the engagement team and the conclusions they reached in formulating the report, an EQCR can provide assurance as to whether reports issued by the firm are appropriate in the circumstances. Additionally, evaluation of significant judgments made by the engagement team as part of the EQCR may provide validation that the firm's quality control procedures over differences of opinion and consultation are operating effectively. However, when problems are noted during an EQCR, it may indicate that deficiencies exist in these areas and highlight to the firm that changes are needed. The additional benefit of identifying problems in conjunction with performing an EQCR is that the engagement is not yet complete and issues can be resolved before the report is issued. This adds to the firm's assurance that the firm has complied with professional standards and that its reports are appropriate in the circumstances. (Isolated deficiencies do not indicate by themselves that the firm's system of QC is insufficient).

Postissuance Review

Postissuance reviews are not specifically defined by SQCS No. 7, other than to characterize them as a review of engagements documentation, reports, and client's financial statements for selected engagements. From this characterization, a postissuance review seems to be more involved than an EQCR, as an EQCR requires review of only selected engagement documentation relating to significant findings. While there is little specific guidance regarding postissuance reviews in SQCS No. 7, it is believed that firms may develop policies and procedures for the use of postissuance reviews to be a significant part of the firm's monitoring process for engagements. To be most effective as a monitoring tool, the following conditions generally need to be considered—

a. The procedures are performed by a qualified management-level individual or a qualified individual under his or her supervision.

b. The individual(s) performing or supervising the performance of the postissuance reviews should not be directly associated with the performance of the engagement. (Except as discussed later in this lesson, where an exception is allowed for small firms with a limited number of individuals having sufficient and appropriate experience and authority.)

c. The postissuance review should be sufficiently comprehensive to enable the firm to assess compliance with all applicable professional standards and regulatory requirements and the firm's control policies and procedures related to the engagement. (This condition does not imply that a postissuance review is to be performed for all engagements. Like inspections, postissuance reviews are performed only for selected engagements.)

d. Findings that indicate the need to improve compliance with or change the firm's quality control policies and procedures are to be periodically summarized and corrective action taken.

Postissuance engagement reviews that meet the above requirements are almost identical to engagement inspection procedures, except that postissuance reviews are assumed to be performed on an ongoing basis, whereas engagement inspections are generally performed annually (or periodically at designated times during the year).

Inspection

SQCS No. 7 (QC 10.05) defines *an inspection* as "a retrospective evaluation of the adequacy of the firm's quality control policies and procedures, its personnel's understanding of those policies and procedures and the extent of the firm's compliance with them. Inspection is an element of monitoring." In contrast to the limited discussion about postissuance review included in SQCS No. 7, the performance of inspections is discussed at greater length (see QC 10.105–.108).

Firms determine the need for and extent of inspection procedures in part based on the existence and effectiveness of its other monitoring procedures. The nature of inspection procedures varies based on the firm's quality control policies and procedures and the effectiveness and results of its other monitoring procedures. Inspection procedures can include both engagement performance-related monitoring procedures and administrative and other monitoring procedures.

The inspection process involves selecting individual engagements, some of which may be selected without prior notification to the engagement team. By not notifying engagement teams of every engagement selected for inspection, the quality control process will be more likely to uncover engagements with deficiencies, if any, since the engagement partner will not have an opportunity to review the engagement documentation prior to the inspection. In determining the scope of the inspections, the firm may take into account the scope or conclusions of a peer review or regulatory inspections.

Engagement inspections are often performed annually or periodically at designated times during the year, especially in small firms. SQCS No. 7 (QC 10.106) indicates that inspections of engagements may be performed on a cyclical basis. For example, in firms with multiple partners, engagements selected for inspection may include at least one engagement for each engagement partner over an inspection cycle that spans no more than three years. [However, since SQCS No. 7 requires at least annual communication to firm leadership of monitoring results, firms should perform both engagement and administrative and other monitoring procedures at least annually.] How the inspection cycle is organized, including the timing of selection of individual engagements, depends on many factors, including—

- Firm size.
- Results of past monitoring.
- Degree of authority the firm has over inspections.
- Nature and complexity of the firm's practice.
- Client and engagement risks.

Each of those factors is discussed in the following paragraphs.

Firm Size. The size of the firm directly relates to the volume of engagements performed by the firm. However, the number of engagements performed by the firm does not necessarily have an impact upon how the firm organizes its inspection cycle. Several factors about firm size, however, do impact how the firm may organize its inspection cycle. Some of those factors include—

- Each partner responsible for accounting and attestation services engagements should have engagements monitored. Accordingly, the more partners who perform such engagements, potentially the greater the number of accounting and attestation engagements that may be monitored.
- As a firm grows in size, it often develops a higher level of in-house expertise in multiple areas. The more in-house expertise available in a firm, the fewer engagements the firm may feel required to select for inspection.
- Growing firms often begin to provide more variety in types of engagements performed and industries served. The firm may organize its inspection cycle to regularly monitor each type of engagement and specialized industries handled by each partner.

Results of Past Monitoring. If firms have experienced few deficiencies as a result of monitoring, that circumstance may impact the firm's decision to monitor fewer engagements during the next inspection cycle (assuming no other factors change within the firm that would create a need to increase engagement monitoring). However, if significant deficiencies are experienced, the firm may choose to perform more engagement monitoring or more monitoring of specific procedures in the areas where deficiencies were noted, at least until the issues causing the deficiencies seem to have been corrected.

Degree of Authority Firm Has over Inspections. Compilation and review firms are generally single office firms and accordingly, have complete control and authority over firm processes and procedures, including how the inspection cycle will be managed. This may not be the situation for firms that are part of a multi-office environment.

Nature and Complexity of the Practice. The nature and complexity of the firm's practice may significantly impact how the firm's inspection cycle is organized and managed. Full-service firms, for example, may have a higher percentage of engagements monitored than firms that offer only one or two types of services. Additionally, firms that offer services to regulated industries, such as governmental entities, employee benefit plans, etc., are subject to additional regulatory monitoring requirements.

Client and Engagement Risks. The extent of client and engagement risk can also play a role in how firms organize their inspection cycle. Firms with limited client and engagement risk may not feel a need to select a large number of engagements to inspect. Alternatively, firms with significant client and/or engagement risk may choose to monitor engagements more frequently or monitor a larger percentage of engagements as an additional response to that risk.

Relationship of Peer Review to Performing Inspection Procedures. Peer review inherently differs from monitoring in that peer review evaluates a firm's QC system as of a point in time, while monitoring is an ongoing process. As a result, the performance of a peer review does not substitute for monitoring procedures. However, SQCS No. 7 (QC 10.119) indicates that since the objective of a peer review is similar to that of inspection procedures, a firm's quality control policies and procedures may provide that a peer review conducted under AICPA standards may substitute for the inspection of engagement documentation, reports, and client financial statements for some or all engagements for the period covered by the peer review. Some firms may choose not to make this election. Often, performing an inspection prior to the peer review reveals deficiencies that can be corrected before they become matters for further consideration during the peer review.

HOW TO PERFORM MONITORING PROCEDURES

SQCS No. 7 Requirements

QC 10.100 states that the policies and procedures over monitoring should—

a. Include ongoing consideration and evaluation of the firm's system of quality control to determine that the system is designed appropriately and operating effectively.

b. Assign responsibility for the monitoring process to a partner(s) or other individual(s) possessing sufficient and appropriate experience and authority in the firm to assume such responsibility.

c. Assign responsibility for the performance of the QC system's monitoring activities to qualified individuals.

Accomplishing Ongoing Monitoring

Despite the requirement for an ongoing consideration and evaluation of the firm's system of quality control by the QC standard, some practitioners question what constitutes "ongoing monitoring" when the firm has a program for testing compliance (through inspection) and a peer review every three years. The answer lies in one of the stated purposes of monitoring in SQCS No. 7—to determine whether the firm's quality control system has been operating effectively so that reports issued by the firm are appropriate in the circumstances. If a failure occurs in the QC system so that it is not operating effectively, and the firm is not monitoring its QC system on an ongoing basis, it could be some period of time before the firm realizes the failure has occurred. Additionally, while periodic inspection is a required component of monitoring, it alone may not always accomplish the objective of monitoring.

A firm that waits for its outside peer reviewer to identify needed changes, risks not complying with professional standards. If such problems are found by a peer reviewer, the firm could receive a less than *passing* peer review report, which could potentially result in negative consequences to the firm. For example, if the firm issued an unqualified review report on materially misleading financial statements, the firm may have to withdraw and reissue its report. In addition, if the firm is a member of AICPA PCPS, the firm's peer review report is available to the public on the AICPA website. As a result, the firm's current clients, potential clients, employment candidates, and even competitors can view the less than *passing* peer review report, which can potentially lead to losing clients and tarnishing the firm's reputation over time.

