

SELF-STUDY CONTINUING PROFESSIONAL EDUCATION

Companion to PPC's Guide to

Quality Control



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Interactive Self-study CPE
Companion to PPC’s Guide to Quality Control

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INTRODUCTION

Companion to PPC's Guide to Quality Control Consists of two interactive self-study CPE courses. These are companion courses to PPC's Guide to Quality Control 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 **March 31, 2011**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit Answer Sheet.

Taking the Courses

Each course is divided into lessons. Each lesson addresses an aspect of quality control for a CPA firm. 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.

Obtaining CPE Credit

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.

Print Grading. You can receive CPE credit by mailing or faxing your completed Examination for CPE Credit Answer Sheet to the Tax & Accounting business of Thomson Reuters for grading. Answer sheets are located at the end of all course materials. Answer sheets may be printed from electronic products. The answer sheet is identified with the course acronym. Please ensure you use the correct answer sheet for each course. Payment of \$79 (by check or credit card) must accompany each answer sheet submitted. We cannot process answer sheets that do not include payment. Please take a few minutes to complete the Course Evaluation so that we can provide you with the best possible CPE.

You may fax your completed **Examination for CPE Credit Answer Sheet** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

If more than one person wants to complete this self-study course, each person should complete a separate **Examination for CPE Credit Answer Sheet**. Payment of \$79 must accompany each answer sheet submitted. We would also appreciate a separate **Course Evaluation** from each person who completes an examination.

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COMPANION TO PPC'S GUIDE TO QUALITY CONTROL**COURSE 1****Engagement Performance and Monitoring (GQCTG101)****OVERVIEW**

COURSE DESCRIPTION: This interactive self-study course discusses the engagement performance and monitoring elements of SQCS No. 7. Lesson 1 details the authoritative guidance requirements, maintenance of engagement documentation, establishing criteria for engagement quality control reviews, assessing the adequacy of the system's design, and monitoring compliance with the firm's policies and procedures. Lesson 2 covers the monitoring element of SQCS No. 7. Various types of monitoring activities and requirements are presented, as well as addressing complaints and allegations. Both lessons cover drafting policies and procedures that can be included in a firm's QC system.

PUBLICATION/REVISION DATE: March 2010

RECOMMENDED FOR: Users of PPC's Guide to Quality Control

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of compilation and review engagements and audit and attestation engagements.

CPE CREDIT: 7 QAS Hours, 7 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 **March 31, 2011**

KNOWLEDGE LEVEL: Basic

Learning Objectives:**Lesson 1—Engagement Performance**

Completion of this lesson will enable you to:

- List the aspects of engagement performance, supervision, and review requirements.
- Determine how to maintain engagement documentation to ensure the engagement quality.
- Recognize when to consult with others and how to document differences of opinion.
- Identify the requirements of an engagement quality control review.
- Identify key issues in drafting the firm's QC policies and procedures.
- Evaluate the overall adequacy of the quality control system's design, and monitor compliance with the firm's engagement performance policies and procedures.

Lesson 2—Monitoring

Completion of this lesson will enable you to:

- Identify the various types of monitoring.
- Illustrate how to perform monitoring procedures, evaluate and communicate the results, and document the monitoring procedures.

- List the various types of complaints and explain how to address the complaints and allegations.
- Identify key issues related to drafting monitoring policies and procedures.

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
GQCTG101 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: Engagement Performance

INTRODUCTION

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. 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 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.

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. Additionally, the ASB issued the exposure draft, *Quality Control for an Audit of Financial Statements*, which would supersede SAS No. 25, *The Relationship of Generally Accepted Auditing Standards to Quality Control Standards*.

Those two standards are being redrafted to apply the ASB's clarity drafting conventions and to converge with the international standards ISQC 1 and ISA 220. 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 SAS is expected to be effective for audits of financial statements for periods beginning on or after December 15, 2010. The proposed SQCS does not change or expand SQCS No. 7 in any significant respect. However, changes affecting the engagement performance QC element deemed more than minor by the authors that are expected to result from the proposed SQCS and SAS have been discussed where applicable throughout this lesson. Finalized standards are not expected to be issued prior to this course going to press. Accordingly, expanded discussion of the finalized standards will be incorporated in the next edition of this course.

Learning Objectives:

Completion of this lesson will enable you to:

- List the aspects of engagement performance, supervision, and review requirements.
- Determine how to maintain engagement documentation to ensure the engagement quality.
- Recognize when to consult with others and how to document differences of opinion.
- Identify the requirements of an engagement quality control review.
- Identify key issues in drafting the firm's QC policies and procedures.
- Evaluate the overall adequacy of the quality control system's design, and monitor compliance with the firm's engagement performance policies and procedures.

ENGAGEMENT PERFORMANCE, SUPERVISION, AND REVIEW REQUIREMENTS

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 and auditing engagements and needs to interface with the accounting and auditing 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, auditing, 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 lesson.

SQCS Requirements

SQCS No. 7 (QC 10.58) indicates that effective policies and procedures will 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 the following:

- 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 type 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 responsibility policies and procedures, 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 considerations such as the following 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

As discussed earlier in this lesson, the ASB has issued two exposure drafts that would supersede SQCS No. 7 and SAS No. 25.

Proposed SQCS. 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 changes 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 experience 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.

Proposed SAS. The proposed SAS indicates that the audit engagement partner—

- Should take responsibility for the direction, supervision, and performance of the audit engagement.
- Should take responsibility for reviews performed in accordance with the firm's review policies and procedures.
- On or before the date of the auditor's report, should be satisfied that sufficient appropriate audit evidence has been gathered to support the conclusions reached and the auditor's report to be issued.

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 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 is expected to 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 section 201.01C) states: "Adequately plan and supervise the performance of professional services." Although Statement on Auditing Standards No. 22 (AU Section 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 section 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 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 nonpublic entity?

Interpretation—No. *Statements on Auditing Standards* do not govern engagements to compile or review financial statements of a nonpublic entity. 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–.10) 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 also includes 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.

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 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 100.28–.34) 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 also includes 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.

Review Documentation Requirements. SSARS No. 1 (AR 100.35–.38) states that the following need to 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 effective for compilations and reviews of financial statements for periods ending on or after December 15, 2010. The following discusses how SSARS No. 19 changes the performance and documentation requirements once the new standard is effective.

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

- The understanding established with the entity is to be documented by using a written, signed engagement letter. The information required in that understanding is expanded.
- Documenting any findings or issues that, in the accountant's judgment, are significant, whether consultation occurred or not. Documentation includes disposition of the matter.

601.20Effect on Review Engagements. In addition to the performance and documentation requirements, SSARS No. 19 makes the following additional performance and documentation 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.

- 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.

Audit Requirements

The audit requirements relating to engagement performance are too numerous to describe individually. As a result, many firms use a *bridging document* to summarize the procedures to be performed in every audit. However, the following paragraphs describe a few of the important new auditing standards that can significantly impact the firm's engagement performance QC element.

SAS No. 115. SAS No. 115, *Communicating Internal Control Related Matters Identified in an Audit*, supersedes SAS No. 112, of the same name, and was issued to align the definitions of the various kinds of deficiencies in internal control and the related guidance for evaluating such deficiencies with the definitions and guidance in PCAOB Auditing Std. No. 5. In addition to changes in terminology and definitions, the internal control communication letters of SAS No. 112 were modified in SAS No. 115 to incorporate the new definitions and add a statement about the auditor's responsibility for identifying control deficiencies in an audit.

Consistent with PCAOB Auditing Std. No. 5, SAS No. 115 defines deficiencies in internal control as follows:

- **Material Weakness**—A deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented or detected and corrected on a timely basis.
- **Significant Deficiency**—A deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

The substance of the material weakness definition in SAS No. 112 and SAS No. 115 are essentially the same; however, significant deficiencies are defined more broadly in SAS No. 115 than in SAS No. 112. SAS No. 115 is effective for audits of financial statements for periods ending on or after December 15, 2009, with early implementation allowed.

SAS No. 116. SAS No. 116, *Interim Financial Information*, was issued to accommodate reviews of interim financial information of nonissuers. The SAS is effective for reviews of interim periods beginning after December 15, 2009, with early application permitted. There are a number of specific conditions that should be met for SAS No. 116 to apply to interim financial information. Those conditions include that the latest annual financial statements were audited, the same accountant expects to be engaged to perform the next year's financial statement audit, and the interim financial statements will be prepared on the same basis of accounting as the annual financial statements. There are additional conditions that apply if the interim financial information is condensed. If the preceding conditions are not met, then SSARS apply to the review of the interim financial information. SSARS No. 18, *Applicability of Statements on Standards for Accounting and Review Services*, was issued to clarify whether the SAS or SSARS apply to reviews of interim financial information. SSARS No. 18 is effective concurrently with SAS No. 116.

SAS No. 117. SAS No. 117, *Compliance Audits*, was issued to address the application of generally accepted auditing standards to a compliance audit performed in conjunction with a financial statement audit. SAS No. 117 will supersede SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*. SAS No. 117 is effective for compliance audits for periods ending on or after June 15, 2010, and early application is permitted. SAS No. 117 (a) clarifies applicability of the standard, (b) revises terminology and guidance for changes in the compliance audit environment, (c) establishes specific requirements for auditors to follow, and (d) identifies required elements of an auditor's report on compliance.

Can the Auditor Draft the Financial Statements? AICPA staff have indicated that some auditors may be misunderstanding important concepts underlying SAS No. 112. Among these misunderstandings is the belief that the auditor's drafting of the financial statements automatically results in a material weakness. Asking the auditor to draft

the financial statements does not cause a control deficiency. However, it may be the result of a control deficiency. The intent of SAS No. 112 is not to prevent auditors from drafting the client's financial statements. Instead, the issue to be considered when determining if a significant deficiency or material weakness exists is whether the client is capable of preparing the financial statements and has the skills and competencies necessary to prevent, detect, and correct a material misstatement.

A system of internal control over financial reporting does not stop at the general ledger. It includes controls over financial statement preparation, including note disclosures. A control deficiency exists when the client does not have controls over preparation of the financial statements which would prevent or detect a misstatement in the financial statements. If the client is not capable of drafting the financial statements and lacks the skills and competencies to prevent, detect, and correct a misstatement, the client has a control deficiency that is probably a material weakness. The auditor can still prepare the financial statements but the material weakness must be communicated to management and those charged with governance. The fact that the auditor drafts the financial statements may mean they are correct, but it does not eliminate the control deficiency.

Stated another way, an auditor cannot be considered part of the client's internal control. Thus, controls over the financial statement preparation function that exist in the auditor's firm cannot be considered. Only controls that the client has in place can be considered in determining whether there is a control deficiency and its severity. (However, a CPA firm other than the auditor's firm can be part of the client's internal control, and those controls could be considered.)

Audit Documentation Requirements. In the last few years, documentation has become an increasingly important aspect of engagement performance, particularly with respect to audit engagements. SAS No. 103 (AU 339), *Audit Documentation*, states, among other things, that auditors must document significant audit findings and provide other documentation requirements when certain types of tests are performed. AU 339.03 states that audit documentation provides the principal support for (a) the representation in the auditor's report that the auditor performed the audit in accordance with generally accepted auditing standards, and (b) the opinion expressed regarding the financial information or the assertion to the effect that an opinion cannot be expressed. Audit documentation has become an integral component of engagement performance.

In addition to the objectives detailed in the preceding paragraph, SAS No. 103 (AU 339.08) provides a list of other purposes for audit documentation, including—

- Assisting the audit team to plan and perform the audit.
- Assisting auditors who are new to an engagement and reviewing the prior year's documentation to understand the work performed as an aid in planning and performing the current engagement.
- Assisting members of the audit team responsible for supervision to direct and supervise the audit work and to review the quality of work performed.
- Demonstrating the accountability of the audit team for its work by documenting the procedures performed, the audit evidence examined, and the conclusions reached.
- Retaining a record of matters of continuing significance to future audits of the same entity.
- Assisting quality control reviewers who review documentation to understand how the engagement team reached significant conclusions and whether there is adequate evidential support for those conclusions.
- Enabling an experienced auditor to conduct inspections or peer reviews in accordance with applicable legal, regulatory, or other requirements.
- Assisting a successor auditor who reviews a predecessor auditor's audit documentation.

Beginning at AU 339.10, SAS No. 103 details the requirements for documenting audit engagement performance. Also, Appendix A to SAS No. 103 provides a listing of audit documentation requirements located in other SASs.

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 the firm is engaged to issue or does issue an examination, 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 need to 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 the following (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 the following (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).
- Indicating that the process by which the entity developed its prospective financial statements was considered in determining the scope of the examination (specifically required for examinations of prospective financial statements) (AT 101.101).
- 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, 401, 601, and 701 of SSAE No. 10 may include additional engagement performance and documentation requirements for specific types of attestation engagements.

SSAE No. 15. SSAE No. 15 (AT 501), *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of its Financial Statements*, establishes standards and provides guidance to firms performing an examination of a nonissuer's internal control over financial reporting that is performed as an integrated audit (an audit of an entity's financial statements and an examination of its internal control). SSAE No. 15 superseded SSAE No. 10 (AT 501, *Reporting on an Entity's Internal Control Over Financial Reporting*) for integrated audits of periods ending on or after December 15, 2008.

SSAE No. 15 revised AT 501 to:

- Make AT 501 applicable only to an examination of the design and operating effectiveness of an entity's internal control over financial reporting that is integrated with an audit of the entity's financial statements.
- Revise the definitions of the terms *significant deficiency* and *material weakness* to conform to the definitions in PCAOB AS 5.
- Introduce the concept of a top-down approach for identifying important controls to test.
- Incorporate fraud risk assessment into the planning process for the examination of internal control.
- Expand performance requirements.
- Provide an illustrative written communication to management and those charged with governance of any significant deficiencies and material weaknesses identified during the integrated audit.
- Not permit the expression of a qualified opinion on the entity's internal control over financial reporting.

The authors have expanded the illustrative audit bridging document at Exhibit 6-7 and GQC-PA-11.2 to include the engagement performance quality control steps for an examination of internal control (AT 501) that is integrated with an audit of the entity's financial statements (integrated audit). This type of engagement is included on the audit bridging document since it is performed in conjunction with an audit of financial statements.

Other Considerations

Cover All Types of Accounting and Auditing Engagements. Engagement performance policies and procedures need to be developed for compilation, review, audit, 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 must 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, many 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 1-1

**Relationship of Engagement Performance to Other QC Elements
(Audit 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			Yes	Yes		2. Communicate the partner’s identity and role to the client.
		Yes		Yes		3. Obtain an engagement letter.
Yes			Yes	Yes		4. Assign staff based on capabilities, competence, and availability.
				Yes		5. Develop an overall audit strategy and obtain background information about the entity, officers, accounting practices, etc.
				Yes		6. Perform risk assessment procedures to obtain an understanding of the entity and its environment, including internal control.
				Yes		7. Perform preliminary analytical procedures.
				Yes		8. Evaluate and document materiality and tolerable misstatement.
				Yes		9. Consider potential fraud implications.
				Yes		10. Identify and assess risks of material misstatement and develop responses to identified risks.
				Yes		11. Prepare an audit plan.
			Opt ^a	Opt ^a		12. Develop a time estimate.
	Yes		Yes	Yes		13. Obtain partner approval of audit plan and staff assignments, and, if applicable, time estimates.
				Yes		14. Perform and document further audit procedures.
			Yes	Yes		15. Supervise procedures (including work of other auditors).
Yes			Yes	Yes		16. Obtain consultation when appropriate and document and implement conclusions.
Yes			Yes	Yes		17. Resolve any differences of opinion and document and implement conclusions.
	Yes			Yes		18. Assist in drafting the financial statements.
				Yes		19. Perform final analytical review.
				Yes		20. Complete a presentation and disclosure checklist and read the financial statements.
				Yes		21. Obtain legal representation letters.
				Yes		22. Obtain a management representation letter.
Yes			Yes	Yes	Yes	23. Review the workpapers.
				Yes		24. Evaluate and conclude on the effect of audit differences.
				Yes		25. Consider and document changes from the audit strategy, planning materiality, or audit plan.
Yes	Yes			Yes		26. Draft the report.
Yes	Yes		Yes	Yes	Yes	27. Obtain an engagement quality control review, if required by firm policy.
				Yes		28. Prepare required client communications.
				Yes		29. Determine that all review points and open items have been cleared.

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		30. Have the partner sign the report or transmittal letter.
Yes			Yes	Yes		31. Evaluate the staff's performance.
	Yes			Yes		32. Maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of the workpapers.
				Yes	Yes	33. Assemble and retain the workpapers for a sufficient period of time (subject to monitoring review).

Note:

^a Opt—Optional.

* * *

The engagement performance system for audits in Exhibit 1-1 is typical of that used by local firms. 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 must 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 and Auditing Manuals. Most firms have some type of engagement performance system. Occasionally, these systems are comprised of accounting and auditing manuals including practice aids such as checklists, programs, confirmation letters, etc., accumulated from various sources. Many firms also adopt audit and accounting manuals purchased from other publishers or firms. The engagement performance QC policies and procedures the firm adopts for its quality control system need to interface with those found in its manuals and practice aids, whether developed internally, purchased by the firm, or a combination of the two.

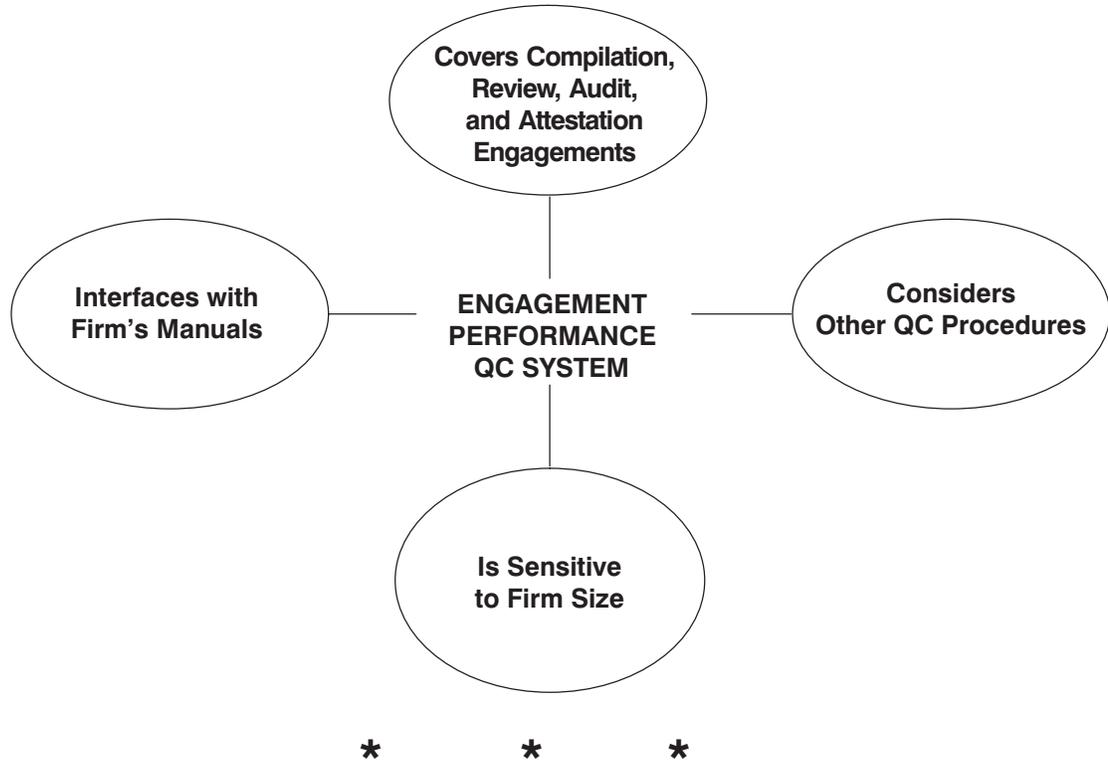
Consider Firm Size. Many of the examples of engagement performance systems found in QC literature or in accounting and auditing manuals are designed for large firms that need complex systems because of their practice size. Those systems are difficult to adapt to small firms because—

- 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 and some audits take fewer than 100 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 1-2 summarizes the considerations discussed in this lesson.