Obviously, it is better for a firm to identify QC system problems and make the necessary changes prior to its peer review. While no guidelines are established by SQCS No. 7 regarding how often ongoing monitoring procedures should be performed, the QC standard does indicate that monitoring procedures include promptly making necessary modification to the QC system. Additionally, at least annually, the results of monitoring the firm's quality control system are to be communicated to relevant engagement partners, firm management, and appropriate individuals within the firm.

There is more than one way to accomplish the goal of ongoing monitoring. A method is suggested with the monitoring process consisting of the following activities:

- Observing the system.
- Evaluating the system for compliance.
- Making necessary changes to the system.

Observing the System. Observing the system is the continual process of paying attention to the quality control system to determine if it is relevant, adequate, operating effectively and is being complied with in practice. Observing the system is not a formalized task to monitor the QC system, but one that results from the day-to-day effort of making sure the practice is running smoothly and keeping up with changes in professional standards and regulatory and legal requirements.

Evaluating the System for Compliance. Performing inspections and other monitoring activities play a significant part in evaluating the system for compliance to determine if a firm's quality control policies and procedures have been adhered to. Evaluating the system for compliance contributes to the monitoring process because results are reviewed by those individuals entrusted with the responsibility for the monitoring process and they determine whether modification of the firm's quality control policies and procedures is warranted. A secondary benefit relates to the firm's peer review. By performing its own evaluation of the QC system, a firm can identify (before peer review) situations that could cause the firm to receive a *pass with deficiencies* or *fail* peer review report. If identified early enough, such situations can be corrected and a less than favorable peer review report avoided.

Making Necessary Changes. Updating the firm's QC policies and procedures as inadequacies are discovered or when events occur that dictate the policies and procedures need revision, is part of the monitoring process. Performing monitoring procedures may also identify areas where the firm needs to provide additional emphasis within its practice, such as specific areas or industries. Occasionally, an event may occur that creates the need for the firm to immediately revise its quality control system. For example, if a firm accepts its first audit engagement, the firm should make sure its QC system has been revised to include additional procedures required for audit engagements. Another example is a sole practitioner adding another partner to the firm. Additionally, when a firm becomes aware of new professional standards and regulatory and legal requirements that affect its quality control system, the related policies and procedures may require revision.

Changing the quality control system includes eliminating or revising outdated policies and procedures, as well as developing new policies and procedures to encompass new requirements. Keeping the firm's QC system current may require frequent revisions when the firm is experiencing a lot of changes (either internal or external to the firm). While rapid and constant accounting change has become commonplace in recent years, in a more steady environment, firms might not often need to revise their QC policies and procedures once they are operating effectively. Of course, the firm should always continue to observe and evaluate the system, even when changes have not been recently warranted.

Proposed SCQS Changes. The SQCS exposure draft further explains that an ongoing consideration and evaluation of the firm's system of quality control to determine design appropriateness and operating effectiveness includes a periodic review of engagement documentation, reports, and clients' financial statements for a selection of completed engagements.

Assigning Responsibility for the Firm's Monitoring Process

Compilation and review-only firms generally assign responsibility for the monitoring process to the accounting partner because he or she possesses sufficient and appropriate experience and authority within the firm to assume such responsibility. (In small firms where the number of partners who perform compilation and review engagements is limited, the accounting partner who is responsible for overseeing the monitoring process may also perform some or all of the monitoring activities.) The following elements are necessary for a successful effort for developing and implementing the quality control system:

- Commitment to quality.

- Leadership.
- A philosophy that is consistent with a successful effort.

Selecting a Monitoring Team

The following paragraphs discuss selection of the monitoring team and apply to team selection for both postissuance reviews and inspection procedures. The selection of the team is a critical step because without competent, knowledgeable, and experienced individuals to oversee and conduct the monitoring procedures, the program may likely be ineffective. Three factors are important to consider when developing policies and procedures for the selection of the team: (a) technical requirements, (b) independence, and (c) size of the team.

Technical Requirements. The individual responsible for conducting the monitoring procedures would preferably be a partner with a reasonably high degree of accounting experience and firm authority. However, a manager with similar experience can be used. A significant portion of the monitoring deals with the review of engagement documentation, reports, and financial statements to determine if selected engagements comply with the procedural, reporting, presentation, and disclosure requirements of professional standards and regulatory and legal requirements. Consequently, the reviewers would ideally be the partners or managers who qualify technically to serve as reviewers in the peer review program in which the firm participates. Administrative personnel and lower level staff can assist with performing administrative or other monitoring procedures.

Independence and Small Firm Monitoring. The individual or team that performs monitoring procedures should not ordinarily be directly involved or associated with the administrative procedures and engagements that will be reviewed. (Engagement quality control reviewers are specifically required to satisfy the independence requirements relating to the engagements reviewed and cannot be a member of the engagement team.) This can create a problem for the sole practitioner or small firm because there may not be a qualified individual to conduct objective monitoring.

To address the situation, a small firm has several options—

a. The firm can employ another firm of similar size and practice to conduct the engagement inspection and other monitoring procedures. For example, a sole practitioner of hypothetical firm A may engage another sole practitioner of firm B to perform the monitoring on firm A. In turn, firm A can inspect firm B. Some firms prefer this arrangement because they receive the benefit of a fresh viewpoint.

b. Within the firm there may be a creative method of performing the monitoring while retaining a high degree of independence. For example, partners can review each other's engagements, or a manager-level professional not directly involved with an engagement may be able to perform the monitoring with the aid of a good work program. Likewise, a manager not directly involved with administrative matters can be selected to review compliance with the other QC procedures over administrative and personnel records such as ethical and human resources requirements.

c. Consider hiring a QC system consultant to provide an overall assessment of the firm's quality control system. This consultant can be hired again later to perform the firm's peer review, if desired.

Alternatively, SQCS No. 7 (QC 10.109) indicates that self-monitoring may be performed. If a sole practitioner or partner of a small firm conscientiously follows a detailed checklist, the likelihood of overlooking an issue or performing only surface-level monitoring (due to familiarity with the QC system and/or individual engagements selected for monitoring) is greatly diminished. To effectively monitor one's own compliance with the firm's policies and procedures, the individual needs to—

a. Critically review his or her own performance.

b. Assess his or her own strengths and weaknesses.

c. Maintain an attitude of persistent improvement.

SQCS No. 7 also indicates, however, that when firm conditions or the firm environment changes (such as obtaining clients in an industry not previously serviced or significantly changing the size of the firm), such situations may indicate the need to have the QC system monitored by another qualified individual.

SQCS No. 7 (QC 10.110) indicates that an individual inspecting his or her own work may be inherently less effective than having another qualified individual perform the inspection. Additionally, "self-inspection" comes with a higher risk that noncompliance with the firm's policies and procedures will not be detected. Accordingly, it may be beneficial to engage a qualified individual from outside the firm to perform the inspection. However, SCQS No. 7 does not prohibit an individual from inspecting his or her own work; it only emphasizes that such an inspection may be less effective. The comments in this paragraph also apply to postissuance reviews.

Team Size. The size of the monitoring team depends to a great degree on the size and complexity of the firm's practice. It is recommended that engagement monitoring reviews include a cross-section of the firm's accounting practice. The larger the firm, the more types of services provided, and/or the greater the number of specialized industries served, generally speaking. Thus, given more types of services and more numbers of specialized industries, the more engagements that may be reviewed and, consequently, the greater the number of team members needed.

Establishing Ongoing Monitoring Procedures. SQCS No. 7 (QC 10.102) requires that the firm's policies over the performance of monitoring procedures be sufficiently comprehensive to enable the firm to assess compliance with all applicable professional standards and regulatory and legal requirements, and the firm's quality control policies and procedures. The QC standard indicates that monitoring procedures include—

- Reviewing engagement documentation, reports, and client financial statements.
- Reviewing selected administrative and personnel records relating to the quality control elements.
- Conducting discussions with firm personnel.
- At least annually, summarizing the findings from the monitoring procedures and considering the systemic causes of findings that indicate improvements are needed.
- Determining any corrective actions to be taken or improvements to be made with respect to the specific engagements reviewed or the firm's quality control policies and procedures.
- Communicating the identified findings to firm management.
- Firm management considering findings and determining that any actions necessary (including modifications to the QC system) are taken on a timely basis.

SQCS No. 7 (QC 10.103) also indicates that monitoring procedures should include an assessment of—

- The appropriateness of the firm's guidance materials and practice aids, if any.
- New developments in professional standards and regulatory and legal requirements, and how new developments are reflected in the firm's policies and procedures, where appropriate.
- Compliance with independence policies and procedures.
- The effectiveness of continuing professional development, which includes training.
- Decisions related to acceptance and continuance of client relationships and specific engagements.
- Whether firm personnel understand the firm's quality control policies and procedures, including how the policies and procedures are implemented.

When establishing monitoring procedures, the firm needs to address the following:

- Policies and procedures should include an *ongoing* consideration and evaluation of the firm's system of quality control to determine that the system has been designed appropriately and is operating effectively.

- While engagement monitoring procedures are an important component of monitoring, administrative and other monitoring procedures are also necessary for a compliant monitoring process.

Establishing ongoing monitoring procedures includes performing both engagement monitoring and administrative and other monitoring procedures, which are discussed below.

Proposed SCQS Changes. The SQCS exposure draft makes some minor changes to the last three items listed above. Such changes include the following revisions—

- Determining any corrective actions to be taken or improvements to be made in the system, including providing feedback about the firm's policies and procedures relating to education and training.

- Communicating to appropriate firm personnel any weaknesses identified in the system, in the level of understanding of the system, or compliance with it.

- Follow-up by appropriate firm personnel so than any modifications necessary are promptly made to the QC system.

Performing Engagement Monitoring Procedures

Monitoring procedures can generally be divided into two categories—engagement monitoring procedures and administrative and other monitoring procedures. Both types of monitoring procedures should be performed to effectively evaluate the firm's entire system of quality control. The following paragraphs address engagement monitoring procedures, which are the procedures specific to the selected engagement. Administrative and other monitoring procedures are the procedures the firm establishes not specifically related to engagement performance. Such procedures include processes that address the appropriateness of materials and forms used by the firm, assessing how new developments are integrated into the quality control system, determining the effectiveness of continuing professional development (including training), evaluating the understanding of the QC system by firm personnel, and much more.

Reviewing Engagement Documentation. One engagement monitoring procedure is for firms to review engagement documentation (including correspondence, practice aids, and other documentation), reports, and client financial statements. Firms might select a cross-section of engagements at the beginning of its monitoring year and reevaluate that selection throughout the year as circumstances change.

A firm's engagement monitoring procedures should test both compliance with the firm's stated quality control policies and procedures for engagement monitoring and compliance with related authoritative literature. Not stating in the QC document the specific procedures to be performed during engagement monitoring, is suggested, but instead limit the QC document to providing guidelines for developing the procedures. The actual procedures to be performed are normally separately documented in a checklist or memorandum. The procedures a firm follows to inspect engagement documentation are often similar between firms since such procedures address compliance with authoritative requirements, disclosure, and reporting rules.

Identifying errors in engagement performance is the primary objective of engagement monitoring procedures. However, it is important to also identify and discuss misuse of the practice aids with the staff. Proper use of the practice aids increases the probability that the engagement is completed in accordance with professional standards and in the most efficient manner.

Evaluating Independence. Engagement monitoring procedures also include assessing firm compliance with its policies and procedures on independence as part of the engagement acceptance and continuance decision. In performing engagement monitoring procedures to determine whether the firm appropriately evaluated independence with regard to specific engagements, the monitoring team can review (a) documentation of personnel's independence representation forms completed annually, (b) resolution of matters regarding independence to determine that matters have been appropriately considered and resolved, (c) correspondence regarding consultation on independence matters, and (d) the acceptance and continuance procedures performed by the engagement team.

Evaluating Acceptance and Continuance Decisions. Firms are required by SASs, SSARS, and SSAEs to perform appropriate acceptance and continuance decisions as part of the initial engagement administration. SQCS No. 7 requires firms to evaluate those decisions from the perspective of the client relationship and specific engagements. Evaluating those decisions would normally include reviewing engagement files to determine compliance with the firm's quality control policies and procedures relating to acceptance and continuance decisions.

Determining the Timing of Procedures. The type of engagement monitoring activities performed will impact the timing of the procedures.

Engagement Quality Control Review (EQCR). When an engagement meets the EQCR criteria established by the firm, an engagement quality control review should be performed on that engagement. SQCS No. 7 requires that an EQCR be completed prior to the issuance of the engagement report.

Postissuance Engagement Reviews. While performing postissuance reviews promptly has advantages, firms might be cautious in setting time limits within which the reviews are expected to be completed. The phrase "within a reasonable period of time" is suggested followed by a declaration that it is not the intent of the procedure to require the postissuance review within a specific period of time.

Inspection Procedures. SQCS No. 7 does not indicate any specific requirements relating to the timing of inspection procedures. However, SQCS No. 7 does require that firms communicate, at least annually, the results of the monitoring of its quality control system to firm leadership and other relevant individuals within the firm. Thus, if the firm chooses to perform its monitoring procedures primarily through inspections, the communication requirement infers that inspection procedures should also be performed at least annually.

Firms may substitute a peer review conducted under the AICPA standards for the inspection of engagement working papers, reports, and clients' financial statements for some or all engagements for the period covered by the peer review. For this reason, firms utilizing such a substitution will generally perform inspections covering the same annual periods used for peer reviews. This does not mean that the inspection team cannot commence the inspection prior to the inspection year end. Some firms perform interim inspection work in much the same manner they might perform interim audit work.

The only other authoritative guidance alluding to timing of inspections states that inspection of completed engagements may be performed on a cyclical basis. The following example for performing inspections on a cyclical basis is given in SQCS No. 7—engagements selected for inspection may include at least one engagement for each engagement partner over an inspection cycle that spans three years.

Determining the Scope of Engagements Selected for Monitoring. When determining engagement selection for monitoring purposes, firms may find the engagement selection guidelines used by peer reviewers beneficial. The scope of engagements reviewed should include a cross section of the firm's engagements. The criteria for engagement selection may include, but is not limited to, the following:

a. A cross-section of engagements based on the level of service performed (for example, review, compilation, attestation).

b. First-year engagements.

c. Specialized, complex, and high-risk engagements.

d. A cross-section of engagements from all firm partners and other management level personnel having accounting responsibilities.

e. Significant client engagements.

f. Engagements for which there have been complaints or allegations from firm personnel, clients, or other third parties that the work performed by the firm failed to comply with professional standards, regulatory or legal requirements, or the firm's system of quality control.

g. Engagements involving complex issues requiring consultation.

h. Engagements in which there were disagreements among team members or between the engagement quality control reviewer and the engagement partner.

Performing Administrative and Other Monitoring Procedures

Monitoring procedures generally consist of engagement monitoring and administrative and other monitoring procedures. The following paragraphs discuss administrative and other monitoring procedures, including:

- Assessing how new developments are integrated into the quality control system.
- Reviewing written confirmations of firm compliance with independence-related policies and procedures.
- Determining the effectiveness of continuing professional development, including training.
- Evaluating whether firm personnel understand the QC system.
- Determining the appropriateness of materials and forms used by the firm.

Assessing How New Developments Are Integrated into the QC System. Part of maintaining an effective quality control system includes updating the system for necessary changes. While it is one thing to identify situations that impact the firm's system of quality control, it is another to determine what actions are required as a result of the identified situations and then to follow up and determine whether changes made achieved the intended objectives. It is believed that a firm should assign responsibility for this task, including informing professional personnel about such changes, to the individual who has overall responsibility for maintaining the firm's quality control policies and procedures. The firm can easily communicate information electronically or during staff meetings regarding new professional standards or regulatory and legal requirements and the related changes to the quality control system's practice aids.

Reviewing Written Confirmation of Compliance with Policies and Procedures on Independence. SQCS No. 7 (QC 10.24) requires that a firm obtain, at least annually, written confirmation of compliance with its policies and procedures on independence from all firm personnel who are required to be independent by the AICPA *Code of Professional Conduct*, rules of state boards of accountancy, and applicable regulatory agencies. Once the written confirmations of independence are obtained from firm personnel, the forms need to be reviewed. The accounting partner is often responsible for accumulating and evaluating employee responses concerning independence.

Determining the Effectiveness of Continuing Professional Development. Firms should establish quality control policies and procedures related to continuing professional development, including training. As part of monitoring the quality control system, the firm should not only determine compliance with those policies and procedures, but determine whether they are appropriate, effective, and meet the firm's needs. One way to determine such things is to review (a) participant evaluations of office and external training programs and (b) professional development records of personnel. The managing partner can evaluate whether professional personnel are receiving appropriate CPE and training to enhance the performance of their jobs and expand their expertise. Each professional's CPE record should be reviewed to determine compliance with the CPE requirements of the AICPA and other applicable regulators. Additionally, the firm may solicit information regarding the effectiveness of training programs from professional personnel.