Exhibit 1-2

Design Considerations for an Engagement Performance QC System



SELF-STUDY QUIZ

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

1. What should be considered in designing an effective engagement performance component of the quality control system?
 - a. The nature of the firm's engagements and the size of the firm.
 - b. Whether the nature, timing, and extent of work to be performed is appropriate.
 - c. The use of software tools and electronic manuals.
 - d. The availability of authoritative guidance.
2. When considering policies and procedures for engagement supervision, which of the following might firms consider under SQCS No. 7?
 - a. The engagement team should be briefed to obtain an understanding of the objectives of their work.
 - b. Consultations are appropriately documented and concluded.
 - c. The capabilities and competency of the team members.
 - d. The nature, timing, and extent of work performed are appropriate.
3. Nick is performing a compilation engagement. SSARS No. 1 (AR 100) does not provide specific guidance on how to plan and supervise the engagement, but the guidance he found in the auditing literature under SAS No. 22 (AU 311) outlined that he must "adequately plan and supervise the performance of professional services." In connection with this information, which of the following procedures is Nick required to perform?
 - a. Determine if other accounting services are necessary.
 - b. Apply analytical procedures to the financial statements.
 - c. Inquire of members of management regarding unusual or complex transactions.
 - d. Obtain a management representation letter.
4. According to the AICPA, some auditors have a misunderstanding regarding evaluating a client's internal control as it applies to the drafting of financial statements. Which of the following statements is correct regarding this issue?
 - a. When an auditor drafts a financial statement, it automatically results in a material weakness.
 - b. Controls at the auditor's firm cannot be considered when evaluating a client's internal controls over the financial statement preparation function.
 - c. Once the auditor drafts the financial statements, the control deficiency is usually eliminated.
 - d. When a client is not capable of drafting the financial statements, the auditor should assume that the client also lacks the skills and competencies to prevent, detect and correct misstatements of its financial statements, and should withdraw from the engagement.

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. What should be considered in designing an effective engagement performance component of the quality control system? **(Page 3)**
 - a. **The nature of the firm's engagements and the size of the firm. [This answer is correct. The recommended way of designing an effective engagement performance component of the quality control system is to base it on the nature of the firm's engagements and the size of the firm since the engagement performance component of the quality control system must be flexible enough to address all types of engagements performed by the firm.]**
 - b. Whether the nature, timing, and extent of work to be performed is appropriate. [This answer is incorrect. The nature, timing, and extent of work performed should be considered when performing a review of the work performed by other engagement team members. It is not the focus when designing a quality control system.]
 - c. The use of software tools and electronic manuals. [This answer is incorrect. Using effective policies and procedures will facilitate consistency in the quality of engagement performance. This can be achieved by using written or electronic manuals, software tools, or other forms of standardized documentation. However, this is not considered an effective way to design the engagement performance component of the quality control system.]
 - d. The availability of authoritative guidance. [This answer is incorrect. Authoritative Guidance, such as that issued by the Auditing Standards Board and the Accounting Review and Services Committee can be used to tailor a firm's policies and procedures regarding its quality control system. A firm's access to these resources is not a consideration of a quality control system.]
2. When considering policies and procedures for engagement supervision, which of the following might firms consider under SQCS No. 7? **(Page 4)**
 - a. The engagement team should be briefed to obtain an understanding of the objectives of their work. [This answer is incorrect. Obtaining an understanding of the objectives of work is an example of a firm's policies regarding consistency.]
 - b. Consultations are appropriately documented and concluded. [This answer is incorrect. Documentation of consultations is an example of a consideration of review.]
 - c. **The capabilities and competency of the team members. [This answer is correct. SQCS No. 7 states that firms might consider the capabilities and competence of individual engagement team members when determining policies and procedures associated with engagement supervision.]**
 - d. The nature, timing, and extent of work performed are appropriate. [This answer is incorrect. When performing review, the nature, timing, and extent of work performed should be considered; however, it is not an example of appropriate policies and procedures for supervision.]

3. Nick is performing a compilation engagement. SSARS No. 1 (AR 100) does not provide specific guidance on how to plan and supervise the engagement, but the guidance he found in the auditing literature under SAS No. 22 (AU 311) outlined that he must "adequately plan and supervise the performance of professional services." In connection with this information, which of the following procedures is Nick required to perform? **(Page 6)**
- a. **Determine if other accounting services are necessary. [This answer is correct. SSARS No. 1 (AR 100) requires Nick 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.]**
 - b. Apply analytical procedures to the financial statements. [This answer is incorrect. SSARS No. 1 (AR 100) requires Nick to apply analytical procedures to the financial statements including developing expectations and comparing recorded amounts to those expectations in review engagements.]
 - c. Inquire of members of management regarding unusual or complex transactions. [This answer is incorrect. Inquiring about unusual or complex transactions is required by SSARS No. 1 (AR 100) for a review engagement. Another inquiry would be regarding the status of uncorrected misstatements identified during the previous engagement.]
 - d. Obtain a management representation letter. [This answer is incorrect. Nick would be required to obtain a management representation letter in a review engagement, not a compilation engagement.]
4. According to the AICPA, some auditors have a misunderstanding regarding evaluating a client's internal control as it applies to the drafting of financial statements. Which of the following statements is correct regarding this issue? **(Page 10)**
- a. When an auditor drafts a financial statement, it automatically results in a material weakness. [This answer is incorrect. SAS No. 112's position is not to prevent auditors from drafting a client's financial statement, but to determine if a significant deficiency or material weakness exists by evaluating whether the client is capable of preparing the financial statements and possesses the skills and competencies necessary to prevent, detect, and correct a material misstatement.]
 - b. **Controls at the auditor's firm cannot be considered when evaluating a client's internal controls over the financial statement preparation function. [This answer is correct. An auditor cannot be considered part of the client's internal control. Thus, controls over the financial statement preparation function that exist in the auditor's firm cannot be considered. Only controls that the client has in place can be considered when determining if there is a control deficiency and its severity, including preparation by a CPA firm other than the auditor's firm.]**
 - c. Once the auditor drafts the financial statements, the control deficiency is usually eliminated. [This answer is incorrect. The auditor can still prepare the financial statements; however, any material weakness must be communicated to management and those charged with governance. The fact that the auditor drafts the financial statements may mean they are correct, but it does not eliminate the control deficiency.]
 - d. When a client is not capable of drafting the financial statements, the auditor should assume that the client also lacks the skills and competencies to prevent, detect and correct misstatements of its financial statements, and should withdraw from the engagement. [This answer is incorrect. Even when clients lack the skills prepare them, but must communicate a material weakness to those charged with governance.]

MAINTAINING 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 need to 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. As explained earlier in this lesson, 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.

Audit Requirements. SAS No. 103, *Audit Documentation*, established requirements and restrictions for assembling and completing an audit engagement file and making changes to the engagement workpapers. SAS No. 103 stipulates the final assembly and completion of the audit engagement file should occur within 60 days of the date that the auditor gives the client permission to use the auditor's report. SAS No. 103 refers to the date that workpapers are complete as the *documentation completion date*. Practitioners may adopt documentation completion periods that are shorter than 60 days, either on an engagement-by-engagement basis or as part of the firm's policy of quality control. In addition, practitioners need to consider whether there are regulatory or state requirements that require a shorter documentation completion period.

Compilation and Review Requirements. No specific documentation assembly requirements exist in the SSARS. As a result, the new engagement documentation assembly requirements of SQCS No. 7 impose such requirements for the first time 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 might—

- 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 address the retention of audit workpapers and 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 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.

Audit Requirements. Auditing standards include specific engagement documentation retention requirements. SAS No. 103 specifically indicates that the retention period for audit engagement documentation is not shorter than five years from the report release date. In determining appropriate document retention periods for the firm's engagement documentation, the firm may consider the nature of the engagement and the firm's unique circumstances.

[The SQCS exposure draft adds new guidance to the proposed standard that mirrors the SAS No. 103 engagement documentation retention requirements.]

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.

Proposed SQCS Changes. As explained earlier in this lesson, 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 auditor. 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 court 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.

Additional Audit Requirements. Auditors are required to apply appropriate controls to protect the integrity, retrievability, and accessibility of workpapers. Controls are necessary to safeguard workpapers from unauthorized use or alteration or from becoming lost or damaged. According to SAS No. 103 (AU 339), such controls—

- Enable clear identification of when and by whom documentation was created, changed, or reviewed.
- Ensure the integrity of the information at all stages of the audit. This is critical when the information is shared among the audit team or electronically transmitted to other parties.
- Permit necessary access to the documentation by the audit team or other authorized parties.
- Prevent unauthorized changes to documentation.

In addition, SAS No. 103 (AU 339.30) indicates that after the engagement workpapers are assembled and completed, the auditor must not discard or delete any documentation before the end of the retention period. If changes to the workpapers are necessary to reflect either new audit procedures or conclusions reached, documentation of such changes should include—

- When and by whom the changes were made and reviewed.
- The reasons for the changes.
- The effect of the changes on the auditor's conclusions, if any.

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 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.

5. Which of the following statements regarding how to assemble engagement documentation is most accurate?
 - a. Practitioners should refer to SSARS for specific documentation assembly requirements.
 - b. To ensure engagement quality, the engagement documentation should be completed in a timely manner.
 - c. Assembling documentation related to the engagement as it progresses is less efficient than obtaining all of the information at the end of the engagement and quickly performing procedures associated with that documentation.
 - d. Time limits that are imposed by firms are not relevant, since there are specific guidelines established by professional standards that address the assembly of audit documentation.

6. Ordinarily, engagement documentation cannot be shown outside a firm without the client's permission. Which of the following is considered an exception to engagement documentation confidentiality?
 - a. To defend against a possible claim against the firm.
 - b. When the practitioner's practice is sold.
 - c. When a predecessor communicates with a successor auditor.
 - d. When the practitioner's engagement documentation is electronic.

7. SQCS No. 7 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." All of the following are specific examples of procedures per SQCS No. 7 that firms may choose for engagement documentation retention **except**:
 - a. Access to the engagement documentation during the retention period must be accessible.
 - b. Make the specific engagement documentation accessible for authorized external parties for quality control or other purposes.
 - c. Once the assembly process is complete, provide a record of any changes made to the engagement documentation.
 - d. Allow the audit team access to the documentation.

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 statements regarding how to assemble engagement documentation is most accurate? **(Page 20)**
- a. Practitioners should refer to SSARS for specific documentation assembly requirements. [This answer is incorrect. No specific documentation assembly requirements exist in the SSARS. As a result, the new engagement documentation assembly requirements of SQCS No. 7 impose such requirements for the first time on accountants performing compilation and review engagements.]
 - b. To ensure engagement quality, the engagement documentation should be completed in a timely manner. [This answer is correct. Timely completion of engagement documentation is important to ensure engagement quality. As a practical matter, firms should strive to prepare engagement documentation as the engagement progresses to avoid inadvertently omitting critical information or incorrectly recording aspects of the procedures that were completed or the evidence obtained.]**
 - c. Assembling documentation related to the engagement as it progresses is less efficient than obtaining all of the information at the end of the engagement and quickly performing procedures associated with that documentation. [This answer is incorrect. It is suggested that assembling documentation related to the engagement as it is received helps the engagement to progress and avoid inadvertently omitting crucial information that may be obtained at the time the documentation is received from the client.]
 - d. Time limits that are imposed by firms are not relevant, since there are specific guidelines established by professional standards that address the assembly of audit documentation. [This answer is incorrect. Firms should consider any relative time constraints established by professional standards or laws or regulations of the states and industries in which they operate.]
6. Ordinarily, engagement documentation cannot be shown outside a firm without the client's permission. Which of the following is considered an exception to engagement documentation confidentiality? **(Page 21)**
- a. To defend against a possible claim against the firm. [This answer is correct. According to Ethics Ruling No. 20 under Rule 301, one example of an exception to engagement documentation confidentiality is when the information is provided solely to assist in the defense against an actual or potential claim against the firm.]**
 - b. When the practitioner's practice is sold. [This answer is incorrect. 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." Even if a practitioner sells their practice to another firm, the auditor should obtain the client's explicit permission before disclosing any confidential client information.]
 - c. When a predecessor communicates with a successor auditor. [This answer is incorrect. The need to maintain confidentiality of an engagement document must be met even if a predecessor communicates with a successor auditor. The predecessor must obtain specific consent.]
 - d. When the practitioner's engagement documentation is electronic. [This answer is incorrect. Regardless of what format engagement documentation exists, controls and policies should be in place to appropriately safeguard it from unauthorized use.]

7. SQCS No. 7 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.” All of the following are specific examples of procedures per SQCS No. 7 that firms may choose for engagement documentation retention **except: (Page 22)**
- a. Access to the engagement documentation during the retention period must be accessible. [This answer is incorrect. SQCS No. 7 provides examples of procedures that firms may adopt for retention of an engagement document. The procedure might 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.]
 - b. Make the specific engagement documentation accessible for authorized external parties for quality control or other purposes. [This answer is incorrect. One example of a procedure that firms may adopt for retention of engagement documentation is to enable authorized external parties to access and review specific engagement documentation for quality control or other purposes.]
 - c. Once the assembly process is complete, provide a record of any changes made to the engagement documentation. [This answer is incorrect. Another example of a procedure that firms may adopt for retention of engagement documentation is to provide a record of any changes made to engagement documentation after the assembly process is complete. Per SAS No. 103 (AU 339.30), if changes to the workpapers are necessary to reflect new audit procedures or conclusions reached, documentation should include who made and who reviewed the changes.]
 - d. **Allow the audit team access to the documentation. [This answer is correct. Controls are necessary to safeguard workpapers from unauthorized use or alteration or from becoming lost or damaged. According to SAS No. 103 (AU 339), an example of such controls is to permit necessary access to the documentation by the audit team or other authorized parties.]**

CONSULTATION AND DIFFERENCES OF OPINION

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

- Consultation takes place when appropriate (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.

Proposed SQCS Changes. As explained earlier in this lesson, 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.
- 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.
- Adding that consultation conclusions should be understood by the individual seeking consultation and the individual providing the consultation.

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 may 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 when an accounting, SSARS, audit, or tax issue is encountered. 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 using such services, the firm needs to evaluate the external provider's qualification for that purpose. (The proposed SQCS standard indicates that considering the competence and capabilities of the external provider helps in determining whether the provider is qualified.)

It is important that the firm's consultation procedures 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. Such complete and detailed documentation helps provide understanding of the results of the consultation, including decisions made, the basis for those decisions, and how the decisions were implemented.

Documentation of consultation includes 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. Larger firms may also need to prepare a list of firm experts or specialists if such information is not common knowledge to all members of the professional staff.

Proposed SAS. As explained earlier in this lesson, the ASB has issued an exposure draft that would supersede SAS No. 25. The proposed SAS places responsibility on the audit engagement partner to ensure that appropriate consultation is undertaken on difficult or contentious matters. Further, the engagement partner should be satisfied that—

- Members of the engagement team have followed consultation policies during the course of the engagement.
- The nature and scope of the consultation is agreed upon with the party consulted.
- The conclusions resulting from such consultations are understood by the party consulted.
- The conclusions resulting from such consultations have been implemented.

The proposed SAS also indicates that the auditor should include in the engagement documentation, the nature and scope of, and conclusions resulting from, consultations occurring during the audit engagement.

Maintaining an Adequate and Up-to-date Reference Library. To help minimize the need for external consultation and resolve differences of opinion, it is important to have easy access to technical resources. Additionally, having adequate and up-to-date technical reference materials may allow professional personnel to resolve some issues more efficiently without the involvement of supervisory personnel. At a minimum, this course recommends that a firm provide all professional personnel with access to adequate and current reference materials, including the following where applicable—

- a. *AICPA Professional Standards.* This service contains all of the AICPA professional standards arranged by topic. It is available in a loose-leaf service from the AICPA, in an electronic format from the AICPA and Thomson Reuters, and in a paperback version published annually by the AICPA. This information is also available online through Checkpoint® at ria.thomson.com. New statements are published in the *Journal of Accountancy* or may be purchased individually from the AICPA.
- 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**. 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. *GASB Accounting Standards—Current Text*. The GASB's *Codification of Governmental Accounting and Financial Reporting Standards* contains all of the governmental accounting standards arranged by topic. It is available in a paperback version published annually by the GASB and in an electronic format from the GASB and Thomson Reuters. This information is also available online through Checkpoint® at **ria.thomson.com**. New statements are published in the *Journal of Accountancy* or may be purchased individually from the GASB.
- d. *GASB Comprehensive Implementation Guide*. The GASB publishes a Comprehensive Implementation Guide annually that includes all previous individually issued implementation guides. The comprehensive guide is updated annually for new standards and is available in a paperback version and in an electronic format from the GASB and Thomson Reuters. This information is also available online through Checkpoint® at **ria.thomsonreuters.com**.
- e. *AICPA Audit and Accounting Guides*. These guides are available in a four-volume loose-leaf service from the AICPA, in an electronic format from the AICPA and Thomson Reuters, and in individual paperback guides from the AICPA. This information is also available online through Checkpoint® at **ria.thomsonreuters.com**. Although most small firms do not need all of these guides, firms should have the loose-leaf or electronic format service or at least one copy of each paperback guide that is applicable to its practice. The paperback guides are updated and published periodically and, accordingly, old editions may not be current in all areas.
- f. *AICPA Risk Alerts*. Although most small firms do not need all of the alerts, each firm should have the alerts that are applicable to its practice. The alerts are included in the AICPA Audit and Accounting Guides loose-leaf and electronic format service or they may be purchased separately from the AICPA.
- g. *Accounting and Auditing Manuals*. There are several sources that provide accounting and auditing manuals for local firms. Obviously, the authors prefer and recommend Thomson Reuters manuals because they are interfaced with this *QC Guide*, are updated annually, and generally have been peer reviewed. The manuals are available from Thomson Reuters. For more information and a list of all accounting and auditing manuals available, visit Thomson Reuters' website at **ppc.thomsonreuters.com** or call (800) 323-8724.
- h. *AICPA Technical Practice Aids*. This service presents selected inquiries handled by the AICPA Technical Information Service, plus statements of position, AICPA practice bulletins, and practice alerts. It is available in a loose-leaf service from the AICPA and in an electronic format from Thomson Reuters. This information is also available online through Checkpoint® at **ria.thomsonreuters.com**. Some firms purchase the individual statements of position, practice bulletins, and practice alerts applicable to their practice rather than the full service. New statements of position are published in the *Journal of Accountancy*.
- i. *FASB Implementation Guides*. Although most small firms do not need all of these guides, firms should have those that are applicable to their practice.
- j. *Industry and Specialty Reference Sources*. The firm's library should include reference manuals that provide specialized guidance relating to the types of industries served by the firm.

Other technical resource services that firms can consider include—

- a. *Monthly Newsletters.* Thomson Reuters publishes three newsletters that keep the practicing CPA current on recent accounting and auditing pronouncements and other issues of concern:
 - *The PPC Accounting and Auditing Update.*
 - *The PPC Governmental Update.*
 - *The PPC Nonprofit Update.*
- b. *A General Purpose Income Tax Service and Related Books on Special Tax Issues.* A tax service is required so that tax-related issues can be researched. There are several comprehensive income tax services available. Tax manuals and tax services are available from Thomson Reuters. For more information and a list of all tax manuals and services available, visit Thomson Reuters' website at **ppc.thomson.com** or call (800) 323-8724. This information is also available online through Checkpoint® at **ria.thomsonreuters.com**.
- c. *Consulting and Personal Financial Planning Guides.* Guides covering consulting and financial advisory services are available from Thomson Reuters. For more information and a list of all consulting and financial advisory services manuals available, visit Thomson Reuters' website at **ppc.thomson.com** or call (800) 323-8724.

Audit and Attestation Requirements for Using Specialists. SAS No. 73 (AU 336) discusses the use of a specialist in performing an audit of financial statements. AT 101.22 also 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 or auditing, 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 auditing and attestation literature. Rather, one is referring to an individual with special knowledge or expertise within the accounting, auditing, or tax field. 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 believed it is appropriate to include special procedures for those types of consultation in the QC system.

Nonaccounting Specialists. Most firms think of consultation quality control procedures in terms of resolving accounting, auditing, or tax issues. However, firms may have occasional need on audit or attestation engagements to consult with nonaccounting specialists such as actuaries, engineers, and valuation specialists. SAS No. 73, *Using the Work of a Specialist*, provides guidance to practitioners who use the work of a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing. It is recommended that a firm's quality control procedures contain a step that makes all professionals aware of their added responsibilities under SAS No. 73 when a nonaccounting specialist is used by the firm. SAS No. 73 at AU 336.08 provides guidance for evaluating the professional qualifications of a specialist. Those guidelines are reproduced in Exhibit 1-3.

Exhibit 1-3

Suggested Attributes of an Outside Specialist

The auditor should consider the following to evaluate the professional qualifications of the specialist in determining that the specialist possesses the necessary skill or knowledge in the particular field:

- a. The professional certification, license, or other recognition of the competence of the specialist in his or her field, as appropriate.
- b. The reputation and standing of the specialist in the views of peers and others familiar with the specialist's capability or performance.
- c. The specialist's experience in the type of work under consideration.

(SOURCE: AU 336.08)

* * *

Specifying Situations that Need Consultation. It is impossible to identify every situation that could need consultation; therefore, many firms may question the practicality of specifying such situations. However, it is recommended that the consultation component of the QC document contain a list of common situations that generally need consultation. 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, auditing, 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.
- 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 or generally accepted auditing standards 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 need consultation and documentation in the firm's quality control policies and procedures, the firm needs to ensure that all personnel are aware of, and recognize, situations in which firm policy stipulates consultation and documentation.

Differences of Opinion

Prior to the issuance of SQCS No. 7, the SQCSs 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. SAS No. 108 (AU 311.32) states, ". . . when differences of opinion concerning accounting and auditing issues exist among firm personnel. . . procedures should enable an assistant to document his or her disagreement with the conclusions reached if, after appropriate consultation, he or she believes it necessary to disassociate himself or herself from the resolution of the matter. In this situation, the basis for the final resolution should also be documented." 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 and auditing 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 (paragraph 78) states that firms establish policies and procedures for dealing with and resolving differences of opinion. Those policies and procedures 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, the procedures 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.

Conclusions reached when dealing with differences of opinion should be documented. Specific guidance regarding this documentation is not provided in SQCS No. 7. It is suggested that care 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, while matters of a general nature or of minor technical importance do not require documentation. The decision of whether a question is of a general nature or of minor technical importance versus one that is material is to be made by the engagement partner. Once the determination has been made that the issue is material, the firm then follows consistent documentation procedures.

SELF-STUDY QUIZ

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

8. When encountering complex technical issues, engagement teams may need to consult with an individual not involved with the engagement. Which of the following statements is correct regarding such a consultation?
 - a. Any consultations regarding technical issues that are unique to the industry must be handled by an expert within the firm.
 - b. Many large firms designate specialists within industries to handle consultations regarding complex matters.
 - c. Specialists should avoid using any reference materials within the firm's library.
 - d. Consultations are best handled by the most senior member of the firm.
9. SQCS No. 7 provides all of the following information regarding consultation and differences of opinion **except**:
 - a. How conclusions reached need to be documented when handling differences of opinion.
 - b. Consultation documentation needs to be specific and completely explain the issue requiring consultation.
 - c. Policies and procedures need to be established for dealing with differences of opinion.
 - d. Firms must implement policies and procedures concerning consultation to provide reasonable assurance that enough resources are available.

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.)**

8. When encountering complex technical issues, engagement teams may need to consult with an individual not involved with the engagement. Which of the following statements is correct regarding such a consultation? **(Page 28)**
- a. Any consultations regarding technical issues that are unique to the industry must be handled by an expert within the firm. [This answer is incorrect. When an engagement team encounters complex, technical issues or unique industry situations in an engagement that they have not previously encountered, 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.]
 - b. Many large firms designate specialists within industries to handle consultations regarding complex matters. [This answer is correct. Some firms appoint specialists in particular industries. Some firms appoint a particular person to become an 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. Large firms are more likely to have in-house specialists as opposed to small firms because of the availability of talent across all industry lines.]**
 - c. Specialists should avoid using any reference materials within the firm's library. [This answer is incorrect. 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.]
 - d. Consultations are best handled by the most senior member of the firm. [This answer is incorrect. A firm's consultation procedures may provide for someone with experience within the firm, but knowledge regarding the subject matter of the consultation and relevant experience and technical expertise are also important matters when seeking guidance from a consultant.]
9. SQCS No. 7 provides all of the following information regarding consultation and differences of opinion **except:** **(Page 33)**
- a. How conclusions reached need to be documented when handling differences of opinion. [This answer is correct. Any conclusions reached when dealing with differences of opinion should be documented; however, specific guidance regarding this documentation is not provided in SQCS No. 7.]**
 - b. Consultation documentation needs to be specific and completely explain the issue requiring consultation. [This answer is incorrect. SQCS No. 7 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. This type of complete and detailed documentation helps provide understanding of the results of the consultation.]
 - c. Policies and procedures need to be established for dealing with differences of opinion. [This answer is incorrect. According to SQCS No. 7, firms should establish policies and procedures for dealing with and resolving differences of opinion. Those policies and procedures require that (a) conclusions reached be documented and implemented, and (b) the report not be released until the difference of opinion is resolved.]
 - d. Firms must implement policies and procedures concerning consultation to provide reasonable assurance that enough resources are available. [This answer is incorrect. SQCS No. 7 indicates that firms establish policies and procedures over consultation to provide the firm with reasonable assurance that sufficient and appropriate resources are available to allow appropriate consultation to occur.]

ENGAGEMENT QUALITY CONTROL REVIEW

One of the most controversial changes in SQCS No. 7 includes the requirement for the firm to establish criteria against which all engagements are to be evaluated to determine whether an engagement quality control review needs to 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) is 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, an other 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. As explained earlier in this lesson, 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 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 an engagement quality control reviewer has been modified. Instead of stating that the reviewer possess sufficient and appropriate experience and authority to perform the EQCR, the proposed standard indicates that the reviewer is to 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.

Upcoming Proposed SAS Changes. The ASB has issued an exposure draft that would supersede SAS No. 25. The proposed SAS includes requirements related to engagement quality control review indicating that when an EQCR is required for an audit engagement, the engagement partner should:

- Ascertain that an engagement quality control reviewer has been appointed.
- Discuss significant findings or issues that arose during the audit engagement with the reviewer.
- Ensure that the auditor's report is not released before the EQCR is completed.

In the circumstance that the EQCR identifies additional procedures are needed or evidence is required and the EQCR has been completed after the auditor's report is dated, the report date needs to be changed to the date when the additional procedures have been satisfactorily completed or the additional evidence has been obtained.

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 is 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, the first step in the process of developing EQCR policies and procedures is considering its unique structure and nature. Firm structure includes the size of the firm, whether the firm is a single-office firm or part of a multi-office practice, 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 audits, reviews, compilations, and attest engagements? Or does the firm provide only compilations, reviews, and tax engagement services? (Tax services are not subject to SQCS No. 7 requirements. However, those services could be included in the population of engagements to be evaluated.)

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 full service firm with a larger tax practice and a smaller audit practice may designate that all audits 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 audit and tax services, there may be a more pressing need to have EQCRs performed on a larger number of audit engagements. Alternatively, a firm that primarily performs audits may feel more confident in its ability to follow established auditing guidance because all of its partners routinely perform audits as a matter of course. Thus, that firm may designate only audit 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 audit engagements may result in most audits being subjected to EQCRs, while the criteria established for compilation engagements may result in few compilations being subject to EQCR. SQCS No. 7 suggests that when establishing criteria for EQCRs, firms 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; for example, the firm begins to offer prospective financial information services.
- New or complex specialized industries.
- Client entities without competent or experienced accounting personnel.
- Client entities with substantial fraud risk factors.
- New firm partners.
- 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.

Any circumstance that creates an unusual or a higher level of engagement risk needs to 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 each firm’s unique circumstances, it is necessary for the firm to consider whether their established EQCR criteria need to change when firm circumstances change. The firm’s quality control system must be a dynamic system that changes with the firm.

Proposed SQCS Changes. As explained earlier in this lesson, 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 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 goes through to determine its unique EQCR performance criteria. Exhibit 1-4 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 1-4 represent the authors’ 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. Additionally, through this illustration the authors hope to stress the importance for firms to reevaluate whether their EQCR policy is still appropriate when changes occur in the firm’s A&A practice. The authors recommend that firms reevaluate the appropriateness of their EQCR criteria when changes occur in the firm’s risk-related circumstances, or at least annually.

Exhibit 1-4

Example of Establishing EQCR Performance Criteria

Scenario #1

A single-office firm performed the following audit and attest services during its last fiscal year:

- 45 compilations (both interim and annual, including one full-disclosure GAAP)
- 5 reviews (3 of which are required by client banks)
- 15 audit engagements

The firm’s clients are primarily in the manufacturing, hospitality, and retail industries and A&A personnel have experience in those industries. The firm had no deficiencies in its most recent peer review.

A&A personnel include:

Managing Partner (primarily tax)	20 years experience
Other Partner	15 years experience

Senior Manager	10 years experience
Senior 1	6 years experience
Senior 2	3 years experience
Staff 1	2 years experience

Firm EQCR Policy—

Based on its services, client base, and personnel, the firm has established a policy that an EQCR should be performed for the following engagements during 20X1:

- Audit engagements of entities not in the manufacturing, hospitality, and retail industries.
- Review engagements of entities with significant debt covenants.
- All full-disclosure compilation engagements and year-end compilation engagements of entities not in the manufacturing, hospitality, and retail industries.
- Initial engagements for any new clients.
- Other engagements at the discretion of the managing partner.

Scenario #2

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, and personnel, the firm has established a policy that an EQCR be performed for the following engagements during 20X1:

- Audit engagements of entities not in the manufacturing, hospitality, and retail industries.
- Review engagements of entities with significant debt covenants.
- All full-disclosure compilation engagements and year-end compilation engagements of entities not in the manufacturing, hospitality, and retail industries.
- Initial engagements for any new clients.
- **All engagements for which New Partner is responsible.**
- Other engagements at the discretion of the managing partner.

Scenario #3

Assume the same fact pattern in Scenario #1, except that one of the firm's existing clients wants to expand its manufacturing processes into a new area and its bank has requested a financial projection prior to supporting the client's expansion. The firm has been engaged to assist the client in preparing the financial projection. The firm revises its EQCR policy as follows (revision in **bold**):

Firm EQCR Policy—

Based on its services, client base, and personnel, the firm has established a policy that an EQCR be performed for the following engagements during 20X1:

- Audit engagements of entities not in the manufacturing, hospitality, and retail industries.
- Review engagements of entities with significant debt covenants.
- All full-disclosure compilation engagements and year-end compilation engagements of entities not in the manufacturing, hospitality, and retail industries.
- Initial engagements for any new clients.
- All other types of engagements performed for the first time.
- Other engagements at the discretion of the managing partner.

Scenario #4

Assume the same fact pattern in Scenario #1, except that the firm is acquiring the practice of a smaller CPA firm effective 1/1/20X1. The acquired firm's clients include some employee benefit plan and construction contractor

audits, as well as other type engagements the acquiring firm is already experienced in. The sole proprietor of the acquired firm is retiring, but the acquiring firm will be hiring the other A&A personnel, comprised of one staff and one senior. The firm revises its EQCR policy as follows (revision in **bold**):

Firm EQCR Policy—

Based on its services, client base, and personnel, the firm has established a policy that an EQCR be performed for the following engagements during 20X1:

- Audit engagements of entities not in the manufacturing, hospitality, and retail industries.
- Review engagements of entities with significant debt covenants.
- All full-disclosure compilation engagements and year-end compilation engagements of entities not in the manufacturing, hospitality, and retail industries.
- Initial engagements for any new clients.
- **All Acquired Firm employee benefit plan and construction contractor audits.**
- **All other Acquired Firm engagements performed for the first time.**
- Other engagements at the discretion of the managing partner.

* * *

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 standard 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 an audit 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 needs to 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 standard 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.)

Not Selected by Engagement Partner. To maintain the objectivity of the engagement quality control reviewer, the firm's policies and procedures may include a requirement that the engagement quality control reviewer is not selected by the engagement partner. For example, in larger firms, it may be established that the engagement quality control reviewer is selected by the director of quality control or the managing partner. However, for firms with few partners, it may not be practical for the engagement partner not to be involved in selecting the engagement quality control reviewer.

No Participation in Engagement Performance Other than Consultation. 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, when 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 standard 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.]

No Engagement Team Decisions. Policies and procedures designed to maintain the objectivity of the engagement quality control reviewer may include a requirement that the engagement quality control reviewer not make decisions for the engagement team.

Additional Proposed SQCS Changes. The proposed SQCS standard 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 must maintain his or her objectivity.

Replacement of Reviewers. The firm's policies and procedures needs to provide 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 standard has modified slightly 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, qualified external individuals or firms may be contracted to perform the function.

Additional Proposed SQCS Changes. As explained earlier in this lesson, the ASB has issued an exposure draft that would supersede SQCS No. 7. The exposure draft includes discussion of considerations specific to governmental audit organizations. Firms that perform audits of governmental entities may have a statutorily appointed auditor who acts in the capacity of an engagement partner with overall responsibility for governmental audits. In such a situation, the selection of an engagement quality control reviewer includes consideration of the need for independence from the audited entity and the ability of the engagement quality control reviewer to provide an objective evaluation.

Performing Engagement Quality Control Reviews

SQCS No. 7 (QC 10.85) states that engagement quality control review policies and procedures should 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 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.
- Matters to be communicated to management and those charged with governance, and other parties such as regulatory bodies, if any.

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.

Proposed SAS Changes. As explained earlier in this lesson, the ASB has issued an exposure draft that would supersede SAS No. 25. The proposed SAS includes requirements related to performing an objective evaluation of the significant judgments made and conclusions reached in formulating the auditor's report. The proposed SAS indicates that the evaluation should involve:

- Discussion with the audit engagement partner about the significant findings or issues.
- Review of the financial statements and the proposed auditor's report.
- Review of selected audit engagement documentation relating to the significant judgments the engagement team made and the conclusions it reached.
- Evaluation of the conclusions reached in formulating the auditor's report and consideration of whether the proposed auditor's report is appropriate.

Additionally, the proposed SAS includes application and other explanatory material guidance that supplements those requirements.

Documenting Engagement Quality Control Review

SQCS No. 7 (QC 10.99) indicates that firms 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 made and conclusions reached were not appropriate.

Documentation supporting performance of the EQCR indicates 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.

10. Which of the following statements best describes the engagement quality control reviewer?
 - a. A member of the engagement team.
 - b. An individual, other than a firm partner, who has the experience and authority to review the work performed on an engagement prior to the issuance of the report.
 - c. An individual with sufficient knowledge, experience, and authority to review the work performed on an engagement prior to the issuance of the report.
 - d. A member of a regulatory body not affiliated with the firm that oversees industry policies and procedures.
11. Which of the following statements most accurately describes how criteria for the performance of an EQCR are established?
 - a. The engagement quality control reviewer must determine if the firm has an adequate up-to-date reference library what would aid the reviewer with the review.
 - b. The engagement quality control reviewer should consider the timing of the EQCR.
 - c. Engagement documentation retention should be considered when determining the criteria for the performance of an EQCR review.
 - d. The criteria should change as the firm's circumstances change.
12. Julia is performing an engagement quality control review of the firm of Lewis & Clark. Julia reviews an audit performed by Lewis & Clark to determine if the report is appropriate. This step is listed under which of the following?
 - a. What should be included in engagement quality control procedures?
 - b. What should be considered when engagement quality control reviews are performed?
 - c. What significant judgments are made by the engagement team?
13. Which of the following is a consideration of an engagement quality control review?
 - a. If workpapers chosen for review reflect the conclusions reached.
 - b. Decisions made with respect to significant materiality and risks.
 - c. Issues communicated to management.
 - d. Responses to identified risks.

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.)**

10. Which of the following statements best describes the engagement quality control reviewer? **(Page 37)**
- a. A member of the engagement team. [This answer is incorrect. 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.”]
 - b. An individual, other than a firm partner, who has the experience and authority to perform the engagement quality control review (EQCR). [This answer is incorrect. The engagement quality control reviewer may be a partner in the firm.]
 - c. **An individual with sufficient knowledge, experience, and authority to review the work performed on an engagement prior to the issuance of the report. [This answer is correct. The engagement quality control reviewer may be a qualified external person, or a team comprised of such individuals. The reviewer(s) should possess sufficient and appropriate experience and authority to perform the EQCR.]**
 - d. A member of a regulatory body not affiliated with the firm that oversees industry policies and procedures. [This answer is incorrect. While the EQCR may be a qualified external person, the reviewer should possess sufficient and appropriate experience to perform a quality control review. An individual who has experience in particular industry regulations may not understand the requirements of the work being performed and therefore may not have the required expertise to review the engagement team’s work.]
11. Which of the following statements most accurately describes how criteria for the performance of an EQCR are established? **(Page 39)**
- a. The engagement quality control reviewer must determine if the firm has an adequate up-to-date reference library what would aid the reviewer with the review. [This answer is incorrect. Although having an adequate up-to-date reference library can help minimize the need for external consultation, it is not necessary when establishing such criteria.]
 - b. The engagement quality control reviewer should consider the timing of the EQCR. [This answer is incorrect. The timing of an EQCR is not considered a criterion when determining how the performance of an EQCR should be established.]
 - c. Engagement documentation retention should be considered when determining the criteria for the performance of an EQCR review. [This answer is incorrect. SQCS No. 7 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.” However, documentation retention is not normally a consideration when establishing criteria for engagement quality control reviews.]
 - d. **The criteria should change as the firm’s circumstances change. [This answer is correct. Since EQCR criteria are based on each firm’s unique circumstances, firms should consider if their established EQCR criteria needs to change as the firm’s circumstances change.]**

12. Julia is performing an engagement quality control review of the firm of Lewis & Clark. Julia reviews an audit performed by Lewis & Clark to determine if the report is appropriate. This step is listed under which of the following? **(Page 42)**
- a. **What should be included in engagement quality control procedures? [This answer is correct. When performing engagement quality control reviews, SQCS No. 7 states that engagement quality control review policies and procedures should 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; reviewing selected engagement documentation relating to the significant judgments and the conclusions reached; discussing with the engagement partner about significant findings and issues; and 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.]**
 - b. What should be considered when engagement quality control reviews are performed? [This answer is incorrect. Engagement quality control reviews may include consideration of the engagement team evaluation of the firm's independence relating to the engagement; if consultation has occurred relating to matters regarding differences of opinion or other difficult or contentious matters, and the conclusions reached as a result of such consultation.]
 - c. What significant judgments are made by the engagement team? [This answer is incorrect. Significant judgments made by the engagement team may include 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; and matters to be communicated to management and those charged with governance, and other parties such as regulatory bodies, if any.]
13. Which of the following is a consideration of an engagement quality control review? **(Page 43)**
- a. **If workpapers chosen for review reflect the conclusions reached. [This answer is correct. The extent of an EQCR may depend on, among other things, the complexity of the engagement and the risk that the report might not be appropriate in the circumstances. One consideration of an engagement quality control review is if the workpapers selected for review reflect the work performed and the conclusions reached relating to significant judgments. Other considerations include if 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; and the engagement team evaluation of the firm's independence relating to the engagement.]**
 - b. Decisions made with respect to significant materiality and risks. [This answer is incorrect. A judgment made, particularly with respect to significant risks and materiality is an example of important judgments made by the engagement team.]
 - c. Issues communicated to management. [This answer is incorrect. Matters to be communicated to management and those charged with governance, and other parties such as regulatory bodies, if any is an example of judgments made by the engagement team.]
 - d. Responses to identified risks. [This answer is incorrect. Any significant risks identified and responses to those risks is an example of a significant judgment made by the engagement team.]

DRAFTING THE FIRM'S QC POLICIES AND PROCEDURES

For some of the elements of quality control, authoritative accounting, auditing, 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.

AICPA QC and Peer Review Materials

AICPA Practice Aid. After reviewing authoritative literature, it is recommended that the illustrative examples suggested by the AICPA for designing the engagement performance element of the quality control system 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).

Shown at Exhibit 1-5 is a section from one of the sample quality control documents included in the AICPA's Practice Aid. This portion of the quality control document contains suggested policy statements followed by procedures that can be used in designing and documenting a firm's engagement performance quality control system. This particular document illustrates an engagement performance quality control system for a local one-office accounting firm (referred to as Single-office CPA Firm). The firm has three partners and ten professionals and uses purchased practice aids that have been subjected to peer review in accordance with AICPA standards. The suggested policies are in bold type, and suggested procedures are in regular type.

Exhibit 1-5

AICPA Illustrative Quality Control Policies and Procedures Related to Engagement Performance

Engagement Performance, Supervision, and Review Requirements

1. **Planning for engagements meets professional, regulatory, and the firm's requirements.** Single-office CPA Firm implements this policy by maintaining and providing personnel with the firm's practice aids that prescribe the factors the engagement team should consider in the planning process and the extent of documentation of those considerations. Planning considerations may vary depending on the size and complexity of the engagement. Planning generally includes the following activities:
 - a. Assigning responsibilities to appropriate personnel during the planning phase.
 - b. Developing or updating background information on the client and the engagement.
 - c. Considering client significance to the firm.
 - d. Developing a planning document that includes the following:
 - (1) Proposed work programs tailored to the specific engagement.
 - (2) Staffing requirements and the need for specialized knowledge.
 - (3) Consideration of the economic conditions affecting the client and its industry and their potential effect on the conduct of the engagement.
 - (4) The risks, including fraud considerations, affecting the client and the engagement and how the risks may affect the procedures performed.
 - (5) A budget that allocates sufficient time for the engagement to be performed in accordance with professional standards and the firm's quality control policies and procedures.

2. The engagement is performed, supervised, reviewed, documented, and reported (or communicated) in accordance with the requirements of professional standards, applicable regulators, and the firm.

Single-office CPA Firm implements this policy through the following procedures:

- a. Providing adequate supervision during the course of an engagement, including briefing the engagement team on the objectives of their work. The training, ability, and experience of the personnel are considered when assigning supervisors to the engagement.
- b. Requiring that a written work program be used in all engagements.
- c. Addressing significant issues arising during the engagement, considering their significance, and appropriately modifying the planned approach.
- d. Adhering to the guidelines set forth by the firm for the form and content of documentation of the work performed and conclusions reached. Such documentation includes standardized forms, checklists, and questionnaires used in the performance of engagements and explanations, when required, of how the firm integrates such aids into engagements.
- e. Requiring engagement documentation in accordance with professional standards, applicable regulatory requirements, and the firm's policies.