Evaluating Whether Firm Personnel Understand QC Policies and Procedures. Professional personnel need to be informed of their responsibilities for complying with the firm's standards of quality, including the firm's QC system, as they perform their duties. Additionally, it is important for the firm to determine whether its personnel understand the stated policies and procedures that make up the QC system. The firm might discover during monitoring (due to uncovering performance deficiencies) that its personnel do not understand how to appropriately comply with certain aspects of the firm's QC system.

Alternatively, the firm may interview professional personnel to gather information to determine whether personnel know about, and understand the firm's QC policies and procedures. If personnel do not know about the firm's quality control system or specific aspects of it, then the firm is not effectively communicating such information to its personnel. If personnel know about the QC system but do not understand how they need to apply it, the firm has not provided adequate training. Obviously, a firm in either situation needs to take immediate action to improve the personnel's knowledge and understanding.

Determining the Appropriateness of Firm Materials. The firm's guidance materials are an integral part of the firm's QC system. Such guidance materials include work programs, forms, checklists, and other practice aids. It is important that such guidance materials periodically be reviewed and evaluated to consider whether they reflect current professional standards and regulatory and legal requirements. Obviously, if the materials used by the firm do not reflect current authoritative guidance, the firm will not be conducting their engagements properly.

Firms may develop their own materials or purchase such materials from third-party providers. Thomson Tax & Accounting is a third-party provider of such materials, such as PPC guides. Because all materials found in the PPC accounting guides are part of a comprehensive quality control system, their use is recommended. Additionally, PPC's accounting guides undergo peer review by an independent third party, including the materials and the system for developing the materials, which provides reasonable assurance of their appropriateness.

HOW TO EVALUATE AND COMMUNICATE THE RESULTS OF MONITORING

A system of quality control has inherent limitations that can reduce its effectiveness. For example, establishing a system of quality control, especially initially, may require occasional revisions before the firm identifies the best set of policies and procedures for its particular needs. Additionally, firm circumstances do not remain stagnant, but frequently change: authoritative guidance is constantly changing, firm personnel come and go, firms alter their practices by changing their services, etc. Also, compliance with the QC system is the responsibility of individuals and everyone makes mistakes occasionally, not to mention that new employees require a period of time to become familiar with the firm's QC system. All of those factors make it challenging for a firm to keep their quality control system in perfect working order.

Because of factors such as those, SQCS No. 7 (QC 10.111) indicates that when a firm discovers quality control deficiencies in individual engagements, such a situation does *not*, by itself, indicate that the firm's system of quality control is insufficient to provide reasonable assurance that its personnel comply with applicable authoritative standards. Every QC system has inherent limitations and, as a result, errors and deficiencies are bound to occur. If occasional errors and deficiencies are detected during the monitoring process, this actually may be an indication that the monitoring QC element is working effectively. That being said, it is important for a firm to promptly evaluate the effect of deficiencies discovered as a result of the monitoring process and determine whether corrective action is required.

Evaluating Deficiencies and Developing Recommendations

Deficiencies identified during the monitoring process do not necessarily indicate that the firm's system of quality control is insufficient to provide reasonable assurance that it complies with professional standards and regulatory and legal requirements. Nor do they necessarily indicate that the reports issued by the firm or engagement partners are inappropriate in the circumstances. On the other hand, some deficiencies identified during the monitoring process may represent systemic, repetitive, or other significant deficiencies that require prompt corrective action. When deficiencies are identified as a result of performing monitoring procedures, regardless of its cause or severity, the firm should communicate those deficiencies and recommendations for appropriate remedial action to relevant engagement partners and other appropriate personnel.

The firm's QC system should outline procedures for implementing corrective actions for identified QC system deficiencies. The determination of what corrective actions, if any, are taken will generally be made by the individual(s) assigned responsibility for managing the firm's quality control system. It is generally appropriate to have someone independent of the affected engagement(s) evaluate quality control deficiencies, although in very small firms such a procedure may not be supportable.

SQCS No. 7 (QC 10.114) provides guidance on recommendations that should result from the firm's evaluation of identified QC system deficiencies. Generally, the firm should pursue one or more of the following recommended actions—

- Take appropriate remedial action directed toward the individual engagement or person.
- Communicate the findings to those responsible for training and professional development.
- Revise the firm's quality control policies and procedures.
- Discipline individuals who fail to follow the firm's QC policies and procedures.

Taking Appropriate Remedial Action Regarding an Engagement or Personnel. If the quality control system deficiency is determined to be an isolated occurrence on one engagement or by one individual, an appropriate firm response would be to provide individual instruction to, or counseling with, the specific engagement team or individual. Corrective action may also include changing staff assignments.

Communicating Findings to Professional Development Personnel. The firm ordinarily communicates the results of the evaluation of deficiencies to the appropriate training or professional development personnel if it appears that the cause of the deficiencies may be a lack of training or understanding by firm personnel of specific policies and/or procedures. Such a situation might occur after the firm has made revisions to its quality control system. Additional training of professional personnel may be appropriate for a better understanding of the recent revisions and how to apply the policies and procedures in practice. If the cause of the deficiency is isolated to certain areas or industries, the additional staff training can focus on those areas or industries.

Revising QC Policies and Procedures. Revisions to the quality control policies and procedures may be necessary when systemic causes are the reason for QC system deficiencies. Such revisions may include rewriting or modifying certain QC policies or procedures, as well as updating, changing, or adopting new quality control materials (forms, checklists, work programs, etc.). The firm may also choose to perform more careful monitoring of compliance with QC policies and procedures for a period of time after systemic QC deficiencies are discovered.

Initiating Disciplinary Action for Failure to Comply. Occasionally, it may be necessary for the firm to take disciplinary action against personnel who fail to comply with the firms QC policies and procedures, especially those individuals who fail to do so repeatedly.

Implementing and Monitoring Corrective Actions. Once the appropriate corrective action(s) are decided upon, the firm should assign responsibility to determine that those corrective actions are properly implemented. In a small firm, the managing partner usually assumes that responsibility. It is also suggested that the subsequent year's monitoring program contain a procedure for the monitoring team to investigate whether the firm is complying with the newly implemented or modified procedures.

Determining Action If an Inappropriate Report Is Identified. Occasionally, the QC system deficiency may be so severe that required engagement procedures were not performed or an issued report is inappropriate. Such situations require the firm to determine what further actions are needed to comply with relevant professional standards and regulatory and legal requirements.

The following corrective actions on specific engagements may also be necessary:

- Compilation and Review:
  - AR 100 discusses the considerations and procedures to follow when accountants subsequently discover facts existing at the date of the compilation or review report that would have caused the accountant to make different decisions had he or she been aware of such facts.
- Attestation:
  - The standards for prospective financial statements are generally the same as those for historical financial statements; therefore, no corrective actions are necessary.

The firm may also consider consulting legal counsel or the firm's legal liability insurance provider.

Proposed SCQS Changes. The SQCS exposure draft (discussed earlier in this lesson) strengthens the guidance related to the identification of an inappropriate report or the omission of procedures during the performance of an engagement by indicating that the firm should establish QC policies and procedures to address such situations. In addition to such policies and procedures requiring the firm to determine what further action is appropriate to comply with relevant professional standards and legal and regulatory requirements, the firm also is required to consider whether to obtain legal advice.

Annual Communication of Monitoring Results

Annually, *at a minimum*, SQCS No. 7 (QC 10.116) requires the firm to communicate the results of monitoring its quality control system process to firm management, relevant engagement partners, and other appropriate individuals within the firm. Firms that perform specific monitoring procedures more than once a year may choose to communicate findings more frequently than once a year. It is suggested that communicating monitoring results semi-annually or quarterly is adequate for firms that desire more than one annual communication. Firms should establish in their QC policies and procedures how often monitoring results will be formally communicated, being careful not to commit the firm to a more frequent basis than can or needs to be performed. Regardless of the frequency of formal monitoring communications, findings that indicate situations needing immediate attention should be promptly communicated so that corrective actions can be implemented as quickly as possible.

SQCS No. 7 indicates that the following information should be communicated:

a. A description of the monitoring procedures performed.

b. The conclusions reached based on the monitoring procedures.

c. Where relevant, a description of systemic, repetitive, and other significant deficiencies and the actions taken to resolve or amend those deficiencies.