3. Qualified engagement team members review work performed by other team members on a timely basis.

Single-office CPA Firm implements this policy by adhering to the following guidelines established by the firm regarding review of the documentation of the work performed and conclusions reached, the financial statements and reports, and documentation of the review process:

- a. All reviewers are to have appropriate experience, competence, and responsibility.
- b. For each engagement, there is to be evidence of appropriate review of documentation of the work performed and conclusions reached, the financial statements, and the report.
- c. Engagement documentation is reviewed to determine whether the following have occurred:
 - (1) The work has been performed in accordance with professional standards and regulatory and legal requirements.
 - (2) Significant findings and issues have been raised for further consideration.
 - (3) Appropriate consultations have taken place, and the resulting conclusions have been documented and implemented.
 - (4) The nature, timing, and extent of work performed are appropriate and do not need revision.
 - (5) The work performed supports the conclusions reached and is appropriately documented.
 - (6) The evidence obtained is sufficient and appropriate to support the report.
 - (7) The objectives of the engagement procedures have been achieved.

Maintaining Engagement Documentation

4. Engagement teams complete the assembly of final engagement files on a timely basis. Single-office CPA Firm implements this policy by completing the assembly of final engagement files in accordance with professional standards and applicable regulatory requirements, if any.

5. The firm maintains the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation. Single-office CPA Firm implements this policy through the following procedures:

- a. Establishing and applying controls to accomplish the following:
 - (1) Clearly determine when and by whom engagement documentation was prepared and reviewed.
 - (2) Protect the integrity of the information at all stages of the engagement, especially when the information is shared within the engagement team or transmitted to other parties via electronic means.
 - (3) Prevent unauthorized changes to the engagement documentation.
 - (4) Allow access to the engagement documentation by the engagement team and other authorized parties as necessary to properly discharge their responsibilities.
 - b. Implementing procedures for properly distributing engagement documentation materials to engagement teams at the start of the engagement, preparing engagement documentation during the engagement, and assembling final documentation at the end of the engagement.
 - c. Implementing procedures to restrict access to, and enable proper distribution and confidential storage of, hard copy engagement documentation.
 - d. Requiring the use of passwords by engagement team members and data encryption to restrict access to electronic engagement documentation to authorized users.
 - e. Implementing appropriate back-up routines for electronic engagement documentation at appropriate stages during the engagement.
 - f. Implementing procedures regarding original paper documents that have been electronically scanned or otherwise copied to another media that accomplish the following:
 - (1) Generate copies that contain the entire content of the original paper documentation, including manual signatures, cross-references, and annotations.
 - (2) Integrate the copies into the engagement files, including indexing and signing off on the copies as necessary.
 - (3) Enable the copies to be retrieved and printed as necessary.
6. **The firm retains engagement documentation for a period of time sufficient to meet the needs of the firm, professional standards, laws, and regulations.** Single-office CPA Firm implements this policy through the following procedures:
- a. Retaining engagement documentation for a period of time sufficient to meet the requirements of the state board of accountancy and applicable professional standards.
 - b. Establishing procedures that—
 - (1) Enable the retrieval of, and access to, the engagement documentation during the retention period, particularly in the case of electronic documentation because the underlying technology may be upgraded or changed over time;
 - (2) Provide, where necessary, a record of changes made to engagement documentation after the assembly of engagement files has been completed; and
 - (3) Enable authorized external parties to access and review specific engagement documentation for quality control or other purposes.

Consultation and Differences of Opinion

7. **The firm requires that consultation take place when appropriate; that sufficient and appropriate resources are available to enable appropriate consultation to take place; that all the relevant facts known**

to the engagement team are provided to those consulted; that the nature, scope, and conclusions of such consultations are documented; and that conclusions resulting from such consultations are implemented. Single-office CPA Firm implements this policy through the following procedures:

- a. Consulting with those having appropriate knowledge, authority, and experience within the firm (or, where applicable, outside the firm) on significant technical, ethical, and other matters. Single-office CPA Firm uses advisory services provided by other firms, professional and regulatory bodies, and commercial organizations that provide relevant quality control services. Before using such services, the firm evaluates whether the external provider is qualified for that purpose.
 - b. Informing personnel of the firm's consultation policies and procedures.
 - c. Requiring sufficiently experienced engagement team members to identify matters for consultation or consideration during the engagement.
 - d. Requiring consultation in specialized areas or situations with appropriate individuals within and outside the firm when matters such as the following arise:
 - (1) The application of newly issued technical pronouncements.
 - (2) Industries with special accounting, auditing, or reporting requirements, including unusually complex employee benefit plans.
 - (3) Emerging practice problems.
 - (4) Choices among alternative generally accepted accounting principles upon initial adoption or when an accounting change is made.
 - (5) Reissuance of a report, consideration of omitted procedures after a report has been issued, or subsequent discovery of facts that existed at the date a report was issued.
 - (6) Filing requirements of regulators.
 - (7) Meetings with regulators at which the firm is to be called on to support the application of generally accepted accounting principles or generally accepted auditing standards that have been questioned.
 - e. Providing all professional personnel with access to adequate and current reference materials.
 - f. Including all relevant facts, circumstances, the professional literature used, and conclusions reached in the engagement documentation of the work performed and conclusions reached.
 - g. Documenting the issue on which consultation was sought and the results of the consultation, including any decisions taken, the basis for those decisions, and how they were implemented. If there is an unresolved disagreement, an outside source may be consulted to assist in determining the appropriate application of accounting principles.
- 8. The firm deals with and resolves differences of opinion, documents and implements conclusions reached, and does not release the report until the matter is resolved.** Single-office CPA Firm implements this policy through the following procedures:
- a. Requiring that all differences of professional judgment among members of an engagement team be resolved by the engagement and the quality control partners, and the managing partner if necessary, and that the report not be released until the matter is resolved.
 - b. Requiring that conclusions reached be appropriately documented. If members of the team continue to disagree with the resolution, they may disassociate themselves from the resolution of the matter and may document that a disagreement continues to exist.

Engagement Quality Control Review

9. **The firm has criteria for determining whether an engagement quality control review should be performed, evaluates all engagements against the criteria, performs an engagement quality control review for all engagements that meet the criteria, and completes the review before the report is released.** Single-office CPA Firm implements this policy through the following procedures:
- a. Establishing criteria such as the following:
 - (1) The identification of unusual circumstances or risks in an engagement or class of engagements as determined by the engagement partner or quality control partner.
 - (2) An engagement quality control review is required by law or regulation.
 - b. Evaluating all engagements against the criteria.
 - c. Performing an engagement quality control review for all engagements that meet the criteria.
10. **The firm establishes procedures addressing the nature, timing, extent, and documentation of the engagement quality control review.** Single-office CPA Firm implements this policy through the following procedures:
- a. Implementing procedures addressing the nature, timing, and extent of the review. The firm has concluded that performing an engagement quality control review is not necessary to obtain sufficient appropriate audit evidence for audit engagements; therefore, the engagement quality control review does not need to be completed before the date of the auditor's report. When the engagement quality control review results in additional audit procedures being performed, the date of the auditor's report is changed to the date by which sufficient appropriate audit evidence has been obtained. The firm's procedures require that for audit and attestation engagements, the engagement quality control reviewer do the following:
 - (1) Discuss significant accounting, auditing, and financial reporting issues with the engagement partner, including matters for which there has been consultation.
 - (2) Discuss with the engagement partner the engagement team's identification and audit of high-risk assertions, transactions, and account balances.
 - (3) Confirm with the engagement partner that there are no significant unresolved issues.
 - (4) Review selected working papers relating to the significant judgments the engagement team made and the conclusions they reached.
 - (5) Review documentation of the resolution of significant accounting, auditing, or financial reporting issues, including documentation of consultation with firm personnel or external sources.
 - (6) Review the summary of uncorrected misstatements related to known and likely misstatements.
 - (7) Review additional engagement documentation to the extent considered necessary.
 - (8) Read the financial statements and the report and consider whether the report is appropriate.
 - (9) Complete the review before the release of the report. The review may be conducted at appropriate stages during the engagement.
 - (10) Determine whether the issues raised in the review indicate a need to change the auditor's report date.
 - b. Resolving conflicting opinions between the engagement partner and the engagement quality control reviewer regarding significant matters. The policy requires documentation of the resolution of conflicting opinions before the release of the audit report.

- c. Implementing procedures addressing documentation by the engagement quality control reviewer. The firm’s procedures require documentation of the following:
 - (1) The procedures required by the firm’s policies on engagement quality control review have been performed.
 - (2) The engagement quality control review has been completed before the report is released.
 - (3) No matters have come to the attention of the engagement quality control reviewer that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.

11. **The firm establishes criteria for the eligibility of engagement quality control reviewers.** Single-office CPA Firm implements this policy by establishing the following criteria for an engagement quality control reviewer:

- a. Is selected by the quality control partner or the managing partner.
- b. Has sufficient technical expertise and experience.
- c. Carries out his or her responsibilities with objectivity and due professional care without regard to the relative positions of the audit engagement partner and the engagement quality control reviewer.
- d. Meets the independence requirements relating to the engagements reviewed, even though the engagement quality control reviewer is not a member of the engagement team.
- e. Does not make decisions for the engagement team or participate in the performance of the engagement except that the engagement partner may consult the engagement quality control reviewer at any stage during the engagement.

When the firm does not have suitably qualified personnel to perform the engagement quality control review, the firm contracts with a suitably qualified external person to perform the engagement quality control review.

* * *

While the AICPA’s illustrative policies and procedures provide a logical starting point for designing the engagement performance quality control system, this course urges careful consideration of the firm’s needs before adopting them. Many firms will find that the suggested policies and procedures may not meet their firm’s particular needs.

AICPA Peer Review Program Manual. A review of the *AICPA Peer Review Program Manual* (PRPM) is especially important when designing the engagement performance QC system because this element receives close scrutiny during a peer review. The extra attention given to this element occurs because the peer review team must review the workpapers of selected engagements. The workpaper review subjects the engagement performance system to a thorough evaluation. A review of the PRPM is also helpful to enable an understanding of the consultation areas a peer reviewer will emphasize.

The PRPM contains checklists for the review of engagements to audit, compile, and review historical financial statements. It also includes checklists for the review of engagements to examine or compile prospective financial statements and for the review of various agreed-upon procedures and other attestation engagements. Also included in the PRPM are checklists for the review of audits of government entities, not-for-profits, and employee benefit plans. All of those checklists and their locations are identified in Section 20,000 of the PRPM.

It is recommended that all practitioners involved in designing a QC system for engagement performance scan the peer reviewers’ checklists included in the PRPM. The PRPM provides quality control policies and procedures questionnaires for firms to complete prior to the commencement of an AICPA peer review. (The firm need only complete one questionnaire.) Section 4400 of the PRPM presents the questionnaire for firms with more than ten

professional staff (summarized in Exhibit 1-6), and Section 4300 of the PRPM provides the questionnaire for firms with ten or fewer professionals (summarized in Exhibit 1-7). It is recommended that all practitioners involved in designing a quality control system for engagement performance scan the quality control policies and procedures questionnaire for their firm size found in the PRPM. *However, the authors also want to caution against relying exclusively on the current AICPA PRPM material, as it does not yet reflect the new quality control requirements of SQCS No. 7.*

Exhibit 1-6

Attributes of an Engagement Performance QC System or Review Steps Emphasized on Peer Review Checklist (Firms with More Than Ten Professional Staff)^a

- Does the firm develop its own quality control materials (e.g. checklists, templates, practice aids, tools, etc.) to assist with engagement performance, either as an integral part of the firm's system of quality control or for a specified purpose or a specific industry?
- Does the firm use third-party quality control materials to assist with engagement performance, either as an integral part of the firm's system of quality control or for a specified purpose or a specific industry, and have the provider quality control materials been peer reviewed?
- Does the firm provide its personnel with documented policies and procedures for planning audit and accounting engagements?
- Do the firm's policies and procedures for planning include—
 - Who has responsibility for planning the engagement?
 - Developing or updating background information on the client and the engagement?
 - Developing a proposed work program, tailored to the specific engagement?
 - Staffing requirements, and specialized knowledge?
 - Considering economic conditions affecting the client or its industry and their potential impacts on the conduct of the engagement?
 - Considering risks and how they may affect the procedures to be performed?
 - Preparing a budget that allocates a sufficient amount of time so the engagement will be performed in accordance with professional standards and the firm's quality control procedures?
- Do the firm's policies and procedures—
 - Require that a written program be used on all engagements?
 - Specify the form and content of working papers, including standardized forms, checklists, and questionnaires, that are to be used in the performance of engagements and the method by which the firm integrates such aids into engagements?
 - Require documentation of—
 - Consideration of internal control structure in planning and performing the engagement?
 - Assessment of control risk?
 - Consideration of audit risk and materiality when planning and performing an audit?

- Audit sampling technique?
- Consideration of fraud in the financial statement audit?
- Conduct of and degree of reliance placed on analytical procedures?
- Describe the steps to follow when the firm uses other offices or correspondents for audit or accounting engagements?
- Specify the extent of engagement review so that the financial statements, communications with management and the board of directors meet professional and firm presentation and disclosure standards?
- Do the firm's policies and procedures assign responsibility for review of all reports, financial statements, and working papers to a reviewer who is senior (when possible) to the preparer?
- Does the firm require that a partner of the firm be assigned as the person ultimately responsible for each engagement (certain standards may require partner responsibility)?
- Does the firm require a second review of reports, financial statements, and selected working papers by a partner or manager having no other significant responsibility for the engagement?
- Do the firm's policies and procedures regarding review of reports, financial statements, working papers, and for documentation of the review process ensure that—
 - All reviewers have appropriate experience, competence and responsibility?
 - All engagements performed comply with professional standards and firm policy?
 - Appropriate documentation is required on all engagements evidencing review of reports, financial statements, and working papers?
- Does the firm have policies and procedures for personnel to follow to resolve differences of professional judgment within an engagement team?
- Has the firm merged with any other firm since the date of its last peer review or in the last three years? If "Yes,"—
 - Did the firm acquire any personnel in the merger?
 - Did the firm acquire and retain any new offices in the merger?
 - Have the personnel of the acquired firm adopted the firm's quality control policies and procedures?
- Does the firm inform personnel of its consultation policies and procedures?
- Does the firm require the person ultimately responsible for the engagement to determine the need to consult?
- Does the firm identify circumstances, including specialized situations, when firm personnel are expected to consult?
- Does the firm designate individuals within and outside the firm as consultants in certain areas?
- Does the firm maintain or provide its personnel access to adequate and up-to-date reference materials which include materials related to the clients it serves?
- Does the firm require documentation of consultation?

- Does the firm have guidance regarding reports on the application of accounting principles under SAS No. 50? If "Yes," has that guidance been communicated to personnel?

Note:

- ^a These questions reflect the most recent changes made to the AICPA PRPM. At the date of this course, the latest update to the AICPA PRPM is designated as 001-2009.

* * *

Exhibit 1-7

Attributes of an Engagement Performance QC System or Review Steps Emphasized on Peer Review Checklist (Firms with Ten or Fewer Professionals)^a

- Does the firm develop its own quality control materials (e.g. checklists, templates, practice aids, tools, etc.) to assist with engagement performance, either as an integral part of the firm's system of quality control or for a specified purpose or a specific industry?
- Does the firm use third-party quality control materials to assist with engagement performance, either as an integral part of the firm's system of quality control or for a specified purpose or a specific industry, and have the provider quality control materials been peer reviewed?
- Do the firm's planning procedures include—
 - Developing or updating background information on the client and the engagement?
 - Obtaining an understanding of the engagement by use of an engagement letter or documentation in the working papers?
 - Reviewing prior financial statements and accountant/auditor's report?
 - Using work programs?
- Does the firm use purchased practice aids in the performance of engagements?
- Does the firm prepare working papers and checklists to document the work performed on engagements?
- Does the firm require documentation of—
 - Consideration of internal control structure in planning and performing the engagement?
 - Assessment of control risk?
 - Consideration of audit risk and materiality when planning and performing an audit?
 - Audit sampling techniques?
 - Consideration of fraud in the financial statement audit?
 - Conduct of, and degree of reliance placed on, analytical procedures?
- Do the firm's policies and procedures assign responsibility for review of all reports, financial statements, and working papers to a reviewer who is senior (when possible) to the preparer?
- If the firm uses other accounting firms for audit or accounting engagements, how does the firm provide instruction to the other firms and to what extent is the other firms' work reviewed?

- Does the firm maintain appropriate up-to-date technical reference materials?
- Does the firm consult based on the following factors—
 - The materiality of the matter?
 - Its experience in a particular industry or functional area?
 - Whether relevant GAAP or GAAS is—
 - Based on authoritative pronouncements that are subject to varying interpretations?
 - Based on varied interpretations of prevailing practice?
 - Yet to be developed?
 - Under active consideration by an authoritative body?
 - New to the firm (that is, the firm has not previously interpreted the literature)?
- Does the firm consult with outside parties, such as the AICPA Technical Hotline or another CPA qualified in the area, when a technical question arises?
- Does the firm document consultation, including all of the relevant facts and circumstances and references to professional literature?

Note:

- ^a These questions reflect the most recent changes made to the AICPA PRPM. At the date of this course, the latest update to the AICPA PRPM is designated as 00-1 2009.

* * *

The practitioner should understand that the size and other unique characteristics of each firm will dictate the quality control needs of a given firm and, therefore, not all questions in the PRPM questionnaires apply to every CPA firm. Also, there is always the alternative procedure that is equally acceptable for a given firm. However, the questions should be considered by a firm when designing or revising its quality control system. Having a general understanding of what AICPA peer reviewers focus on during firm quality control system review may be helpful when drafting the firm's policies and procedures.

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. In developing QC policies and procedures, firms should consider various factors such as the size of the firm, the number of firm locations, operating characteristics of the firm, the knowledge and experience of firm personnel, and the nature and complexity of the firm's practice.

Developing Engagement Level Quality Control Steps

Developing the actual engagement performance quality control system is a very difficult task. Referring back to Exhibit 1-2, the following considerations enter into the design of the procedures:

- The procedures should cover all types of attest engagements (compilation, review, audit, and attestation).
- Procedures from other QC elements should be incorporated into the procedures.

- The procedures should interface with the accounting and auditing 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, the AICPA illustrative procedures in Exhibit 1-5, and the peer review procedures in Exhibits 1-6 and 1-7 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, audit, and attestation) are difficult to capture in a concise narrative.

Referencing to Engagement Procedures Located in the Firm's Accounting and Auditing Manuals. Another widely used approach is to make reference in the QC document to the engagement procedures and checklists located in the accounting and auditing 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 audit and 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 by the writers of this course 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 and auditing manuals, those designed by the firm, or a combination of both.) Exhibit 1-8 illustrates a bridging document for an audit engagement. Exhibit 1-9 illustrates a bridging document for attestation engagements. Exhibit 1-10 illustrates a bridging document for compilation and review engagements.

Exhibit 1-8

Illustration of an Engagement Performance Bridging Document (Audit Engagements)

Engagement Performance Quality Control Steps	Person or Group Responsible for Completing Step		Historical Financial Statements ^a	
	Primary Responsibility	Secondary Responsibility	Audits	Examinations of Internal Control (AT 501)
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. Communicate the partner's identity and role to the client.	P	ET	Yes	Yes
3. Obtain an engagement letter.	P	ET	Yes	Yes
4. Assign staff based on capabilities, competence, and availability.	P	ET	Yes	Yes
5. Develop an overall audit strategy and obtain background information about the entity, officers, accounting practices, etc.	ET	P	Yes	Yes
6. Perform risk assessment procedures to obtain an understanding of the entity and its environment, including internal control.	ET	P	Yes	Yes
7. Perform preliminary analytical procedures.	ET	P	Yes	Yes
8. Evaluate and document materiality and tolerable misstatements.	ET	P	Yes	Yes
9. Consider potential fraud implications.	ET	P	Yes	Yes
10. Identify and assess risk of material misstatement and develop responses to identified risks.	ET	P	Yes	Yes
11. Prepare an audit plan.	ET	P	Yes	Yes
12. Develop a time estimate.	ET	P	Opt	Opt
13. Obtain partner approval of audit plan and staff assignments, and, if applicable, time estimates.	P	ET	Yes	Yes
14. Test, evaluate, and document design and operating effectiveness of internal control.	ET	P	Opt ^a	Yes

Engagement Performance Quality Control Steps	Person or Group Responsible for Completing Step		Historical Financial Statements ^a	
	Primary Responsibility	Secondary Responsibility	Audits	Examinations of Internal Control (AT 501)
15. Perform and document further audit procedures.	ET	P	Yes	Yes
16. Supervise procedures (including work of other auditors).	ET	P	Yes	Yes
17. Obtain consultation when appropriate and document and implement conclusions.	P	ET	Yes	Yes
18. Resolve any differences of opinion and document and implement conclusions.	P	ET	Yes	Yes
19. Assist in drafting the financial statements.	ET	P	Yes	Yes
20. Perform final analytical review.	ET	P	Yes	Yes
21. Complete a presentation and disclosure checklist and read the financial statements.	ET	P	Yes	Yes
22. Obtain legal representation letters.	ET	P	Yes	Yes
23. Evaluate management’s report on internal control for completeness and propriety.	ET	P	No	Yes
24. Obtain a management representation letter.	ET	P	Yes	Yes
25. Review the workpapers.	P & ET	—	Yes	Yes
26. Evaluate and conclude on the effect of audit differences.	P	ET	Yes	Yes
27. Consider and document changes from the audit strategy, planning materiality, or audit plan.	ET	P	Yes	Yes
28. Draft the report(s).	ET	P	Yes	Yes
29. Obtain an engagement quality control review, if required by firm policy.	P	ET	Yes	Yes
30. Prepare required client communications.	ET	P	Yes	Yes
31. Determine that all review points and open items have been cleared.	ET	P	Yes	Yes
32. Have the partner sign the report or transmittal letter.	P	ET	Yes	Yes
33. Evaluate the staff’s performance.	ET	P	Yes	Yes
34. Maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of the workpapers.	ET	P	Yes	Yes
35. Assemble and retain the workpapers for a sufficient period of time (subject to monitoring review).	ET	P	Yes	Yes

Notes:

^a Opt—Optional.

* * *

Exhibit 1-9

Illustration of an Engagement Performance Bridging Document (Attestation Engagements)

Engagement Performance Quality Control Steps	Person or Group Responsible for Completing Step		Engagements Subject to QC Standards ^a					
			Forecasts and Projections			Other Attestations		
			Compilations	Examinations	Agreed-upon Procedures	Reviews	Examinations ^b	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	Yes
2. Communicate the partner’s identity and role to the client.	P	ET	<u>Yes</u>	<u>Yes</u>	<u>Yes</u>	<u>Yes</u>	<u>Yes</u>	<u>Yes</u>
3. Obtain an engagement letter.	P	ET	Yes	Yes	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	Examinations	Agreed-upon Procedures	Reviews	Examina- tions ^b	Agreed-upon Procedures
4. Assign staff based on capabilities, competence, and availability.	P	ET	Yes	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	Yes
6. Evaluate and document materiality and tolerable misstatement.	ET	P	No	Yes	No	Yes	Yes	No
7. Consider potential fraud implications.	ET	P	No	No	No	Yes	Yes	No
8. Identify and assess risks of material misstatement and develop responses to identified risks.	ET	P	No	Opt	No	Opt	Opt	No
9. Prepare an engagement plan.	ET	P	Yes	Yes	Yes	Yes	Yes	Yes
10. Develop a time estimate.	ET	P	Opt	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	Yes
12. Perform and document the procedures.	ET	P	Yes	Yes	Yes	Yes	Yes	Yes
13. Supervise procedures (including work of other accountants).	ET	P	Yes	Yes	Yes	Yes	Yes	Yes
14. Evaluate the propriety of a step down to a lower level of service.	ET	P	Opt	N/A	Opt	Opt	N/A	Yes
15. Obtain consultation when appropriate and document and implement conclusions.	P	ET	Yes	Yes	Yes	Yes	Yes	Yes
16. Resolve any differences of opinion and document and implement conclusions.	P	ET	Yes	Yes	Yes	Yes	Yes	Yes
17. Draft (or assist in drafting) the financial statements.	ET	P	Yes	Yes	Yes	Yes	Yes	Yes
18. Perform analytical procedures.	ET	P	No	Opt	No	Yes	Opt	No
19. Complete a presentation and disclosure checklist and read the financial statements.	ET	P	Yes	Yes	Opt	N/A	N/A	N/A
20. Obtain legal representation letters.	ET	P	No	Opt	No	No	Opt	No
21. Obtain a management representation letter.	ET	P	Yes	Yes	Yes	Yes	Yes	Yes
22. Review the workpapers.	P & ET	—	Yes	Yes	Yes	Yes	Yes	Yes
23. Draft the report.	ET	P	Yes	Yes	Yes	Yes	Yes	Yes
24. Obtain an engagement quality control review, if required by firm policy.	P	ET	Yes	Yes	Yes	Yes	Yes	Yes
25. Determine that all review points and open items have been cleared.	ET	P	Yes	Yes	Yes	Yes	Yes	Yes
26. Have the partner sign the report or transmittal letter.	P	ET	Yes	Yes	Yes	Yes	Yes	Yes
27. Evaluate the staff's performance.	ET	P	Opt	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	Yes
29. Assemble and retain the workpapers for a sufficient period of time (subject to monitoring review).	ET	P	Yes	Yes	Yes	Yes	Yes	Yes

Notes:

^a Opt—Optional.

^b Examinations of internal control (AT 501) are included because AT 501 examinations (also known as integrated audits) must be performed in conjunction with an audit of financial statements. Due to the close relationship with an audit, it is believed to be more

meaningful to include AT 501 examinations on the bridging document with audits. However, the authoritative guidance for an AT 501 examination is included in the SSAEs, not in the SASs.

* * *

Exhibit 1-10

Illustration of an Engagement Performance Bridging Document (Compilation and Review Engagements)

Engagement Performance Quality Control Steps	Person or Group Responsible for Completing Step		Historical Financial Statements ^a	
	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. Communicate the partner's identity and role to the client.	P	ET	Yes	Yes
3. Obtain an engagement letter.	P	ET	Yes	Yes
4. Assign staff based on capabilities, competence, and availability.	P	ET	Yes	Yes
5. Plan the work and obtain background information about the entity, officers, accounting practices, etc.	ET	P	Yes	Yes
6. Consider potential fraud implications.	ET	P	Yes	Yes
7. Prepare an engagement plan.	ET	P	Yes	Yes
8. Develop a time estimate.	ET	P	Opt	Opt
9. Obtain partner approval of engagement plan and staff assignments, and, if applicable, time estimates.	P	ET	Opt	Yes
10. Perform and document the procedures.	ET	P	Yes	Yes
11. Supervise procedures (including work of other accountants).	ET	P	Yes	Yes
12. Evaluate the propriety of a step down to a lower level of service.	P	ET	Yes	Yes
13. Obtain consultation when appropriate and document and implement conclusions.	P	ET	Yes	Yes
14. Resolve any differences of opinion and document and implement conclusions.	P	ET	Yes	Yes
15. Draft (or assist in drafting) the financial statements.	ET	P	Yes	Yes
16. Perform analytical procedures.	ET	P	No	Yes
17. Complete a presentation and disclosure checklist and read the financial statements.	ET	P	Yes	Yes
18. Obtain a management representation letter.	ET	P	Opt	Yes
19. Review the workpapers.	P & ET	—	Yes	Yes
20. Draft the report.	ET	P	Yes	Yes
21. Obtain an engagement quality control review, if required by firm policy.	P	ET	Yes	Yes
22. Determine that all review points and open items have been cleared.	ET	P	Yes	Yes
23. Document significant, unusual matters, including disposition.	P	ET	Yes	Yes
24. Document management's response to inquiries of (a) unexpected/inconsistent fluctuations or relationships and (b) significant matters. ^b	P	ET	No	Yes
25. Have the partner sign the report or transmittal letter.	P	ET	Yes	Yes
26. Evaluate the staff's performance.	ET	P	Opt	Opt

Engagement Performance Quality Control Steps	Person or Group Responsible for Completing Step		Historical Financial Statements ^a	
	Primary Responsibility	Secondary Responsibility	Compilations	Reviews
27. Maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of the workpapers.	ET	P	Yes	Yes
28. 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 sections 20, 50, and 100, and is effective for compilations and reviews of financial statements for periods ending on or after December 15, 2010.

* * *

Interfacing the Bridging Document with the Firm's Accounting and Auditing Manuals. Rarely does a firm follow every procedure in its accounting and auditing manuals verbatim (especially if the manuals are purchased from a third party). For firms that choose to adapt the accounting and auditing manuals developed by a third party into its practice, this course provides the following paragraph which can be added to the engagement performance section of a firm's QC document. (In the following illustration the firm uses Thomson Reuters PPC brand engagement manuals and practice aids.)

The firm adopts and integrates within its quality control system the use of PPC accounting and auditing 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 requiring a higher level of performance or documentation than the minimum specifically required neither by our firm's QC policies and procedures nor to override the exercise of professional judgment.

It is believed this additional paragraph, along with an engagement performance bridging document, allows 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. Illustrated in Exhibits 1-8, 1-9, and 1-10, this course has established specific steps in the engagement performance QC system. It is the opinion of this course that these steps are necessary for all 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 1-1).

It is believed these 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 1-8, 1-9, or 1-10.

Additionally, the use of bridging documents, practice aids, and monitoring memoranda to document compliance with a firm's engagement performance quality control component is recommended.

Assigning Responsibilities for Completion of the Engagement Level QC Steps

Referring to the bridging documents in Exhibits 1-8, 1-9, and 1-10, it is obvious that some of the quality control steps should be 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.

Indicating the Applicability of Steps to Each Type of Engagement

Some of the quality control steps illustrated in Exhibits 1-8, 1-9, and 1-10 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 an audit, but inappropriate for a compilation. Bridging documents like those illustrated in Exhibits 1-8, 1-9, and 1-10 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 1-8, 1-9, and 1-10, in this course 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 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. Those changes will be effective before the next edition of this course is available and will require revisions to various compilation and review engagement performance procedures.) 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 believed 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, the firm needs to 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, it is believed engagement quality control reviews are desirable for most engagements, it may be appropriate for a firm to require EQCRs only for high-risk audit 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, such decisions need to be made based on the firm’s own client base and circumstances.

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, it is recommended that the firm’s work programs for each type of engagement 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. It is also recommended that the use of standardized work programs to ensure that the procedures are performed on each engagement. Each PPC guide contains work programs/checklists that incorporate the QC steps in the exhibits.

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. As long as the firm meets the minimum requirements of that type of engagement and conforms to its specified QC procedures, peer reviewers will be satisfied.

Developing Policies and Procedures for Maintaining Engagement Documentation

Document Retention. In setting engagement and other documentation, the cost of storage space and the administrative burden of maintaining records require that files be kept for only so long and then be discarded. In addition, many attorneys and CPAs believe that it is easier for a firm to defend itself in a lawsuit if the related workpapers have been discarded in accordance with a reasonable document retention policy. But how long should the firm keep its files? The answer varies depending on regulatory requirements, firm policies, and the type of files.

SAS No. 103 requires audit documentation to be maintained for a minimum of five years. In addition, 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 1-11; however, the retention periods are only examples. The firm may consider consulting its attorney and insurance carrier when establishing a document retention policy. In addition, it is recommended that policies be reviewed annually and updated as necessary, considering changes in governmental and professional requirements and the cost of retaining records.

Exhibit 1-11

Example Engagement Document Retention Policy

	Retention Period ^a	
	<u>Current Client</u>	<u>Former Client</u>
Engagement files		
Client correspondence files	7 years	7 years
Draft financial statements and reports	Until engagement completion	N/A
Audited financial statements and reports	Indefinitely	7 years
Compiled or reviewed financial statements and reports	Indefinitely	7 years
Special reports	Indefinitely	7 years
Workpaper files:		
Audit workpapers	7 years	7 years
Compilation or review workpapers	7 years	2 years
Special reports workpapers	7 years	2 years
Tax return workpapers	7 years	2 years

	Retention Period^a	
	<u>Current Client</u>	<u>Former Client</u>
Special tax report workpapers	7 years	2 years
Permanent files	Indefinitely	7 years

Note:

^a These are example document retention periods only. It is believed that 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. Firms should consult their state board of accountancy to determine the applicable requirements in their states.

* * *

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

Consultation includes conversation with appropriate, professional level individuals (either inside or outside the firm) who have relevant or specialized expertise. Consultation inside the firm also includes making use of the technical reference materials in the firm’s library as well as seeking the professional expertise of other individuals within the firm. Consultation outside the firm may involve advisory services provided by other firms, professional and regulatory bodies, or commercial organizations that provide relevant quality control services. When consulting outside the firm, an evaluation of whether the external provider is suitably qualified for such a purpose should be made. Recognition of consultation in the firm’s quality control policies and procedures helps promote a firm environment where consultation is seen as strength. In designing the firm’s engagement performance QC system, the following key considerations related to consultation might be kept in mind:

- *Encourage Consultation.* The increased complexity of accounting and auditing requirements has increased the 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, the opinions of all parties to a consultation need to be carefully considered, even if the opinion is unpopular. Furthermore it is advised that all 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 significant enough to be documented. As a result, the firm’s documentation requirements 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 and the reasons for those decisions.

It is believed that firm consultation policies should address three important requirements: (a) that all professional personnel refer to authoritative literature or other sources when appropriate (b) that professional personnel have a constant exchange of ideas and opinions about technical issues; and (c) that all professional personnel seek consultation on a timely basis within (or outside) the firm whenever they are uncertain about any issues.

Establishing Steps to Perform a Consultation. It is believed that the consultation process 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, it is preferred stating in the QC procedures that the managing partner be consulted if the engagement team is not aware of the name of a specialist within the firm.

Designating Outside Specialists. Some firms elect to state in their quality control policies the name of outside specialists that the firm wants the engagement team to consult 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 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. The managing partner or the quality control director is an appropriate individual to make the final determination, although others may also be appropriate.

Even after a final determination has been made, one of the members of the engagement team may disagree with the chosen resolution. The firm's QC document may 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, it is acceptable to have dissenting opinions on the final resolution to the difference of opinion (as discussed in the preceding paragraph) and still consider that the issue is 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 its unique 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.

Smaller firms may also choose to include consulting and tax engagements within their population of engagements to be evaluated, even though such engagements are not subject to SQCS No. 7. It is believed that expanding engagement quality control review criteria to all engagements performed by a firm helps protect the firm against legal liability claims.

Once the EQCR criteria have been developed, the firm establishes a procedure to ensure that all engagements are compared to the EQCR criteria. This course suggests 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 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 easier, rather than more complex, to evaluate against, bearing in mind that the objective of establishing EQCR criteria is to identify engagements that need reviews.

Addressing Nature, Timing, Extent, and Documentation of EQCR. Firms need to 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 need to 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 individual. Individuals contracted with must meet SQCS No. 7 requirements for engagement quality control reviewers.

SELF-STUDY QUIZ

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

14. Firms should maintain the safe custody, integrity and confidentiality of the engagement documentation. Which of the following is one example outlined in the AICPA's Practice Aid, *Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practices* of how a firm accomplishes this?
- During the planning phase, assign responsibilities to appropriate personnel.
 - By implementing the guidelines set forth by the firm for the form and content of documentation of the work performed and conclusions reached.
 - By requiring engagement documentation in accordance with professional standards, applicable regulatory requirements, and the firm's policies.
 - By implementing and applying controls to determine when and by whom engagement documentation was prepared and reviewed.
15. What should *quality control policies* achieve?
- Quality control policies are designed to achieve the overall objectives of the QC system and specific objectives of individual QC elements.
 - Quality control policies are designed to provide actions needed to implement and monitor compliance with the QC system and QC elements.
16. The single-office CPA firm of Pinta & Santa Maria is establishing procedures that address the extent, nature, timing, and documentation of an engagement quality control review. Pinta & Santa Maria conclude that performing an engagement quality control review is not necessary to obtain enough appropriate audit evidence for audit engagements; therefore, Pinta & Santa Maria conclude that it is not necessary to complete the engagement quality control review before the date of the auditor's report. When the engagement quality control review resulted in additional audit procedures being performed, the auditor's report date was changed to the date by which sufficient appropriate audit evidence was obtained. Pinta & Santa Maria's procedures require that for audit attestation engagements, the engagement quality control reviewer must do which of the following?
- Assess all engagements against the criteria and complete an engagement quality control review for all engagements that meet the criteria.
 - Verify with the engagement partner that there are no significant unresolved issues; discuss any important accounting, auditing, and financial reporting issues with the engagement partner; and review the outline of any uncorrected misstatements related to likely and known misstatements. Issues raised in the review indicate a need to change the auditor's report date.
 - Inform personnel of the firm's consultation procedures and policies and providing access to adequate and current reference materials to all professional personnel.
 - Follow the guidelines set forth by the firm for the form and content of documentation of the work performed and conclusions reached; and addressing significant issues arising during the engagement.
17. When developing engagement-level quality control steps, which of the following methods presents the most challenges?
- Developing a bridging document.
 - Making reference in the QC document to the engagement procedures that are located in the accounting and auditing manuals used by the firm.
 - Including engagement performance QC procedures in the body of the QC document.

18. Which of the following statements regarding developing policies and procedures for consultation is *true*?
- a. A firm's policies and procedures should be drafted so as to discourage the use of consultation.
 - b. Because of the possible legal liability to the firm, the opinions, however unpopular, of all parties should be considered.
 - c. Since designing a policy for documenting consultations can be a bothersome task, it is recommended that the firm only include those issues that can be proved worthy of documentation.
 - d. It is not necessary for a consultation inside the firm to include any technical reference materials from the firm's library.

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.)**

14. Firms should maintain the safe custody, integrity and confidentiality of the engagement documentation. Which of the following is one example outlined in the AICPA's Practice Aid, *Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, of how a firm accomplishes this? **(Page 48)**
- a. During the planning phase, assign responsibilities to appropriate personnel. [This answer is incorrect. When planning for engagements to meet professional, regulatory, and firm requirements, the activities include assigning responsibilities to appropriate personnel.]
 - b. By implementing the guidelines set forth by the firm for the form and content of documentation of the work performed and conclusions reached. [This answer is incorrect. By implementing the guidelines set forth by the firm for the form and content of documentation of the work performed and conclusions reached, the practitioner is performing a procedure to ensure the engagement is performed, supervised, reviewed, documented, and reported in accordance with the requirements of professional standards, applicable regulators, and the firm.]
 - c. By requiring engagement documentation in accordance with professional standards, applicable regulatory requirements, and the firm's policies. [This answer is incorrect. By requiring engagement documentation in accordance with professional standards, applicable regulatory requirements, and the firm's policies, the practitioner is performing a procedure to ensure the engagement is performed, supervised, reviewed, documented, and reported in accordance with the requirements of professional standards, applicable regulators, and the firm.]
 - d. By implementing and applying controls to determine when and by whom engagement documentation was prepared and reviewed. [This answer is correct. To maintain the safe custody, integrity and confidentiality of the engagement documentation a firm should establish and apply controls to clearly determine when and by whom engagement documentation was prepared and reviewed; protect the integrity of the information at all stages of the engagement, especially when the information is shared within the engagement team or transmitted to other parties via electronic means; prevent unauthorized changes to the engagement documentation; and allow access to the engagement documentation by the engagement team and other authorized parties as necessary to properly discharge their responsibilities.]**
15. What should *quality control policies* achieve? **(Page 57)**
- a. Quality control policies are designed to achieve the overall objectives of the QC system and specific objectives of individual QC elements. [This answer is correct. The intent is to achieve the overall objectives of the QC system and specific objectives of individual QC elements by designing quality control procedures to provide the actions necessary to implement and monitor compliance with the quality control policies.]**
 - b. Quality control policies are designed to provide actions needed to implement and monitor compliance with the QC system and QC elements. [This answer is incorrect. This is the definition of *quality control procedures*. QC procedures are designed to support and achieve the QC policies.]

16. The single-office CPA firm of Pinta & Santa Maria is establishing procedures that address the extent, nature timing, and documentation of an engagement quality control review. Pinta & Santa Maria conclude that performing an engagement quality control review is not necessary to obtain enough appropriate audit evidence for audit engagements; therefore, Pinta & Santa Maria conclude that it is not necessary to complete the engagement quality control review before the date of the auditor's report. When the engagement quality control review resulted in additional audit procedures being performed, the auditor's report date was changed to the date by which sufficient appropriate audit evidence was obtained. Pinta & Santa Maria's procedures require that for audit attestation engagements, the engagement quality control reviewer must do which of the following? **(Page 48)**
- a. Assess all engagements against the criteria and complete an engagement quality control review for all engagements that meet the criteria. [This answer is incorrect. These are tasks that should be performed when the firm has criteria for determining if an engagement quality control review should be performed; evaluating all engagements against the criteria; performing an engagement quality control review for all engagements that meet the criteria; and completing the review before the report is released.]
 - b. Verify with the engagement partner that there are no significant unresolved issues; discuss any important accounting, auditing, and financial reporting issues with the engagement partner; and review the outline of any uncorrected misstatements related to likely and known misstatements. [This answer is correct. Other tasks the reviewer must perform include discussing with the engagement partner the engagement team's identification and audit of high-risk assertions, transactions, and account balances; reviewing selected working papers relating to the significant judgments the engagement team made and the conclusions they reached; reviewing documentation of the resolution of significant accounting, auditing, or financial reporting issues, including documentation of consultation with firm personnel or external sources; reviewing additional engagement documentation to the extent considered necessary; reading the financial statements and the report and consider whether the report is appropriate; completing the review before the release of the report; conducting the review at appropriate stages during the engagement; and determining if the issues raised in the review indicate a need to change the auditor's report date.]**
 - c. Inform personnel of the firm's consultation procedures and policies and providing access to adequate and current reference materials to all professional personnel. [This answer is incorrect. These are tasks that should be performed when the firm requires that consultation occurs when appropriate; that sufficient and appropriate resources are available to enable appropriate consultation to occur; that all the relevant facts known to the engagement team are provided to those consulted; that the nature, scope, and conclusions of such consultations are documented; and that conclusions resulting from such consultations are implemented.]
 - d. Follow the guidelines set forth by the firm for the form and content of documentation of the work performed and conclusions reached; and addressing significant issues arising during the engagement. [This answer is incorrect. These tasks should be performed when the engagement is performed, supervised, reviewed, documented, and reported (or communicated) in accordance with the requirements of professional standards, applicable regulators, and the firm.]