The communication should enable the firm to take prompt and appropriate action where necessary in accordance with firm personnel's defined roles and responsibilities. However, reporting of identified deficiencies at the engagement level to individuals other than the relevant engagement partners is not ordinarily required, unless such reporting is necessary for the proper discharge of the responsibilities of the individuals other than the engagement partners.

As described above, SQCS No. 7 requires the firm to communicate the results of monitoring to other appropriate individuals within the firm. It is believed that *other appropriate individuals* refers to professional personnel responsible for applying any changes made in the quality control system to future engagements. (That is, staff involved in upcoming engagements and engagements in process may need to receive communication regarding identified QC system deficiencies immediately to ensure that those engagements do not suffer similar deficiencies.) In addition, the firm may choose to communicate monitoring findings to professional staff at all levels to promote transparency and quality and heighten awareness of potential problems that can occur. Accordingly, it would be beneficial for professional personnel to be apprised of the deficiencies noted during the monitoring process and related changes made to the firm's QC system. The actual detail and extent of the communication may depend on the size, structure, and number of partners.

The smaller the firm, the greater the benefits of an open discussion of the actual details of the findings with all of the staff. Although not required, the specific engagements and related findings can be discussed in more detail since all personnel have actual knowledge of or experience with some of the engagements reviewed, and several staff members may have worked on the engagements being discussed. Any changes that need to be made in the QC system or how the QC system is applied, and why, may also be discussed. This type of discussion may be beneficial for most compilation and review-only firms.

PREPARING MONITORING DOCUMENTATION

SQCS No. 7 (QC 10.118) requires firms to establish policies and procedures requiring appropriate documentation of monitoring. According to the QC standard, such appropriate documentation includes the following:

a. Evidence of the monitoring procedures performed, including the procedures for determining which completed engagements were inspected.

b. A record of the firm's evaluation regarding—

   (1) Its adherence to professional standards and regulatory and legal requirements.

   (2) Whether the quality control system has been appropriately designed and effectively implemented.

   (3) Whether the firm's quality control policies and procedures have been operating effectively, so that reports issued by the firm are appropriate in the circumstances.

c. Identification of deficiencies found during the monitoring process, an evaluation of their effect, and the basis for determining whether and what further action is necessary.

Monitoring Procedures

Monitoring procedures consist of the procedures previously discussed in this lesson. The firm should include in its documentation evidence of the performance of each of those procedures, as well as the procedures the firm used to determine which completed engagements were inspected.

Evaluation

The firm should make an evaluation of the factors considered in determining whether the firm has achieved the purpose of monitoring. The firm should document that evaluation process as part of its monitoring documentation.

Identification of Noted Deficiencies

The firm identifies deficiencies found, evaluates their effect, and considers whether and what further action is needed. Evaluating identified deficiencies and developing recommendations for corrective action is discussed earlier in this lesson. The firm should include information about that process within its documentation of monitoring.

Form of Documentation

The QC standard does not provide a description of what monitoring documentation should look like, only what the documentation should include. Accordingly, the firm has complete latitude in the forms it chooses to document its monitoring process. One method often used is to complete a memorandum describing the process the firm followed to monitor its QC system.

Another alternative is to complete a checklist or questionnaire that documents the firm's monitoring of its system. If the firm performs its monitoring during a set time of the year, the questionnaire may be completed as part of that process. However, the questionnaire can also be used any time events or occurrences indicate that changes may be needed in the system. The questionnaire is divided into distinct sections. The first section addresses common events that generally require a change in the firm's QC system. The remainder of the questionnaire devotes a section to each QC element and addresses circumstances for that QC element that may require a change to the QC system.

While use of the monitoring questionnaire is optional, it can facilitate both the completion and documentation of the monitoring process. It can also serve as a "memory jogger" for identifying changes to the QC system. Because the memorandum referred to above can be easily customized by each firm, that approach may be an efficient and effective method of documenting the monitoring process. Sole practitioners and other small firms may find, however, that the monitoring questionnaire can serve as adequate documentation in lieu of the memorandum, provided the documentation requirements of SQCS No. 7 listed above, are met.

Monitoring involves keeping the QC system up to date for (a) changes in professional standards and regulatory and legal requirements and (b) changes in the nature of the firm's practice. Ordinarily, firms only revise their QC systems for changes in authoritative pronouncements if they have modified the PPC quality control system (for example, by tailoring PPC's engagement performance bridging documents) or if new authoritative literature with very short effective dates has recently been issued.

Identification of Clients in Monitoring Documentation. It is suggested that, in order to protect the confidentiality of client information, client names not be recorded in the monitoring documentation. Instead, client codes may be assigned. A list showing the code assigned to each client can be retained while the engagement monitoring is in progress and then be destroyed.

Retention of Monitoring Documentation

Firms should consider the need to retain the detailed monitoring documentation, programs, and checklists as required by SQCS No. 7. SQCS No. 7 (QC 10.127) indicates that firms should establish policies and procedures for retention of QC system documentation for a time sufficient to allow those monitoring the QC system, including peer reviewers, to evaluate the firm's compliance with its system. Documentation should be kept longer if required by law or regulation.

Firms whose reviewers plan to rely, or who may consider relying, on the firm's monitoring generally retain all monitoring documentation, checklists, and reports until the next peer review. Specific questions about what to retain is best discussed with the firm's peer reviewers.

It is suggested that firms may also elect to retain completed monitoring checklists, even if they prepare a separate monitoring report. The checklists can be helpful when performing the next year's monitoring, just as the prior year engagement documentation can be helpful when performing the next year's engagement. However, engagement checklists used when performing engagement reviews need not be retained. (Because engagement-specific checklists can be subpoenaed as discoverable evidence in litigation, it is generally preferable to destroy such checklists as soon as they are no longer needed for the monitoring process.)

PPC's Approach to Documenting Monitoring

To assist in the performance and documentation of monitoring procedures, monitoring checklists have been developed for small and medium-sized firms and for sole practitioners with no professional staff. The checklists provide (a) sufficient guidance for efficient and effective monitoring and (b) an adequate, but not overly burdensome, level of documentation.

Engagement quality control review is performed prior to engagement completion and is addressed as part of the engagement performance QC element.] Compliance testing and documentation of inspection/review procedures include the following:

a. *Documenting the Firm's Practice, the Monitoring Team, and the Scope of the Monitoring.* Sections I–III of the detailed inspection/review checklists document the firm's engagement statistics, industry specializations (if any), the quality control elements to be reviewed, and the engagements selected for review.

b. *Documenting Compliance Tests of the Firm's QC System.* Section IV of the detailed monitoring checklists list compliance procedures for each of the applicable quality control elements.

c. *Documenting Engagement Reviews.* In reviewing the engagement documentation, reports, and clients' financial statements, firms may use the PPC engagement review checklists or the AICPA engagement review checklists used by peer reviewers (found in the AICPA *Peer Review Program Manual*). Some firms use the work programs and disclosure checklists found in PPC guides as reference aids and do not complete a checklist. At a minimum, each engagement review should be documented by completing Section V of the detailed monitoring checklists, which documents evaluation of the factors required by

SQCS No. 7, QC 10.118, b. Since they can be subpoenaed as discoverable evidence in litigation, it is generally preferable to destroy engagement-specific checklists once they are no longer needed for the monitoring process or peer review. (Firms should keep monitoring documentation longer if required by law or regulation.)

d. *Summarizing Findings and Recommendations.* Once inspection/review procedures are performed, any findings and deficiencies identified in the process are summarized and evaluated. Section VI of the detailed checklists provide a place to document conclusions, findings, and recommendations based on monitoring procedures performed. In addition, the "Summary of Identified Monitoring Deficiencies" form can be used to summarize identified findings, evaluate deficiencies, and determine corrective actions as appropriate for communication to appropriate firm personnel.

e. *Preparing the Annual Monitoring Communication.* SQCS No. 7 requires firms to communicate, at least annually, the results of monitoring its quality control system process. The communication should include a description of monitoring procedures performed and the conclusions drawn from such procedures, and where relevant, information about significant deficiencies and the actions taken by the firm to resolve those deficiencies.

PPC's Engagement Review Checklists. PPC engagement review checklists for documenting engagement reviews are based on the checklists used in peer reviews with added references to the practice aids used in PPC guides. However, many of the PPC checklists and practice aids are considered optional and some areas do not require practice aid documentation. As a result, such references are not included in a practice aid. In some instances, the reviewer may find that a standard practice aid was not used but that proper and adequate documentation was nevertheless provided. In some instances, the practice aids may provide the primary (or only) evidence of compliance with the requirement. However in other instances, the practice aid provides only secondary evidence. For example, a practice aid may (by answers on a checklist, signed engagement plan step, etc.) indicate that the accountants' report is in conformity with professional standards, but a reading of the report shows that it is not. A signed engagement plan step may indicate a procedure was performed but the engagement documentation may indicate that it was not or was not properly completed. In these instances, the requirement is not met, irrespective of the information provided in the practice aid and the question in the review checklist should be answered "No." The review checklist should be completed based on the preponderance of evidence.