17. When developing engagement-level quality control steps, which of the following methods presents the most challenges? **(Page 58)**
- a. Developing a bridging document. [This answer is incorrect. A bridging document is the term used to describe a worksheet that shows the engagement performance QC steps performed by the firm for each type of engagement. This 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.]
 - b. Making reference in the QC document to the engagement procedures that are located in the accounting and auditing manuals used by the firm. [This answer is incorrect. Another approach used is making reference in the QC document to the engagement procedures and checklists located in the accounting and auditing manuals used by the firm. This approach avoids the problem of including the numerous procedures into the QC document; however, the one major disadvantage is that rarely does a firm follow every procedure in its audit and accounting manuals verbatim.]
 - c. Including engagement performance QC procedures in the body of the QC document. [This answer is correct. Although 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 lengthy and difficult to understand because the nuances of each type of engagement are difficult to capture in a concise narrative.]**
18. Which of the following statements regarding developing policies and procedures for consultation is *true*? **(Page 66)**
- a. A firm's policies and procedures should be drafted so as to discourage the use of consultation. [This answer is incorrect. Because of the increased complexity of accounting and auditing requirements, the need for consultation has increased regarding technical issues. In today's environment, no one is expected to have all the answers. Consequently, the firm's policies and procedures should be drafted in a way so as to encourage, rather than discourage, the use of consultation.]
 - b. Because of the possible legal liability to the firm, the opinions, however unpopular, of all parties should be considered. [This answer is correct. Consultations are serious matters, and at stake, among other things, is possible legal liability to the firm if a wrong decision is made. Consequently, the opinions of all parties to a consultation should be carefully considered, even if the opinion is unpopular. Furthermore, all consultation systems should include a procedure to allow someone who disagrees with the resolution to a consultation to document their disagreement in the engagement documentation.]**
 - c. Since designing a policy for documenting consultations can be a bothersome task, it is recommended that the firm only include those issues that can be proved worthy of documentation. [This answer is incorrect. Designing a policy for documenting consultations can be bothersome 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 end up inconsequential. Other consultations deal with issues that are so important they should always be documented. As a result, the firm's documentation requirements 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 and the reasons for those decisions.]
 - d. It is not necessary for a consultation inside the firm to include any technical reference materials from the firm's library. [This answer is incorrect. Consultation inside the firm also includes making use of the technical reference materials in the firm's library as well as seeking the professional expertise of other individuals within the firm.]

EVALUATE THE OVERALL ADEQUACY OF THE QUALITY CONTROL SYSTEM'S DESIGN

The ideas, recommendations, and suggestions in this course can assist the firm in designing a practical engagement performance quality control system. The ultimate responsibility for the system, however, resides with the firm, and the firm should know its unique needs better than anyone else.

As previously mentioned in this course, 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 problems noted in peer reviews in making a final evaluation of its QC system. Exhibit 1-12 provides examples of the significant common problems noted in recent peer reviews. Exhibit 1-13 specifically addresses common deficiencies noted during peer reviews of employee benefit plan and *Government Auditing Standards* audits. Additionally, it is suggested that the firm consider common consultation problems noted in peer reviews. Exhibit 1-14 provides some of the common problems noted.

Exhibit 1-12

Common Engagement Performance Problems Noted in Peer Reviews

Engagement Deficiencies

Reports:

- Failure to appropriately qualify an auditor's report for a scope limitation or 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 an audit or 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 or auditor'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 common interest realty association (CIRA)].
- Inappropriate references to GAAP in the accountant's report on financial statements in conformity with an OCBOA.
- Failure to communicate internal control matters required by SAS No. 115.
- Improper dating of auditor's report.

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 accounting and audit 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.

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.
- Failure to document reportable conditions.

Audit Procedures and Documentation:

- Failure to use a written audit program.
- Failure to document audit planning procedures.
- Failure to document the auditor's consideration of internal control.
- Substantial documentation deficiencies related to key audit areas.
- Failure to document compliance with the independence requirements of Interpretation 101-3.
- Failure to consult industry audit guides.
- Failure to request a legal representation letter, if an attorney was consulted.
- Failure to tailor audit programs for specialized industries or for a specific type of engagement (for example, significant areas of inventory and receivable balances).
- Failure to obtain a client management representation letter.
- Omission of key components in a client management representation letter.

- Failure to assess or document the risk of fraud.
- Failure to observe inventory when the amount is material to the balance sheet.
- Failure to perform essential audit procedures required by an industry audit guide.
- Failure to perform adequate tests in key audit areas, including tests related to fraud risk.
- Failure to confirm significant receivables or document appropriateness and utilization of other audit techniques.
- Failure to assess the level of materiality and control risk.
- Failure to document the nature and extent of analytical procedures.
- Failure to test for unrecorded liabilities.
- Failure to review loan covenants relating current and long-term liabilities.
- Failure to perform audit cut-off procedures.
- Failure to document communications between predecessor and successor auditors.
- Failure to perform a review of subsequent events.

SSARS Procedures and Documentation:

- Failure to perform and document analytical and inquiry procedures for a review engagement.
- Engagement letters that omit the required descriptions or statements documenting the understanding with the client for a SSARS 8 engagement.
- 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.

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.
- Cash 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.

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).
- 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.

* * *

Exhibit 1-13**Common Deficiencies for Employee Benefit Plan and Government Auditing Standards Audits****Common ERISA Audit Deficiencies:**

- Inadequate audit planning.
- Failure to assess the risk of material misstatement due to fraud.
- Failure to document an understanding of internal controls, often when a substantive audit is being performed.
- Inadequate use of SAS No. 70 reports and a lack of testing when the SAS No. 70 report is obtained.
- No audit work performed in the contributions area.
- Failure to obtain adequate audit evidence for contributions back to contributing employers for multi-employer plans. (Reliance on contribution report is not enough.)
- Failure to test elective deferrals in the area of payroll audit procedures.
- No audit work performed in the investments area.
- Failure to test end-of-year values of investments.
- Failure to properly value hard-to-value investment assets.
- Improper use of limited scope certifications in the investment area.
- No audit work performed in the area of benefit payments.
- Inadequate auditing regarding eligibility of claims to be covered by the plan.
- Insufficient testing of participant payroll data.
- Failure to test participant eligibility, forfeitures, and allocations.
- In defined contribution plans with limited scope audits, failure to test the allocation earnings and gains/losses to participant accounts.
- Sample sizes used to test participant data are too low.
- Inadequate workpaper documentation.
- Only evidence of audit work is a signoff on an audit program step; no additional supporting documentation available.

Common Government Auditing Standards Audit Deficiencies:

- Failure to issue reports on compliance and internal controls.
- Failure to include appropriate A-133 reports as required.
- Failure to document tests of controls and compliance subject to OMB Circular A-133.
- Poor audit documentation results in many other quality problems.

- Failure to audit, as major programs, Type A programs not qualifying as low-risk.
- Failure to audit Type A programs as major because of errors made in determining the Type A/Type B program dollar threshold.
- Failure to audit all programs included in a cluster of programs.
- Failure to meet the percentage-of-coverage requirement in Circular A-133, section 520(f).
- Use of inadequate or outdated reference material.
- Problems with the schedule of expenditures of federal awards are not noticed by the auditor.
- Extremely small samples, inadequate sampling techniques, and a general lack of documentation about samples and their selection.
- Inadequate *Government Auditing Standards*, Circular A-133, and Data Collection Form reporting.
- Write-ups that do not include all the required elements.
- Noncompliance with continuing professional education and audit documentation requirements.

* * *

Exhibit 1-14

Common Consultation Problems Noted in Peer Reviews

- Library not utilized because staff is not comfortable with research.
- Library does not contain appropriate technical manuals and guidance materials relative to the firm's practice and/or contains outdated versions.
- Failure to document consultation performed.
- Failure to specify areas and specialized situations requiring consultation.
- Failure to consult when required by firm policy.
- Failure to recognize situations requiring consultation.
- Consultations that are insufficiently thorough and result in the wrong conclusion.

* * *

SELF-STUDY QUIZ

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

- 19. Which of the following is an example of an engagement deficiency in audit procedures and documentation?
 - a. Omitting disclosures related to accounting principles.
 - b. Inappropriate dating of the auditor's report.
 - c. Exclusion of significant components in a client management representation letter.
 - d. Failure to segregate the current portion of long-term debt.

- 20. Financial statement deficiencies include assets, liabilities, statements of income, and statement of cash flows. Which of the following lists are examples of financial statement deficiencies in liabilities?

List A	List B	List C	List D
Investments not consolidated in a majority owned or subsidiary.	All periods not covered in accountant's report.	Capital leases not recognized.	Activity misclassification.
Current and long-term assets not properly classified.	Income tax expense not presented as a separate line item.	Deferred revenue not properly recognized.	Missing disclosure of noncash investing and financial activities.
Debt and equity security investments not correctly measured.	Income tax provision, where applicable, not recorded in interim financial statements.	Deferred income taxes not properly classified.	Missing disclosure of interest and income taxes paid for indirect cash flow statement.
Recording of capital leases as operating leases not properly recorded.		Demand liabilities classified as long-term.	Lack of reconciliation between net income and net cash flow from operations.

- a. List A.
- b. List B.
- c. List C.
- d. List D.

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.)**

19. Which of the following is an example of an engagement deficiency in audit procedures and documentation? **(Page 74)**
- Omitting disclosures related to accounting principles. [This answer is incorrect. This is an example of an engagement deficiency related to disclosures.]
 - Inappropriate dating of the auditor's report. [This answer is incorrect. This is an example of a common engagement deficiency in a report as noted in peer reviews.]
 - Exclusion of significant components in a client management representation letter. [This answer is correct. Other examples of engagement deficiencies in audit procedures and documentation include failure to assess the level of materiality and control risk; failure to document communications between predecessor and successor auditors; and failure to assess or document the risk of fraud.]**
 - Failure to segregate the current portion of long-term debt. [This answer is incorrect. This is an example of a common engagement deficiency related to financial statement presentation.]
20. Financial statement deficiencies include assets, liabilities, statement of income, and statement of cash flows. Which of the following lists are examples of financial statement deficiencies in liabilities? **(Page 74)**

List A	List B	List C	List D
Investments not consolidated in a majority owned or subsidiary.	All periods not covered in accountant's report.	Capital leases not recognized.	Activity misclassification.
Current and long-term assets not properly classified.	Income tax expense not presented as a separate line item.	Deferred revenue not properly recognized.	Missing disclosure of noncash investing and financial activities.
Debt and equity security investments not correctly measured.	Income tax provision, where applicable, not recorded in interim financial statements.	Deferred income taxes not properly classified.	Missing disclosure of interest and income taxes paid for indirect cash flow statement.
Recording of capital leases as operating leases not properly recorded.		Demand liabilities classified as long-term.	Lack of reconciliation between net income and net cash flow from operations.

- List A. [This answer is incorrect. List A is a list of examples of financial statement deficiencies of assets.]
- List B. [This answer is incorrect. List B is a list of examples of financial statement deficiencies of the income statement.]

- c. **List C. [This answer is correct. Other examples of financial statement deficiencies of liabilities include no recognition of a liability for compensated absences and improper classifications between current and long-term debt.]**
- d. List D. [This answer is incorrect. List D is a list of examples of financial statement deficiencies for the statement of cash flows.]

EXAMINATION FOR CPE CREDIT**Lesson 1 (GQCTG101)**

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. The requirements in SQCS No. 7 concerning engagement quality, review, documentation, consultation, and resolution of differences apply to which of the following?
 - a. Only audit engagements.
 - b. Only to compilation and review engagements.
 - c. Equally to compilation and review engagements, and audit and attestation engagements.
 - d. Do not select this answer choice.
2. What is the first step an auditor should take before beginning the process of designing engagement performance, supervision, and review policies and procedures that are suitable for the firm's practice?
 - a. Determine if there is enough evidence to support the report.
 - b. Identify matters for consultation with experienced engagement team members.
 - c. Develop the engagement team.
 - d. Determine what particular requirements exist in authoritative guidance for audits, attestations, compilations, and reviews.
3. Which of the following is considered a compilation performance requirement?
 - a. Obtaining an understanding with the entity regarding services to be performed.
 - b. Inquire about misstatements previously identified.
 - c. Obtain an updated representation letter based on events that may have occurred.
 - d. Obtain information regarding actions taken at stockholder meetings.
4. All of the following address the revisions proposed by SAS No. 117, Compliance Audits, **except**:
 - a. Clarifies the applicability of the standards it supersedes.
 - b. Establishes specific requirement for auditors to follow.
 - c. Identifies required elements of an auditor's report on compliance.
 - d. Maintains previous terminology and includes no guidance for changes in the compliance audit environment.
5. Which of the following is **not** a purpose for audit documentation per SAS No. 103 (AU339)?
 - a. Improving engagement economics.
 - b. Maintaining a record of matters of continuing importance to future audits of the same entity.
 - c. Providing assistance to an auditor who reviews a predecessor auditor's audit documentation.
 - d. Providing assistance to the audit team in planning and performing the audit.

6. Assisting members of the audit team responsible for supervision, assisting auditors who are new to an engagement, and assisting a successor auditor who reviews a predecessor auditor's documentation are examples of the purposes for audit documentation as outlined by which auditing standard?
 - a. SAS No. 110.
 - b. SAS No. 108.
 - c. SAS No. 107.
 - d. SAS No. 103.
7. On June 9, 2009, accountants Thompson & Taylor, a CPA firm, accepted an audit engagement for Kelly's Collectibles, Inc. (KKI). Thompson & Taylor gave KKI permission to use their report on August 1, 2009. According to SAS No. 103, *Audit Documentation*, when did the final assembly and completion of the audit engagement file have to occur?
 - a. By July 15, 2009.
 - b. By August 9, 2009.
 - c. By September 30, 2009.
 - d. By December 31, 2009.
8. SQCS No. 7 requires the retention of engagement workpapers for which of the following?
 - a. For three years from the report release date.
 - b. For compilation or review workpapers where none existed before.
 - c. For 60 days after document completion.
 - d. For engagements where none existed before.
9. SQCS No. 7 provides guidance regarding consultations and differences of opinion. Which of the following is an example of that guidance?
 - a. Consultation documentation does not need to be specific as long as it explains the issue requiring consultation.
 - b. How conclusions are reached when handling differences of opinion need to be documented.
 - c. Policies and procedures need to be established for dealing with differences of opinion.
 - d. Firms that implement policies and procedures concerning consultation are not required to have other resources available.
10. In regards to the documentation of differences in opinion, which of the following always requires documentation?
 - a. Minor technical issues.
 - b. Material issues.
 - c. General questions.
 - d. Regulatory body procedures.

11. In order to establish criteria for engagement quality control review, a firm should consider the characteristics of the firm's practice. All of the following are examples of determining when an engagement quality control review (EQCR) should be performed **except**:
- Any pertinent regulations or laws requiring an engagement quality control review.
 - Identified risks relating to the engagement.
 - The nature of the engagement, including a matter of public interest.
 - If the reviewer is qualified to conduct the engagement quality control review.
12. Which of the following situations would usually result in fewer engagements being subject to an EQCR?
- New firm partners.
 - Clients with no related party transactions.
 - New types of services for the firm.
 - Entities subject to governmental regulations.
13. Which of the following factors should be considered when determining the qualifications for appointing and replacing engagement quality control reviewers?
- How qualified the reviewer is to make decisions for the engagement team.
 - If the reviewer is capable of consulting as well as participating in the engagement.
 - The reviewer's technical expertise and experience in a specialized industry.
 - The engagement partner's qualifications to choose the reviewer in a large firm.
14. When designing a firm's quality control policies, after a review of the authoritative literature, the next recommended step would be to perform which of the following?
- Develop a planning document.
 - Review illustrative examples suggested by the AICPA.
 - Update background information on the client.
 - Select the engagement team.
15. Match the following tasks with the appropriate policy suggested by the AICPA.

<p>A. Planning for engagements meets regulatory, professional, and the firm's requirements.</p>	<p>1. Assure that all reviewers are experienced, competent, and responsible.</p>
<p>B. Qualified engagement team members review work performed by other team members on a timely basis.</p>	<p>2. Prevent unauthorized changes to the engagement documentation.</p>

<p>C. The firm maintains the confidentiality, safe, custody, integrity, accessibility, and the ability to retrieve the engagement documentation.</p>	<p>3. Independence requirements relating to the engagement are met.</p>
<p>D. The firm establishes criteria for the eligibility of engagement quality control reviewers.</p>	<p>4. Update background information on the engagement and the client.</p>

- a. A 1; B 2; C 4; D 3.
 - b. A 4; B 1; C 2; D 3.
 - c. A 3; B 2; C 1; D 4.
 - d. A 2; B 3; C 1; D 4.
16. A firm must maintain the confidentiality, safe custody, integrity, and accessibility of engagement documentation. A single-office CPA firm can achieve this by performing which of the following?
- a. Engaging the use of passwords and data encryption to prevent access to electronic engagement documentation to unauthorized users.
 - b. Allow authorized external parties to access and review certain engagement documentation for quality control purposes.
 - c. Determine if the EQCR has sufficient technical expertise and experience.
 - d. Determine if the EQCR meets the independence requirements relating to the engagements reviewed.
17. What is the recommendation for documenting in regards to unique engagement performance issues for compilation engagements and QC procedures?
- a. The differing QC procedures are documented in the body of the engagement performance QC procedures.
 - b. The differing QC procedures do not need to be documented.
 - c. The QC procedures are the same for each engagement type and documented in the bridging document.
 - d. The differing QC procedures related to the particular types of compilation engagements are specified in the bridging document.
18. Arrange the following steps in the correct order that best illustrates how the consultation process evolves.

<p>A. Ensure that enough resources are available to allow meaningful consultation.</p>
<p>B. Supply all significant facts known to the engagement team to the in-firm and/or external specialist.</p>
<p>C. Establish policies and procedures to ensure that consultation occurs when necessary.</p>
<p>D. When issues 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.</p>
<p>E. Document the scope and nature of consultations and the conclusions reached and implement the decision.</p>
<p>F. Discuss the issue creating the need for consultation with members of the engagement team after a situation requiring consultation is identified.</p>
<p>G. 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.</p>

- a. C, E, A, B, D, F, G.
 - b. C, G, E, D, A, B, F.
 - c. C, F, A, G, D, B, E.
 - d. C, A, F, B, E, D, G.
19. SQCS No. 7 states that firms need to establish quality control procedures that address how an EQCR will be performed for engagements meeting the EQCR criteria. Which of the following is not an example of these procedures:
- a. Documentation requirement.
 - b. Criteria related to the nature and extent of reviews.
 - c. Consultation with outside parties.
 - d. Timing of reviews.
20. Which of the following engagement deficiencies are related to disclosures?
- a. Omission of a summary of significant assumptions in a projection.
 - b. Misclassification of a material balance.
 - c. No client management representation letter was obtained for a review engagement.
 - d. Failure to assess the level of materiality and control risk.

Lesson 2: Monitoring

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 and auditing services and to increase its efficiency in delivering those services.

SQCS No. 7 (QC 10.5) 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.

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 policies and procedures seem appropriate, but firm personnel are not complying with them. The firm needs to learn why the policies and procedures are not being followed in order to take corrective action, either with firm personnel or by improving the policies and procedures.

Upcoming Changes to SQCS No. 7

As discussed in Lesson 1, 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. Additionally, the ASB issued the exposure draft, Quality Control for an Audit of Financial Statements, which would supersede SAS No. 25, The Relationship of Generally Accepted Auditing Standards to Quality Control Standards.

As further explained in Lesson 1, those two standards are being redrafted to apply the ASB's clarity drafting conventions and to converge with the international standards ISQC 1 and ISA 220. 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 SAS is expected to be effective for audits of financial statements for periods beginning on or after December 15, 2010. The proposed SQCS does not change or expand SQCS No. 7 in any significant respect. However, changes affecting the monitoring QC element deemed more than minor by the authors that are expected to result from the proposed SQCS and SAS have been discussed where applicable throughout this lesson.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the various types of monitoring.
- Illustrate how to perform monitoring procedures, evaluate and communicate the results, and document the monitoring procedures.
- List the various types of complaints and explain how to address the complaints and allegations.
- Identify key issues related to drafting monitoring policies and procedures.

TYPES OF MONITORING ACTIVITIES

Monitoring is an ongoing process intended to determine that a firm's quality control policies and procedures continue to be relevant and adequate, that 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 the following three types of monitoring activities:

- Engagement quality control review (EQCR).
- Post-issuance 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 must 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 need to 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. It is believed that 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

Paragraph 100 of SQCS No. 7 states that monitoring policies and procedures need to 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.