As previously discussed, monitoring procedures include engagement quality control review (EQCR), inspection, and postissuance review. EQCR is performed prior to completion of the engagement as part of the engagement performance QC element. Thus, the retrospective monitoring procedures addressed in the monitoring practice aids relate to inspection and postissuance review, which are collectively referred to as inspection/review. Generally, monitoring documentation will be maintained by the accounting partner or the individual responsible for the monitoring process.

System Documentation

SQCS No. 7 (QC 10.125–126) requires the firm to establish policies and procedures to appropriately document the performance of each element of its QC system, not only the monitoring process. The form and content of such documentation is a matter of judgment and will be affected by—

- The size of the firm.
- The nature and the complexity of the firm's practice and its organizational structure.

Documentation can span the spectrum; from using electronic databases to manual preparation of notes, checklists, and forms.

Policies and procedures relating to retention of QC system documentation are the same as discussed for the monitoring element.

ALLEGATIONS AND COMPLAINTS

Establishing QC polices and procedures to address how the firm handles complaints and allegations is a new area of guidance not previously included in the QC standards. SQCS No. 7 (QC 10.120) states that such policies and procedures should provide the firm reasonable assurance that it deals appropriately with—

a. Complaints and allegations that the work performed by the firm fails to comply with:

   (1) Professional standards and regulatory and legal requirements.

   (2) The firm's system of quality control.

b. Deficiencies in the design or operation of the firm's quality control policies and procedures, or noncompliance with the firm's system of quality control by an individual or individuals discovered while investigating item a. above.

An exception to the above requirements is allowed by SQCS No. 7 when the complaint or allegation is clearly frivolous.

Origins of Complaints and Allegations

Complaints and allegations against the firm can originate from either inside or outside the firm. Complaints and allegations may come from firm personnel, clients, state boards of accountancy, regulators, or other third parties. Those making a complaint or allegation may communicate their issue to engagement team members or to other personnel within the firm. Some complainants may make their initial communication directly to state boards of accountancy or regulators. In an effort to discourage such an initial communication, firms could strongly encourage their clients to direct any complaints directly to the firm. Establishing channels for communicating complaints and allegations is discussed beginning in paragraph [OLDREF].

Types of Complaints and Allegations

There are several common situations that may trigger a complaint or allegation. Those situations are further discussed in the following paragraphs.

Work Performed Failed to Comply with Standards or Requirements. While this type of complaint or allegation may originate from inside or outside the firm, it is probably more likely that it will come from outside the firm. It is not uncommon for third-party investors or lenders of troubled companies to believe that the CPA firm must have been deficient in the performance of its duty.

Accounting firms are frequently viewed by third parties as convenient *deep pockets* which, because of their substantial resources and insurance coverage, are able to ease the financial burdens of those who have suffered economic losses. The deep pocket syndrome is fueled by undue expectations on the part of the public, which seems to hold the view that where services have been performed, the resulting financial information must be accurate in all respects. In short, even though compliance with the firm's appropriately designed and effectively operating system of quality control will go a long way toward reducing a CPA firm's incidence of complaints and allegations; it will not completely eliminate them.

Noncompliance with the QC System. This type of complaint or allegation will probably originate from within the firm since any individual firm's QC policies and procedures are generally not common knowledge outside the firm. This type of complaint or allegation may come from concerned professional personnel seeking to apprise firm management that its QC policies and procedures are not being followed by all engagement teams.

Deficiencies or Noncompliance Identified during Investigations. An investigation of a complaint or allegation can lead to a determination that the firm has (a) deficiencies in the design or operation of its QC system, or (b) incidences of noncompliance with its QC system by one or more individuals.

Establishing Channels of Communication for Complaints and Allegations

SQCS No. 7 (QC 10.121) indicates that in conjunction with establishing QC policies and procedures for handling complaints and allegations, the firm should establish clearly defined channels of communication for firm personnel to raise any concerns in a manner that allows them to come forward without fear of reprisals. The firm needs to ensure that such defined channels of communication and related procedures are effectively communicated to all firm personnel. Posting such information on the firm's website or intranet is one way in which employees can easily gain access to those procedures at the time the information is needed. The firm can also periodically remind its employees about such procedures and continue to encourage them to communicate complaints through the designated channels.

The firm should also consider extending channels of communication for complaints and allegations to clients. Some complainants may make their initial communications directly to state boards of accountancy or other regulators. Opening channels of communication to clients can potentially discourage the initial communication of complaints to parties outside the firm. Providing an easy-to-use mechanism for clients to forward complaints directly to the firm reduces the possibility of the firm experiencing adverse consequences as a result of such complaints. Firms may periodically remind its clients that it has a process for addressing complaints and inform them how to initiate that process if the need arises. One method that might be used is for the firm to put a notice on the bottom of its invoices notifying clients of how they may initiate a complaint if the client is dissatisfied with anything that occurred during the course of the engagement. Another method that may be used is for the firm to conduct engagement satisfaction surveys and include information about how to initiate a compliant if the customer is dissatisfied.

Regardless of whether the complaint or allegation originated from inside or outside the firm, the individual that initiated the communication wants to know that their concern is being given due consideration by appropriate firm personnel.

Investigating Complaints and Allegations

SQCS No. 7 (QC 10.123) establishes guidance for the investigation of complaints and allegations in the following areas—

- Supervision of the investigation of complaints and allegations should be performed by an individual with sufficient and appropriate experience and authority who is not otherwise involved in the engagement relating to the complaint or allegation. (See discussion below)
- The firm may include in its complaints and allegations policies and procedures the involvement of legal counsel as necessary.
- Small firms and sole practitioners may use the services of a qualified external person or another firm to perform the investigation.

Beyond the above points, SQCS No. 7 provides no other specific guidance as to the process for investigating complaints and allegations. Accordingly, the firm has considerable discretion in establishing the related polices and procedures.

It is believed that the individual responsible for supervising the investigation of a complaint or allegation needs to be a partner not affiliated with the specific engagement. A partner generally has sufficient and appropriate experience and authority to supervise such an investigation. Generally, the first step in the process is to determine whether the complaint or allegation is credible, that is, valid and not frivolous or unsubstantiated. If the complaint or allegation is determined to be credible, the partner then begins the investigation process.

As the investigation proceeds, deficiencies in the design or operation of the firm's quality control policies and procedures, or noncompliance with the firm's system of quality control by an individual or individuals, may be uncovered. If such a situation occurs, the firm would ordinarily take appropriate action.

If, during the investigative process, the seriousness of the complaint begins to suggest the potential for a liability claim against the firm, consider implementing damage control procedures. *Damage control* is a term sometimes used to describe procedures that a firm follows when there is a possibility that a liability claim may be asserted. If such a situation occurs, the firm immediately contacts its liability insurance carrier and legal counsel.

Proposed SCQS Changes. The SQCS exposure draft makes a minor change to the information discussed above. The proposed standard replaces the phrase "an individual with sufficient and appropriate experience and authority" in the first bullet with "a partner with sufficient and appropriate experience and authority within the firm."

Communicating with the Complainant. The individual initiating the compliant or allegation often wants to know that his or her issue is being given due consideration by the firm. As part of establishing policies and procedures for complaints and allegations, the firm needs to decide if and how communication regarding the status of the investigation will be made to the individual who initiated it. The firm might consider whether it is appropriate to periodically communicate the status of the complaint or allegation with the complainant. Such firm responsiveness indicates that it takes complaints seriously and is dedicated to dealing with them appropriately. Obviously, however, this can be a touchy situation. Firms are advised to take the recommendation of its liability insurance carrier and legal counsel about whether to communicate with complainants. The communication of such information may be different, depending upon whether the complaint or allegation originated from within or outside the firm.

Documenting Complaints and Allegations

The firm should establish policies and procedures requiring documentation of complaints and allegations and the responses to them. It is recommended that complaints and allegations, regardless of whether they are determined to be credible, be documented to ensure that resolution of all complaints and allegations received by the firm is maintained.

HOW TO DRAFT THE FIRM'S QC POLICIES AND PROCEDURES

For some of the elements of quality control, authoritative accounting and ethics literature will contain considerations or requirements that should be incorporated into the design of the quality control system. Therefore, it is always important to begin the design of any of the quality control elements with a review of the authoritative literature. However, for the monitoring element, the preponderance of the requirements is contained in SQCS No. 7. Firms should also be familiar with any pertinent regulatory or other legal requirements before it begins the design of its quality control system.

AICPA Practice Aid

The illustrative monitoring policies and procedures provided by the AICPA should be reviewed before designing the firm's system. Those examples are found in the AICPA Practice Aid, *Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice*.

While the AICPA Practice Aid illustrative policies and procedures may provide a logical starting point for designing the monitoring quality control system, careful consideration of the firm's needs before adopting them is recommended. Many firms will find that the suggested policies and procedures may not meet their firm's particular needs.

Developing Monitoring Policies and Procedures

Quality control policies are designed to achieve the overall objectives of the QC system and the specific objectives of the individual QC elements. Quality control procedures are designed to provide the actions necessary to implement and monitor compliance with the stated policies. Factors such as the following generally can impact the QC policies and procedures for a given firm—

- Size of the firm.
- Operating characteristics of the firm.
- Knowledge and experience of firm personnel.
- Nature and complexity of the firm's practice.

There is more than one way to develop a firm's quality control policies and procedures. For example, this course chooses to develop one policy statement for each QC element and then design appropriate procedures for each element that implements that one policy. Alternatively, the AICPA Practice Aid illustrative policies and procedures include multiple policy statements for each QC element with procedures related to each policy. Firms need to choose an approach in developing their QC policies and procedures that meets the needs and desires of the firm.

Initial Considerations Relating to Developing Monitoring Policies and Procedures

The following considerations may provide helpful information as the firm develops its monitoring policies and procedures—

- *Monitoring Is Key in Evaluating All Other QC Elements.* Developing policies and procedures related to the monitoring element of quality control enable a firm to evaluate whether its policies and procedures for all the other elements of the firm's quality control system are suitably designed and being applied effectively.

- *Design Procedures that Can Be Easily Monitored.* It is in the best interest of the firm to design procedures that can be easily monitored by the firm and can eventually be easily assessed by a practice monitoring unit.

- *Monitoring Is More Than a Review of Engagement Documentation.* Some practitioners continue to believe that monitoring is only concerned with a review of engagement documentation to determine if engagements conform to professional standards and regulatory and legal requirements. While this is indeed a key element of monitoring, monitoring procedures should cover all of the firm's documented QC procedures as required by SQCS No. 7 and discussed throughout this lesson.

- *Monitoring Applies to Sole Practitioners.* Sole practitioners may believe that monitoring does not apply to them or would be impractical since it requires monitoring their own work. SQCS No. 7 makes it clear that monitoring does apply to sole practitioners. QC 10.110 of SQCS No. 7 indicates that an individual inspecting his or her own work may be inherently less effective than having another qualified individual perform the inspection because "self-inspection" comes with a higher risk that noncompliance with the firm's policies and procedures will not be detected.

- *Perform Monitoring When Client Workloads Are Lightest.* Monitoring, like most other nonrevenue producing work, is often a less pressing priority than client work. While this can be inconvenient and frustrating for a partner or high level staff person who is a member of the monitoring team, firms will be better off performing in-depth monitoring procedures when client workloads are lightest. Such an approach will allow the monitoring team to concentrate on the inspection, postissuance review, or other monitoring procedures and to complete them more efficiently. Cooperation from the engagement team will be easier to obtain during lighter workload times also.

- *Documentation of Monitoring Procedures Is Required.* SQCS No. 7 requires firms to establish policies and procedures for appropriate documentation of monitoring and details specific monitoring procedures to be documented. This is a new QC system requirement. Documentation of the monitoring performed should provide sufficient evidence that the quality control policies and procedures were followed.

- *Addressing Complaints and Allegations.* Monitoring policies and procedures that address handling a firm's complaints and allegations is another new QC system requirement by SQCS No. 7. Firms may consider requesting its insurance agent to review the firm's policies and procedures for complaints and allegations.

Considerations Relating to Developing Engagement Monitoring Procedures. Before the firm begins developing its monitoring QC procedures, a decision needs to be made as to how the firm intends to accomplish the monitoring function as it relates to the performance of engagement monitoring. The type of engagement monitoring chosen will impact the timing of when the related monitoring procedures will be performed. For example, will the firm use a combination of engagement quality control review (based on the criteria established by the firm) and inspection of selected engagements at a specific time of year to accomplish its engagement monitoring? Will the firm perform administrative and other monitoring procedures at the same time the inspection is performed, or will it perform those monitoring activities at a different time of the year? Also, firms may alter the types of engagement monitoring activities performed from one year to the next until they obtain the combination that seems most efficient and effective for the firm.

HOW TO EVALUATE THE OVERALL ADEQUACY OF THE QUALITY CONTROL SYSTEM'S DESIGN

The ideas, recommendations, and suggestions presented in this lesson for designing and documenting the monitoring component of the QC system should allow the firm to design a sound, practical QC system that meets its needs. However, the ultimate responsibility for the effectiveness of the system, of course, rests with the firm.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

41. Which of the following monitoring activities is most likely to reveal engagements with deficiencies?

    a. Engagement quality control review.

    b. Postissuance review.

    c. Inspection.

42. Which of the following factors generally will result in engagement inspections being conducted less frequently?

    a. An increase in the number of partners who perform accounting and attestation service engagements.

    b. An increase in the types of engagements performed and industries served by the firm.

    c. An increase in the level of in-house expertise in a variety of areas.

43. Which of the following statements is accurate regarding procedures the firm should address when establishing monitoring procedures?

    a. Policies and procedures should include periodic consideration/evaluation of the firm's system of quality control.

    b. The firm should address administrative procedures when developing a compliant monitoring process.

44. The firm's guidance materials (work programs, checklists, forms, etc.) are an important part of its quality control system. Which of the following is recommended regarding guidance materials?

    a. Firms should develop their own materials whenever possible.

    b. Firms may either develop their own materials or purchase them from third-party providers.

45. Which of the following statements is accurate regarding the retention of monitoring documentation?

    a. According to SQCS No. 7 (QC 10.127), firms should retain QC system documentation for a period of time not less than one year.

    b. Laws or regulations do not address the retention of monitoring documentation. This subject is addressed in SQCS No. 7 (QC 10.127).

    c. Firms that prepare a separate monitoring report should subsequently discard completed monitoring checklists to preclude confusion.

    d. Engagement checklists used when performing engagement review do not need to be retained.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

41. Which of the following monitoring activities is most likely to reveal engagements with deficiencies? **(Page 137)**

    a. Engagement quality control review. [This answer is incorrect. Engagement quality control review (EQCR) is considered an engagement monitoring procedure and concentrates on reviewing documentation related to client engagements, for example, client financial statements as indicated in SQCS No. 7 (QC 10.100). It would not be the most likely monitoring activity to reveal deficiencies in an engagement.]

    b. Postissuance review. [This answer is incorrect. Postissuance reviews are not specifically defined by SQCS No. 7. Postissuance reviews of engagement documentation, reports, and clients' financial statements for selected engagements are considered an engagement monitoring procedure dealing with, among other things, engagement documentation and the related reports issued and generally is more involved than an EQCR since EQCRs require only selected engagement documentation related to significant findings. Although postissuance reviews are a significant part of the firm's monitoring process, they are not the most likely to reveal engagements with deficiencies.]

    c. Inspection. [This answer is correct. Inspection is defined by SQCS No. 7 (QC 10.05) as "a retrospective evaluation of the adequacy of the firm's quality control policies and procedures, its personnel's understanding of those policies and procedures and the extent of the firm's compliance with them. Inspection is an element of monitoring." Inspections involve the selection of individual engagements and may be selected without prior notification to the engagement team. As a result, engagements with deficiencies are more likely to be discovered since the engagement partner will not have an opportunity to review documentation prior to the inspection.]

42. Which of the following factors generally will result in engagement inspections being conducted less frequently? **(Page 138)**

    a. An increase in the number of partners who perform accounting and attestation service engagements. [This answer is incorrect. The greater the number of partners who perform such engagements, the greater the number of accounting and attestation engagements that may be monitored in order to maintain the effectiveness of the firm's system of quality control to comply with SQCS No. 7.]

    b. An increase in the types of engagements performed and industries served by the firm. [This answer is incorrect. To maintain the firm's level of quality control, they may change the inspection cycle to regularly monitor each type of engagement and specialized industries handled by each partner thus increasing the frequency of engagement inspections.]

    c. An increase in the level of in-house expertise in a variety of areas. [This answer is correct. As the firm develops a higher level of in-house expertise in multiple areas, the fewer engagements the firm may need to select for inspection due to the elevated experience level of its members. This generally results in fewer inspections deemed necessary in order to maintain an effective system of quality control.]