Post-issuance Review

Post-issuance reviews are not specifically defined by SQCS No. 7, other than to characterize them as a review of engagement documentation, reports, and client's financial statements for selected engagements. From this characterization, a post-issuance 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 post-issuance reviews in SQCS No. 7, it is believed that firms may develop policies and procedures for the use of post-issuance reviews to be a significant part of the firm's engagement monitoring process. To be most effective as a monitoring tool, it is believed that the following conditions should 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 post-issuance reviews must not be directly associated with the performance of the engagement. (Except where an exception is allowed for small firms with a limited number of individuals having sufficient and appropriate experience and authority.)
- c. The post-issuance review needs to 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. (This condition does not imply that a post-issuance review is to be performed for all engagements. Like inspections, post-issuance 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.

Post-issuance engagement reviews that meet the above requirements are almost identical to inspection procedures, except that post-issuance 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 10.5) 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." As previously mentioned, while SQCS No. 7 does not discuss post-issuance reviews in any detail, performing inspections is discussed in greater detail in QC 10.105–108.

Firms should 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 three years. [However, since SQCS No. 7 requires annual communication of monitoring results, firms need to 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.
- Number and location of offices.
- 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—

- Larger firms have more partners and each partner needs to have engagements monitored.
- Larger firms generally have a higher level of in-house expertise in multiple areas, and the more in-house expertise available in the firm, the fewer engagements the firm may feel required to select for inspection.
- Larger firms often 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.

Number and Location of Offices. A single office firm has complete control and authority over firm processes and procedures, including how its inspection cycle will be managed. In a multi-office environment, other factors impact management of the inspection cycle. One of those factors is the degree of authority each office has over its monitoring process.

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 seems to have been corrected.

Degree of Authority Firm Has over Inspections. In a multi-office environment, firms with the authority for inspecting their own engagements are able to independently determine how the inspection cycle is organized for their location. The head office may provide some guidelines over the inspection process, for example, that each partner have one engagement inspected annually. Alternatively, when the head office of the firm oversees and conducts the inspections, each individual location has no authority to determine how the inspection cycle is organized.

Nature and Complexity of the Practice. The nature and complexity of the firm 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, public entities, 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 little client and engagement risk may not feel a need to perform other than minimal monitoring. 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.

SELF-STUDY QUIZ

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

21. The degree of inspection is based in part on which of the following?
 - a. The effectiveness other monitoring procedures.
 - b. The nature of the inspection procedures.
22. Which of the following statements regarding the inspection process is most accurate?
 - a. Engagement inspections are only performed on an annual basis.
 - b. Engagement inspections are most accurate when performed after the firm has been notified of the upcoming inspection.
 - c. Firm size is one factor that can affect how an inspection cycle is organized.
 - d. Most single-office firms have no authority over how the inspection cycle is managed.
23. What is one good reason to perform an inspection before a peer review?
 - a. Monitoring the firm's QC system prepares the firm for the peer review.
 - b. An inspection can be substituted for a peer review.
 - c. The inspection may uncover issues that can be resolved before the peer review occurs.

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.)**

21. The degree of inspection is based in part on which of the following? **(Page 91)**
- a. **The effectiveness of other monitoring procedures. [This answer is correct. The existence and effectiveness of a firm's monitoring procedures should determine (for the most part) the need for and extent of inspection procedures. Less effective monitoring procedures require a greater degree of inspection procedures.]**
 - b. The nature of the inspection procedures. [This answer is incorrect. The firm's quality control policies and procedures and results of its other monitoring procedures affect the nature of inspection procedures. However, the nature of the inspection procedures does not affect the degree of inspection.]
22. Which of the following statements regarding the inspection process is most accurate? **(Page 92)**
- a. Engagement inspections are only performed on an annual basis. [This answer is incorrect. Engagement inspections are often performed at a specific time during the year. These inspections can occur annually or periodically.]
 - b. Engagement inspections are most accurate when performed after the firm has been notified of the upcoming inspection. [This answer is incorrect. The quality control process will more likely expose engagements with deficiencies when the engagement team is not notified of the inspection.]
 - c. **Firm size is one factor that can affect how an inspection cycle is organized. [This answer is correct. How the inspection cycle is organized, including the timing of selection of individual engagements, depends on many factors, including firm size; the degree of authority the firm has over inspections; client and engagement risks; the number and location of offices; the nature and complexity of the firm's practice; and the results of past monitoring.]**
 - d. Most single-office firms have no authority over how the inspection cycle is managed. [This answer is incorrect. A single-office firm has total control and authority over firm processes and procedures, including how its inspection cycle will be managed. In a multi-office environment, other factors impact management of the inspection cycle.]
23. What is one good reason to perform an inspection before a peer review? **(Page 93)**
- a. Monitoring the firm's QC system prepares the firm for the peer review. [This answer is incorrect. The peer review assesses the QC system, not monitoring. Therefore, since monitoring is considered an ongoing process the performance of a peer review is not a substitute for monitoring procedures.]
 - b. An inspection can be substituted for a peer review. [This answer is incorrect. An inspection does not substitute for peer review. However, SQCS No. 7 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.]
 - c. **The inspection may uncover issues that can be resolved before the peer review occurs. [This answer is correct. 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.]**

PERFORMING MONITORING PROCEDURES

SQCS No. 7 Requirements

Paragraph 100 of SQCS No. 7 states that the policies and procedures over monitoring—

- 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 the 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 per SQCS No. 7—to determine whether the firm's quality control system has been operating effectively so that reports issued are appropriate in the circumstances. If a break down 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 break down has occurred. Additionally, while inspection is an element 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 modified or adverse peer review report, which could potentially result in negative consequences to the firm. For example, if the firm issued an unqualified audit 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, CAQ, Governmental Audit Quality Center, or Employee Benefits Audit Quality Center, 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 negative 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 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 making necessary modification to the QC system on a timely basis. Additionally, at least annually, the results of monitoring the firm's quality control system are to be communicated to appropriate individuals within the firm.

There is more than one way to accomplish the goal of ongoing monitoring. This course recommends a method that views the monitoring process as 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 effort 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.

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 findings are reviewed by those assigned responsibility for the monitoring process and those individuals 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 modified or adverse peer review report. If identified early enough, such situations can be corrected and a less than favorable peer review report avoided.

Making Necessary Changes. Firms need to update their QC policies and procedures as they discover any inadequacy or when events occur that dictate the policies and procedures need revision. 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 document. 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. Other examples include a firm accepting its first SEC engagement or a sole practitioner adding another partner. 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 should be revised.

Changing the quality control system includes eliminating or revising outdated policies and procedures, as well as developing new policies and procedures to cover 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 and auditing change has become commonplace in recent years, in a more steady environment, firms may 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.

Exposure Draft. 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 statement for a selection of completed engagements.

Assigning Responsibility for the Firm's Monitoring Process

Firms should assign responsibility for the monitoring process to a partner(s) or other individuals who possess sufficient and appropriate experience and authority within the firm to assume such responsibility. It is believed that monitoring activities should generally be performed by, or under the supervision of, the quality control director. Firms that do not have a quality control director might consider using the managing partner to oversee the monitoring process.

Selecting a Monitoring Team

The following paragraphs discuss selection of the monitoring team and apply to team selection for both post-issuance reviews and inspection procedures. The selection of the team is a critical step because without knowledgeable and experienced individuals to oversee and conduct the monitoring procedures, the program may likely be ineffective. Three factors should be considered 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 chosen to conduct the monitoring procedures preferably should be a partner with a reasonably high degree of accounting and auditing experience. However, if necessary, 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. 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 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 independence, integrity, and objectivity, professional development, hiring, personnel evaluations, etc.
- 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) 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 (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 and audit 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 should be reviewed and, consequently, the greater the number of team members needed. Exhibit 2-1 presents some suggested guidelines about the size and make-up of monitoring teams.

Exhibit 2-1**Typical Team Make-up**

Size of Firm	Typical Team Make-up
Fewer than 5 professionals	A partner or senior staff member
5 to 10 professionals	A partner or experienced manager
11 to 25 professionals	A partner and a manager-level staff member
More than 25 professionals	At least a partner and a manager with additional staff as required
*	* *

Establishing 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 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 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 that 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 and performing both engagement monitoring and administrative and other monitoring procedures is addressed in the following paragraphs.

Exposure Draft. The SQCS exposure draft makes some minor changes to the last three items identified under “Establishing Monitoring Procedures” above include the following revisions—

- Determining any corrective actions to be taken or improvement 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 that any modifications necessary are promptly made to the QC system.

Performing Engagement Monitoring Procedures

It is believed that monitoring procedures can generally be divided into two categories—engagement monitoring procedures and administrative and other monitoring procedures. Both types of monitoring procedures are to 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, 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 are effective when they test both compliance with the firm’s stated quality control policies and procedures for engagement monitoring and compliance with related authoritative literature. It is suggested not to state the specific procedures to be performed during engagement monitoring in the QC document. 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 review 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 also to 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 includes assessing firm compliance with its policies and procedures on independence. To determine compliance, the firm’s ethics partner needs to review documentation of personnel’s independence representation forms completed annually, as well as resolution of matters regarding independence to determine that matters have been appropriately considered and resolved, including correspondence regarding consultation on independence matters.

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. If a firm sets such a time limit, peer reviewers will expect the time limit to be complied with. This course suggests use of the term "within a reasonable period of time" 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 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 the firm's governmental audit practice considering the number and types of governmental audits (e.g., single audits and program-specific audits, as defined under OMB Circular A-133, and other compliance audits and attestation engagements performed under various federal, state, or local agency audit guides). (Effective September 1, 2009, peer reviewers must select at least one A-133 audit engagement to evaluate compliance with the requirements of A-133.)
- b. A cross-section of the firm's ERISA employee benefit plan audit practice considering the number and types of plan audits (e.g., defined benefit, defined contribution, health and welfare, multiemployer, ESOPs, limited and full scope).
- c. A cross-section of the firm's FDIC Improvement Act of 1991 (FDICIA) audit practice, which encompasses federally insured depository institutions with \$500 million or more in total assets at the beginning of the fiscal year.
- d. Other specialized, complex, and high-risk engagements (for example, insurance companies, financial institutions not subject to FDICIA requirements, and security brokers and dealers).
- e. First-year engagements.

- f. A cross-section of engagements based on the level of service performed (for example, audit, review, compilation, attestation).
- g. A cross-section of engagements from all firm partners and other management level personnel having accounting and auditing responsibilities.
- h. Significant client engagements.
- i. 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, legal or regulatory requirements, or the firm's system of quality control.
- j. Engagements involving complex issues requiring consultation.
- k. 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

Determining 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 pronouncements. 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 Reuters is a third-party provider of such materials, such as PPC guides. Because all materials found in the PPC accounting and auditing guides are part of a comprehensive quality control system, this course recommends their use. Additionally, PPC's accounting and auditing 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.

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. A firm needs to 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 authoritative standards or regulatory 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 firms 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 under the AICPA's *Code of Professional Conduct*, rules of applicable 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. As explained, the ethics partner is often responsible for accumulating and evaluating employee responses concerning independence.

Determining the Effectiveness of Continuing Professional Development. Establishment of quality control policies and procedures related to continuing professional development, including training is important for all firms. 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 quality control director needs to 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 Understanding of QC Policies and Procedures by Firm Personnel. 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, the firm needs 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.

Special Considerations—Governmental Audit Quality Center Member Firms

There are special requirements for membership in the AICPA Governmental Audit Quality Center, including a requirement to establish annual inspection procedures that include a review of the firm's governmental audit practice and compliance with the Center's membership requirements. This inspection is in addition to the monitoring requirement of the quality control standards. It should be conducted by persons with current experience and knowledge of accounting and auditing practices specific to governmental audits. The inspection includes engagements representative of the firm's governmental audit practice, such as Single Audits and audits performed under OMB Circular A-133, program specific audits, and other compliance audits performed under various federal, state, or local agency audit guides. The firm makes the results of the internal inspection of its governmental audit engagements available to the peer reviewer. The Membership requirements state that a peer review does not substitute for monitoring procedures but that a peer review conducted under AICPA standards may substitute for some or all inspection procedures for the period covered by the peer review.

Special Considerations—Employee Benefit Audit Quality Center Member Firms

There are special requirements for membership in the AICPA Employee Benefit Plan Audit Quality Center, including a requirement to establish annual inspection procedures that include a review of the firm's ERISA employee benefit plan audit practice and compliance with the Center's membership requirements. This inspection should be performed by an experienced person knowledgeable of current accounting and auditing practices relevant to ERISA employee benefit plan audits. This is in addition to the monitoring requirement of the quality control standards. The engagements inspected should be representative of the firm's ERISA practice considering the different types of plans it audits, such as defined contribution, defined benefit, health and welfare, multiemployer, ESOPS, limited-scope, and full-scope audits, and the various locations at which the audits are performed. The firm must also make its internal inspection reports available to the peer reviewer.

SELF-STUDY QUIZ

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

24. Which of the following statements most accurately describes SQCS No. 7's position on self-monitoring?
- a. SQCS No. 7 indicates that an individual inspecting his or her own work is more effective in performing a successful audit because that individual is more familiar with their own QC systems.
 - b. SQCS No. 7 indicates that for self-monitoring to be successful, an individual should follow a detailed checklist.
 - c. Although SQCS No. 7 does not indicate that self-monitoring should not be performed, it does not recommend it.
 - d. SQCS No. 7 indicates that to effectively monitor one's own compliance, that individual should conduct a critical review of the performance of the firm.
25. SQCS No. 7 requires that performance of which of the following monitoring procedures be completed prior to the issuance of the engagement report?
- a. EQCR when the criteria for performance are met.
 - b. Inspection.
 - c. Post-issuance.
 - d. Evaluate firm's independence
26. What is one way a firm can effectively evaluate personnel's understanding of QC policies and procedures?
- a. Training.
 - b. Interviewing personnel.
 - c. Maintaining updated quality control systems.
 - d. Reviewing written confirmations from personnel.

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.)**

24. Which of the following statements most accurately describes SQCS No. 7's position on self-monitoring? **(Page 99)**
- a. SQCS No. 7 indicates that an individual inspecting his or her own work is more effective in performing a successful audit because that individual is more familiar with their own QC systems. [This answer is incorrect. 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.]
 - b. SQCS No. 7 indicates that for self-monitoring to be successful, an individual should follow a detailed checklist. [This answer is correct. 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 is greatly diminished.]**
 - c. Although SQCS No. 7 does not indicate that self-monitoring should not be performed, it does not recommend it. [This answer is incorrect. SQCS No. 7 recommends self-monitoring only when specific guidelines are followed.]
 - d. SQCS No. 7 indicates that to effectively monitor one's own compliance, that individual should conduct a critical review of the performance of the firm. [This answer is incorrect. To effectively monitor one's own compliance with the firm's policies and procedures, the individual needs to critically review his or her own performance; assess his or her own strengths and weaknesses; and maintain an attitude of persistent improvement.]
25. SQCS No. 7 requires that performance of which of the following monitoring procedures be completed prior to the issuance of the engagement report? **(Page 102)**
- a. EQCR when the criteria for performance are met. [This answer is correct. 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.]**
 - b. Inspection. [This answer is incorrect. Although SQCS No. 7 does not indicate any specific requirements relating to the timing of inspection procedures, it does require that firms communicate, at least annually, the results of the monitoring of its quality control system to relevant individuals within the firm.]
 - c. Post-issuance. [This answer is incorrect. Firms should use caution when setting time limits during a post-issuance review. If a firm sets such a time limit, peer reviewers will expect the time limit to be complied with.]
 - d. Evaluate firm's independence. [This answer is incorrect. While it is important to evaluate independence on each engagement prior to engagement and monitor any changes that occur during the engagement, the evaluation of the firm's independence should be performed by the firm's ethics partner at least annually, according to SQCS No. 7.]
26. What is one way a firm can effectively evaluate personnel's understanding of QC policies and procedures? **(Page 104)**
- a. Training. [This answer is incorrect. In this situation, training is best used to develop and enhance personnel's expertise regarding on-going monitoring of the QC systems.]
 - b. Interviewing personnel. [This answer is correct. By interviewing personnel, the firm can gather information to determine if 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.]

- c. Maintaining updated quality control systems. [This answer is incorrect. Maintaining updated quality control systems is a part of an effective quality control system. 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 if changes made achieved the intended objectives. 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. However, this is not effective in evaluating personnel's understanding of QC policies and procedures.]
- d. Reviewing written confirmations from personnel. [This answer is incorrect. The firm's confirmations obtained are an integral part of the firm's QC system. However, such materials are not used to evaluate personnel's understanding of QC policies and procedures but rather acknowledge they have received the firm's QC policies and procedures manual for reference.]

EVALUATING AND COMMUNICATING 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 finds 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; however, a firm needs 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

As mentioned above, 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, and that the reports issued by the firm or engagement partners are appropriate. 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, 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, that need to be 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 deficiencies. Generally, the firm should pursue one or more of the following recommended actions:

- Communicate the findings to those responsible for training and professional development.
- Remedial action directed toward the individual engagement or person.
- Revise the firm's quality control policies and procedures.
- Discipline individuals who fail to follow the firm's QC policies and procedures.

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, staff training that focuses on those areas or industries is appropriate.

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.

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 firm's 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. In larger firms, the responsibility to implement corrective actions is normally delegated to the quality control director. This course suggests that the subsequent year's monitoring program contain a procedure for the monitoring team to investigate whether the firm is complying with the implemented new 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:

- Audits:
 - AU 390 discusses the considerations and procedures necessary when auditors conclude, subsequent to the release of their report, that one or more required audit procedures were omitted.
 - AU 561 discusses the procedures to follow when auditors, subsequent to the release of their report, discover facts that may have existed at the report date that cause them to believe the financial statements may be misleading.
- Compilation and Review:
 - AR 100.64 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.

Exposure Draft. The SQCS exposure draft 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 individu-

als within the firm. Firms that perform periodic engagement monitoring procedures (as opposed to inspections at one set time each 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 can 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 need to be promptly communicated so that corrective actions can be implemented as quickly as possible.

SQCS No. 7 indicates that the following information 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 significant deficiencies and the actions taken to resolve or amend those deficiencies. Significant deficiencies include systemic and repetitive deficiencies.

The communication can 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 partner is not required, unless such reporting is necessary for the proper discharge of the responsibilities of the individuals other than the engagement partner.

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. In addition, the firm may choose to communicate monitoring findings to professional staff at all levels to promote 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. It is believed the actual detail and extent of the communication may depend on the size, structure, and number of partners.

Small Firms. The smaller the firm, the greater the benefits of an open discussion of the actual details of the findings with all of the staff. The actual engagements and related findings can be discussed in more detail since all personnel have actual experience with some of the engagements reviewed and several staff members may have worked on the specific 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. While there is no authoritative definition for what constitutes a small firm, this course suggests this type of discussion may be beneficial for firms with up to 25 staff members.

Larger Firms. Larger firms may find it less desirable to discuss the findings in the same open and detailed fashion as small firms. Instead, larger firms will generally discuss the findings in a more summarized manner. The purpose of the discussion is generally to explain any trends noted in the findings and changes to the QC system being implementing as a result. Specific findings relating to specific engagements should be discussed with the supervisory individuals conducting those engagements. Multiple-office firms will generally hold separate meetings for each office. However, if the offices are geographically close, the partners may decide that one combined meeting is feasible. Also, industry groups within multiple-office firms may have combined meetings and discuss the findings in much the same way.

Upcoming QC Changes

The ASB has issued two exposure drafts that would supersede SQCS No. 7 and SAS No. 25.

Proposed SQCS. The proposed SQCS adds new guidance for firms with network affiliations that use common monitoring procedures for consistency. When firms operating in a network environment place reliance on a common network monitoring system, the firm's policies and procedures should require that:

- At least annually, the network communicates the scope, extent, and results of its monitoring process to appropriate individuals within the network firms.

- The network promptly communicates any identified deficiencies in the QC system to the appropriate individuals within the relevant network firm(s) so that necessary action can be taken.

Such requirements allow engagement partners within the network firms to rely on the results of the monitoring process implemented within the network, unless the firms or the network advises otherwise.

Proposed SAS. In relation to the firm's QC system monitoring process, the proposed SAS indicates that the audit engagement partner consider—

- The results of the firm's monitoring process as detailed in the most recent information circulated to the engagement partner by the firm (and, if applicable, other network firms).
- Whether deficiencies noted in that information may affect the audit engagement.