43. Which of the following statements is accurate regarding procedures the firm should address when establishing monitoring procedures? **(Page 142)**

    a. Policies and procedures should include periodic consideration/evaluation of the firm's system of quality control. [This answer is incorrect. Policies and procedures should include an ongoing consideration and evaluation of the firm's system of quality control. This is necessary to confirm that the system has been designed appropriately and is operating effectively.]

    b. The firm should address administrative procedures when developing a compliant monitoring process. [This answer is correct. In addition to engagement monitoring procedures, administrative and other monitoring procedures are also important components of monitoring in order for the firm's monitoring process to be compliant with SQCS No. 7 and to effectively evaluate the firm's entire system of quality control.]

44. The firm's guidance materials (work programs, checklists, forms, etc.) are an important part of its quality control system. Which of the following is recommended regarding guidance materials? **(Page 146)**

    a. Firms should develop their own materials whenever possible. [This answer is incorrect. Firms may develop their own materials. However, they may also purchase such materials from third-party providers since third-party materials generally are just as reliable as the firm's own materials would be.]

    b. Firms may either develop their own materials or purchase them from third-party providers. [This answer is correct. Since materials from third-party providers often undergo peer review by an independent third party, their materials also provide reasonable assurance of their appropriateness in the same way the firm's own materials would provide.]

45. Which of the following statements is accurate regarding the retention of monitoring documentation? **(Page 150)**

    a. According to SQCS No. 7 (QC 10.127), firms should retain QC system documentation for a period of time not less than one year. [This answer is incorrect. Firms should retain QC system documentation for a time sufficient to allow those monitoring the QC system, including peer reviewers, to evaluate the firm's compliance with its system.]

    b. Laws or regulations do not address the retention of monitoring documentation. This subject is addressed in SQCS No. 7 (QC 10.127). [This answer is incorrect. Requirements covering the length of time monitoring documentation must be retained are often times stipulated by law or regulation.]

    c. Firms that prepare a separate monitoring report should subsequently discard completed monitoring checklists to preclude confusion. [This answer is incorrect. Firms may elect to retain completed monitoring checklists, even in cases where they prepare a separate monitoring report because the checklists can be helpful when performing the next year's monitoring.]

    d. Engagement checklists used when performing engagement review do not need to be retained. [This answer is correct. Engagement checklists used when performing engagement reviews do not need to be retained due to the fact that engagement-specific checklists can be subpoenaed as discoverable evidence in litigation. Generally, such checklists should be destroyed as soon as they are no longer needed for the monitoring process.]

EXAMINATION FOR CPE CREDIT

Lesson 4 (GCRTG101)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

41. Unlike engagement inspections, postissuance engagement reviews are assumed to be performed at which of the following intervals?

    a. Quarterly.

    b. At designated times during the year.

    c. Annually.

    d. On an ongoing basis.

42. As indicated in SQCS No. 7 (QC 10.110), detecting noncompliance with policies and procedures in a small firm is more likely to occur using which of the following?

    a. Self-inspection.

    b. Outside inspection.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

43. For a typical engagement, a firm generally should devote how many of its members to the monitoring team?

    a. Approximately 7 to 10.

    b. Approximately 10 to 20.

    c. Up to 10% of the firm's practice.

    d. Depends primarily on firm's size and complexity.

44. Jackie is in the process of establishing engagement monitoring procedures on behalf of her firm. What should be her primary objective in establishing these procedures?

    a. Identifying the misuse of practice aids.

    b. Identifying errors in engagement performance.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

45. SQCS No. 7 requires which of the following related to monitoring documentation?

    a. A detailed description of the appearance (format) of monitoring documentation.

    b. Detailed information regarding the information that monitoring documentation should include.

    c. Both the format and content required of monitoring documentation.

    d. The firm has complete discretion regarding both the format and content of monitoring documentation.

GLOSSARY

Accounting and auditing practice: A practice that performs audit, attestation, compilation, review, and any other services for which standards have been established by the AICPA Auditing Standards Board or the AICPA Accounting and Review Services Committee under Rules 201 or 202 of the AICPA Code of Professional Conduct.

Alternative practice structure: A nontraditional structure in which nonattest services are performed under public or private partnership and attest services are performed through a separate firm owned and controlled by a member.

Attestation: An engagement in which a practitioner is hired to issue written communication that expresses a conclusion about the reliability of written assertions prepared by a separate party.

Compilation engagement: Presentation of financial statement information by the entity without the accountant's assurance as to conformity with generally accepted accounting principles (GAAP). In performing this accounting service, the accountant must conform to the American Institute of Certified Public Accountants (AICPA) Statements on Standards for Accounting and Review Services (SSARS). For guidance on issues not covered therein, reference should be made to the Statements of Auditing Standards. The engagement letter should set forth the type of services to be rendered, limitations of the service (such as nonreliance to disclose errors and irregularities), and nature of the compilation report.

Engagement partner: An individual responsible for supervising engagements, signing or authorizing an individual to sign the report on such engagements, and who, where required, has the appropriate authority from a professional, legal or regulatory body. Firms may use different titles to refer to individuals with this authority.

Human resources: This QC element is designed to provide reasonable assurance that the firm has sufficient personnel with the capabilities, competence, and commitment to ethical principles to (1) perform engagements in accordance with professional standards and legal and regulatory requirements, and (2) enable the firm to issue reports that are appropriate in the circumstances.

Independence: Condition of accountant having no bias and being neutral regarding the client or another party in performing the audit function. Some independence guidelines for an auditor engaged in the attest function include (1) no family relationship with the client's executives; (2) no financial interest in the company; and (3) no contingent fee based on the type of audit opinion rendered.

Leadership: This QC element is designed to provide reasonable assurance that the firm has policies and procedures to promote an internal culture that is based on the recognition that quality is essential in performing engagements.

Management style: Firms with a formal management style generally have more structured policies and procedures (usually in written form), performance indicators, etc. An organization with an informal management style may communicate using personal contact with supervisors and managers instead of via written policies and procedures.

Partner: An individual with authority to bind the firm with respect to the performance of a professional services engagement. For purposes of this definition, partner may include an employee with this authority who has not assumed the risks and benefits of ownership. Firms may use different titles to refer to individuals with this authority.

Personnel: All individuals who perform professional services for which the firm is responsible, whether or not they are CPAs.

Professional development: Too often professional development is thought of only in terms of continuing professional education (CPE). However, the QC standards cover all activities that enable a firm to provide personnel with the knowledge and capability needed to fulfill their assigned responsibilities and to progress within the firm. While CPE is a significant component of professional development, keeping up-to-date with changes in professional standards and on-the-job training are also important components of a well-designed professional development QC system.

Qualified external person: An individual outside the firm with the capabilities and competence to act as an engagement partner.

Quality control document: The written form of the quality control system consisting of documented policies and procedures and the related forms, checklists, etc., that support those policies and procedures.

Quality control elements: SQCS No. 7 states that the firm's system of quality control should incorporate policies and procedures that address each of the following QC elements: (1) leadership responsibilities for quality within the firm (tone at the top), (2) relevant ethical requirements, (3) acceptance and continuance of client relationships and specific engagements, (4) human resources, (5) engagement performance, and (6) monitoring.

Quality control system: A system designed to provide the firm with reasonable assurance that the firm is (1) complying with professional standards and legal and regulatory requirements and (2) issuing reports that are appropriate in the circumstances.

Peer review: A review of a firm's accounting and auditing practice (which may vary in scope, purpose, nature, and procedures) by peers, that is, an independent CPA or CPAs with experience and expertise in practice areas similar to those of the firm being reviewed. The peer review process focuses on the professional aspects of the reviewed firm's accounting and auditing practice and not on the firm's business aspects.

Practice monitoring: Practice monitoring programs are intended to reduce substandard performance by CPA firms in their delivery of accounting and auditing services. This is being accomplished by periodic peer review of firms' quality control systems. Firms with partners or employees who are members of the AICPA and that are engaged in the practice of public accounting must be enrolled in an AICPA practice-monitoring program. This practice monitoring requirement is applicable to firms that provide compilation, review, audit, or attestation services and requires those firms to undergo a peer review at least once every three years.

Staff: Personnel, other than partners and engagement partners, including any specialists who are employees of the firm.

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Companion to PPC's Guide to Quality Control–Compilation and Review—Ethical Requirements, Client Relationships, Engagement Performance, and Monitoring (GCRTG101)

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