SELF-STUDY QUIZ

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

27. Which of the following statements about the results of monitoring is correct?
- a. The severity of the deficiency determines how promptly the firm will take corrective action.
 - b. Occasional errors identified in a firm's quality control system can be an indication that the QC element is sufficient.
 - c. A firm's system of quality control should not contain any restrictions that would lessen its effectiveness.
 - d. A firm's circumstances frequently change decreasing the quality control deficiencies.
28. A firm may perform which of the following when systemic causes are responsible for QC system deficiencies?
- a. Modify QC policies and procedures.
 - b. Take disciplinary action.
 - c. Take remedial action regarding personnel.
 - d. Implement and monitor corrective actions.
29. The firm of McNabb & Romo, after conducting an inspection of its QC system, concluded for one engagement, that facts that may have existed at the report date may cause them to believe the financial statements may have been misleading. Which of the following guidance should McNabb & Romo consult regarding what corrective action to take?
- a. AR 100.64.
 - b. AU 561.
 - c. AU 390.
 - d. SQCS No. 7.
30. Which of the following statements most accurately describes the communication of monitoring results?
- a. Firms should avoid communicating the monitoring results more than annually.
 - b. Any significant deficiencies should be communicated along with a description of actions taken to resolve the deficiencies.
 - c. The other individuals in the firm that monitoring results should be communicated to should not include personnel responsible for any future quality control system engagements.
 - d. Smaller firms receive fewer benefits from communicating the details of the findings with the firm's staff.

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.)**

27. Which of the following statements about the results of monitoring is correct? **(Page 100)**
- a. The severity of the deficiency determines how promptly the firm will take corrective action. [This answer is incorrect. A firm should promptly evaluate the effect of deficiencies discovered as a result of the monitoring process and determine whether corrective action is required.]
 - b. Occasional errors identified in a firm's quality control system can be an indication that the QC element is sufficient. [This answer is correct. 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 system is effectively working.]**
 - c. A firm's system of quality control should not contain any restrictions that would lessen its effectiveness. [This answer is incorrect. A system of quality control has inherent limitations that can lessen its effectiveness. For example, establishing a system of quality control, especially initially, may require occasional revisions before the firm finds the best set of policies and procedures for its particular needs.]
 - d. A firm's circumstances frequently change decreasing the quality control deficiencies. [This answer is incorrect. Firm circumstances never remain the same making it challenging for a firm to maintain their quality control system in perfect working order.]
28. A firm may perform which of the following when systemic causes are responsible for QC system deficiencies? **(Page 109)**
- a. Modify QC policies and procedures. [This answer is correct. Revisions to the quality control policies and procedures may be necessary when systemic causes are the reason for QC system deficiencies. Such revisions may involve rewriting or modifying certain QC policies or procedures, as well as updating, changing, or adopting new quality control materials.]**
 - b. Take disciplinary action. [This answer is incorrect. Disciplinary action usually occurs when an individual fails to comply with the firm's QC policies and procedures.]
 - c. Take remedial action regarding personnel. [This answer is incorrect. Remedial action is taken against personnel when they have failed to follow the QC policies and procedures in place. This does not indicate that the procedures in place are deficient.]
 - d. Implement and monitor corrective actions. [This answer is incorrect. Corrective actions and follow up of appropriate procedures that the firm outlines is a result of disciplinary actions taken on the part of individuals who do not follow a firm's quality control procedures. This does not indicate that there is a systemic deficiency in the QC policies and procedures that exist at the firm.]
29. The firm of McNabb & Romo, after conducting an inspection of its QC system, concluded that for one engagement, that facts that may have existed at the report date may cause them to believe the financial statements may have been misleading. Which of the following guidance should McNabb & Romo consult regarding what corrective action to take? **(Page 109)**
- a. AR 100.64. [This answer is incorrect. AR 100.64 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.]
 - b. AU 561. [This answer is correct. AU 561 discusses the procedures to follow when auditors, subsequent to the release of their report, discovers facts that may have existed at the report date that cause them to believe the financial statements may be misleading.]**

- c. AU 390. [This answer is incorrect. AU 390 discusses the considerations and procedures necessary when auditors conclude, subsequent to the release of their report, that one or more required audit procedures were omitted.]
- d. SQCS No. 7. [This answer is incorrect. Guidance for this particular issue is not found in SQCS No. 7.]
30. Which of the following statements most accurately describes the communication of monitoring results?
(Page 110)
- a. Firms should avoid communicating the monitoring results more than annually. [This answer is incorrect. It is suggested that communicating monitoring results semi-annually or quarterly is adequate for firms that desire more than one annual communication. However, 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.]
- b. Any significant deficiencies should be communicated along with a description of actions taken to resolve the deficiencies. [This answer is correct. According to SQCS No. 7, a description of the monitoring procedures performed; the conclusions reached based on the monitoring procedures; and where relevant, a description of significant deficiencies and the actions taken to resolve or amend those deficiencies should all be communicated. Significant deficiencies include systemic and repetitive deficiencies.]**
- c. The other individuals in the firm that monitoring results should be communicated to should not include personnel responsible for any future quality control system engagements. [This answer is incorrect. According to SQCS No. 7, the firm should communicate the results of monitoring to other appropriate individuals within the firm. It is believed that other appropriate individuals refer to professional personnel responsible for applying any changes made in the quality control system to future engagements.]
- d. Smaller firms receive fewer benefits from communicating the details of the findings with the firm's staff. [This answer is incorrect. The smaller the firm, the greater the benefits of an open discussion of the actual details of the findings with the entire staff.]

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 authoritative 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

The firm's documentation typically includes evidence of the performance of each monitoring procedure, as well as the procedures the firm used to determine which completed engagements were inspected.

Evaluation

The firm needs to evaluate the factors considered in determining whether the firm has achieved the purpose of monitoring. Those factors and the related evaluation are discussed earlier in this lesson in more detail. The firm needs to document that evaluation process as part of its monitoring documentation.

Identification of Noted Deficiencies

Information about evaluating identified deficiencies and developing recommendations for corrective action needs to be included with the firm's documentation of monitoring.

Form of Documentation

The QC standard does not provide a description of what monitoring documentation looks like. Instead it only describes what the documentation includes. Accordingly, the firm has complete latitude in the forms it chooses to document its monitoring process. One method often used by firms is to complete a memorandum describing the process followed to monitor the 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.

Use of the monitoring questionnaire is optional, although, 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 can be easily customized by each firm, it is believed that approach is 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 earlier in this section, are met.

Monitoring involves keeping the QC system up to date for (a) changes in authoritative pronouncements and (b) changes in the nature of the firm's practice. The first objective, keeping the system current for changes in authoritative pronouncements, is accomplished by following the PPC quality control system, maintaining current versions of PPC's guides, and keeping up with the activities of standard-setting bodies. 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 destroyed.

Retention of Monitoring Documentation

Firms need to consider retaining detailed monitoring documentation, programs, and checklists. SQCS No. 7 (QC 10.127) indicates that firms 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 may 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 also elect to retain the completed monitoring checklist 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 audit documentation can be helpful when performing the next year's audit. 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

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.*
- b. *Documenting Compliance Tests of the Firm's QC System.*
- c. *Documenting Engagement Reviews.* Some firms use the work programs and disclosure checklists found in PPC guides as reference aids and do not complete a checklist. 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 need to 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.
- e. *Preparing the Annual Monitoring Communication.* SQCS No. 7 requires firms to communicate, at least annually, the results of 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.

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 and the number of office locations.
- 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.

SELF-STUDY QUIZ

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

31. Which of the following utilizes questionnaires and memorandum to facilitate the monitoring process?
- a. Monitoring procedures.
 - b. Evaluation.
 - c. Identification of noted deficiencies.
 - d. Form of documentation.
32. When determining how and what monitoring documents a firm retains, which of the following are **not** retained?
- a. Engagement checklists.
 - b. Completed monitoring checklists.
 - c. Programs.
 - d. Reports.

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. Which of the following utilizes questionnaires and memorandum to facilitate the monitoring process?
(Page 116)
- a. Monitoring procedures. [This answer is incorrect. Monitoring procedures include EQCR, inspection, and post-issuance review of engagement documentation. The firm includes, 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. The method of utilizing memorandum and questionnaires is not performed in this activity.]
 - b. Evaluation. [This answer is incorrect. When the firm evaluates the factors considered in determining whether the firm has achieved the purpose of monitoring, memorandum and questionnaires are not included.]
 - c. Identification of noted deficiencies. [This answer is incorrect. Firms that include information about the identification of noted deficiencies within their documentation of monitoring do not use memorandum and questionnaires in this activity.]
 - d. **Form of documentation. [This answer is correct. One method often used by firms when determining what form of documentation to use is to complete a memorandum describing the process followed to monitor the QC system. Another alternative is to complete a checklist or questionnaire that documents the firm's monitoring of its system.]**
32. When determining how and what monitoring documents a firm retains, which of the following are **not** retained?
(Page 117)
- a. **Engagement checklists. [This answer is correct. 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.]**
 - b. Completed monitoring checklists. [This answer is incorrect. This course suggests that firms may also elect to retain the completed monitoring checklist even if they prepare a separate monitoring report. The checklist can be helpful when performing the next year's monitoring just as the prior year audit documentation can be helpful when performing the next year's audit.]
 - c. Programs. [This answer is incorrect. Firms should consider retaining programs for a time sufficient to allow the monitoring the QC system, including peer reviewers, to evaluate the firm's compliance with its system.]
 - d. Reports. [This answer is incorrect. Firms should consider retaining all reports for a time sufficient to allow the monitoring the QC system, including peer reviewers, to evaluate the firm's compliance with its system.]

COMPLAINTS AND ALLEGATIONS

Establishing QC policies and procedures to address how the firm handles complaints and allegations is a new area of discussion not previously included in the QC standards. SQCS No. 7 (QC 10.120) states that such policies and procedures 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 provided 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. Such 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 encourage their clients to direct any complaints directly to the firm.

Types of Complaints and Allegations

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 a client to blame the accountant when the client's business begins to struggle. Likewise, 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 a concerned professional employee 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 that firms 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 is responsible for ensuring 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.

It is suggested the firm 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. Providing such channels 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.

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.
- 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 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 policies and procedures.

The authors believe 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 already 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.

If, during the investigative process, the seriousness of the complaint begins to suggest the potential for a liability claim against the firm, implement damage control procedures. *Damage control* is a term frequently used to describe procedures that a firm follows when there is a possibility that a liability claim may be asserted.

Exposure Draft. The SQCS exposure draft makes a minor change to the information discussed earlier in this lesson. The proposed standard replaces the phrase “an individual with sufficient and appropriate experience and authority” with “a partner with sufficient and appropriate experience and authority within the firm.”

Communicating with the Complainant. The firm should 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, because the firm's

responsiveness indicates that it takes complaints seriously and is dedicated to dealing with them appropriately. Obviously, however, this can be a touchy situation. This course suggests that firms consider the need to include its liability insurance carrier and legal counsel in the decision-making process 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 needs to 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. Firms need to document even those situations determined to be frivolous so that resolutions of all complaints and allegations received by the firm are maintained.

SELF-STUDY QUIZ

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

33. Which of the following statements regarding types of complaints and allegations is most accurate?
- a. Complaints usually originate from within the firm when work performed fails to comply with standards.
 - b. No matter how effective a firm's operating QC system is, the firms will still encounter complaints and allegations.
 - c. Most complaints regarding noncompliance with the QC system originate outside the firm.
 - d. Rarely do third-party lenders of companies in trouble blame a CPA firm for being deficient in performing its duty.
34. SQCS No. 7 provides specific guidance regarding investigating complaints and allegations on all of the following **except**:
- a. External firms can perform an investigation of a sole practitioner.
 - b. What steps should be taken if the complaint begins to suggest the potential for a liability claim against the firm.
 - c. A firm may include the involvement of legal counsel in any complaints or allegations.
 - d. Who has the authority to supervise the investigation complaints?

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.)**

33. Which of the following statements regarding types of complaints and allegations is most accurate? **(Page 121)**
- a. Complaints usually originate from within the firm when work performed fails to comply with standards. [This answer is incorrect. 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.]
 - b. No matter how effective a firm's operating QC system is, the firms will still encounter complaints and allegations. [This answer is correct. Although 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.]**
 - c. Most complaints regarding noncompliance with the QC system originate outside the firm. [This answer is incorrect. 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 a concerned professional employee seeking to apprise firm management that its QC policies and procedures are not being followed by all engagement teams.]
 - d. Rarely do third-party lenders of companies in trouble blame a CPA firm for being deficient in performing its duty. [This answer is incorrect. 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.]
34. SQCS No. 7 provides specific guidance regarding investigating complaints and allegations on all of the following **except: (Page 122)**
- a. External firms can perform an investigation of a sole practitioner. [This answer is incorrect. SQCS No. 7 states that small firms and sole practitioners may use the services of a qualified external person or firm to perform the investigation.]
 - b. What steps should be taken if the complaint begins to suggest the potential for a liability claim against the firm. [This answer is correct. If, during the investigative process, the seriousness of the complaint begins to suggest the potential for a liability claim against the firm, damage control procedures should be implemented. Damage control is a term frequently used to describe procedures that a firm follows when there is a possibility that a liability claim may be asserted. SQCS No. 7 does not provide guidance on this issue.]**
 - c. A firm may include the involvement of legal counsel in any complaints or allegations. [This answer is incorrect. According to SQCS No. 7, the firm may include in its complaints and allegations policies and procedures the involvement of legal counsel as necessary.]
 - d. Who has the authority to supervise the investigation complaints? [This answer is incorrect. SQCS No. 7 indicates that 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.]

DRAFTING THE FIRM'S QC POLICIES AND PROCEDURES

For some of the elements of quality control, authoritative accounting, auditing, and ethics literature will contain considerations or requirements that is 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 that are members of the AICPA Governmental Audit Quality Center or the AICPA Employee Benefit Plan Audit Quality Center have additional monitoring requirements to comply with. Additionally, specific types of engagements for certain industries, such as public company audits or audits of employee benefit plans and governments, may be subject to additional regulatory requirements for firm peer review and monitoring. Firms must also be familiar with such regulatory or other legal requirements before they begin the design of quality control systems.

AICPA QC and Peer Review Materials

AICPA Practice Aid. It is recommended that the illustrative monitoring policies and procedures provided by the AICPA 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*.

Shown at Exhibit 2-2 is a section from one of the sample quality control documents included in the AICPA Practice Aid. This portion of the QC document contains suggested policy statements followed by procedures that can be used in designing and documenting a firm's monitoring quality control system. This particular document illustrates a monitoring quality control system for a local one-office accounting firm (referred to as Single-office CPA firm). The firm has three partners and ten professionals and uses purchased practice aids that have been subjected to peer review. The suggested policies are in bold type, and suggested procedures are in regular type.

Exhibit 2-2

AICPA Illustrative Quality Control Policies and Procedures Related to Monitoring

1. **The firm assigns responsibility for the monitoring process, including performance, to a partner or competent individual.** Single-office CPA Firm implements this policy through the following procedures—
 - a. Designating a partner or senior personnel to be responsible for quality assurance, including ensuring that the firm's quality control policies and procedures and its methodologies remain relevant and adequate. Factors to be considered include—
 - (1) Mergers and divestitures of portions of the practice.
 - (2) Changes in professional standards or other regulatory requirements applicable to the firm's practice.
 - (3) Results of inspections and peer reviews.
 - (4) Review of litigation and regulatory enforcement actions against the firm and its personnel.
 - (5) Changes in applicable AICPA membership requirements.
 - b. Determining whether personnel have been appropriately informed of their responsibilities for maintaining the firm's standards of quality in performing their duties.
 - c. Identifying the need to—
 - (1) Revise policies and procedures related to the other elements of quality control because they are ineffective or inappropriately designed.
 - (2) Improve compliance with firm policies and procedures related to the other elements of quality control.
2. **The firm performs monitoring procedures that are sufficiently comprehensive to enable the firm to assess compliance with all applicable professional standards and the firm's quality control policies and procedures.**

SCENARIO I—Monitoring by Reviewing Engagements throughout the Year. Single-office CPA Firm implements Policy 2 through the following procedures—

- a. Designating a partner or management-level individual not previously associated with the engagement to perform either a preissuance or postissuance review of the engagement.
- b. Establishing the approach for performing preissuance or postissuance reviews, for example, the comprehensiveness of the review and the frequency for summarizing findings (such as monthly or quarterly). The comprehensiveness of the review of selected engagements is similar to that performed in an inspection or peer review.
- c. Designating the forms and checklists to be used during the engagement and functional element reviews and the extent of the documentation required. (Examples of functional elements are the human resources function and the firm's library.)
- d. Selecting a cross-section of engagements at the beginning of the monitoring year for preissuance or postissuance review and reevaluating that selection throughout the year as circumstances dictate. Criteria used for selecting engagements include the following—
 - (1) Significant specialized industries with emphasis on high-risk engagements.
 - (2) Audits of the financial statements of employee benefit plans.
 - (3) First-year engagements.
 - (4) Significant client engagements.
 - (5) Level of service performed (that is, audit and attest, review, or compilation).
 - (6) Engagements performed by all partners and other management level personnel having accounting and auditing responsibilities.
 - (7) Engagements performed under *Government Auditing Standards* (Yellow Book engagements).
 - (8) 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 requirements, or the firm's system of quality control.
 - (9) Engagements in which there were significant disagreements between the review partner and the engagement partner.
- e. Reviewing the selected engagements. Deficiencies identified as a result of this process are summarized and evaluated to determine whether the following are necessary—
 - (1) Additional emphasis on specific areas or industries in future engagements.
 - (2) Modifications to existing policies and procedures to prevent the deficiencies noted from recurring.
- f. Reviewing other engagement files at least annually for compliance with the firm's quality control policies and procedures including reviewing correspondence regarding consultation on independence, integrity, and objectivity matters (for example, assessments of significant clients) and acceptance and continuance decisions.
- g. Reviewing the resolution of matters reported by professional personnel regarding independence to determine that matters have been appropriately considered and resolved.
- h. Preparing a summary of the deficiencies noted resulting from the preissuance and postissuance reviews so that the partner may incorporate any recommended changes into the firm's policies and procedures.

- i. Communicating to all professional personnel the deficiencies noted and related changes in quality control procedures.
- j. Following up on planned corrective actions to determine whether the actions were taken as planned and whether they achieved the intended objectives.

SCENARIO II—Monitoring by Inspecting a Sample of Engagements during a Designated Period of the Year. Single-office CPA Firm implements Policy 2 through the following procedures—

- a. Designating a partner to be responsible for performing an annual inspection using guidance prepared by the AICPA for performing inspection procedures. These procedures include reviewing a cross-section of engagements using the following criteria in selecting engagements—
 - (1) Significant specialized industries with emphasis given to high-risk engagements.
 - (2) Audits of financial statements of employee benefit plans.
 - (3) First-year engagements.
 - (4) Significant client engagements.
 - (5) Level of service performed (that is, audit and attest, review, or compilation).
 - (6) Engagements performed by all partners and other management-level personnel having accounting and auditing responsibilities.
 - (7) Engagements performed under *Government Auditing Standards* (Yellow Book engagements).
 - (8) 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 requirements, or the firm's system of quality control.
 - (9) Engagements in which there were significant disagreements between the quality review partner and the engagement partner.
- b. Establishing an approach and timetable for performing the inspection procedures and determining the forms and checklists to be used during the inspection and the extent of documentation required.
- c. Deciding how long to retain detailed inspection documentation (as opposed to summaries).
- d. Reviewing correspondence regarding consultation on independence, integrity, and objectivity matters, and acceptance and continuance decisions.
- e. Reviewing the resolution of matters reported by professional personnel regarding independence to determine that matters have been appropriately considered and resolved.
- f. Selecting a sample of engagements for review to determine compliance with the firm's quality control policies and procedures, reevaluating that selection throughout the process, and reviewing the selected engagements.
- g. Preparing a summary inspection report for the partner or management group that evaluates the overall results of the inspection and sets forth any recommended changes that should be made to the firm's policies and procedures.
- h. Reviewing the recommended corrective actions and reaching final conclusions about the actions to be taken.

- i. Communicating inspection findings and quality control changes to all professional personnel.
- j. Following up on planned corrective actions to determine whether those actions were taken and whether they achieved the intended objective(s).

In addition to the procedures described under Scenarios 1 or 2, Single-office CPA Firm also implements Policy 2 through the following procedures—

- a. Reviewing and evaluating firm practice aids, such as audit programs, forms, and checklists, and considering whether they reflect recent professional pronouncements.
 - b. Providing information during staff meetings regarding new professional standards, regulatory requirements, and the related changes that should be made to firm practice aids.
 - c. Reviewing or designating a management-level individual to be responsible for reviewing, the professional development policies and procedures to determine whether they are appropriate, effective, and meeting the needs of the firm.
 - d. Reviewing or designating a management-level individual to review summaries of CPE records of the firm's professional personnel to evaluate each individual's compliance with the requirements of the AICPA and other applicable regulators.
 - e. Reviewing other administrative and personnel records pertaining to the quality control elements.
 - f. Soliciting information from the firm's personnel during staff meetings regarding the effectiveness of training programs.
3. **The firm communicates (a) deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action to relevant engagement partners and other appropriate personnel and (b) the results of the monitoring of its quality control system process to relevant firm personnel at least annually.** Single-office CPA Firm implements this policy through the following procedures—
- a. Preparing a summary report for the partners that evaluates the overall results of the monitoring and sets forth any recommended changes that should be made to the firm's policies and procedures.
 - b. Reviewing the recommended corrective actions and reaching final conclusions as to the actions to be taken.
 - c. Communicating to all professional personnel the deficiencies noted and the related changes in quality control procedures.
 - d. Following up on planned corrective actions to determine whether those actions were taken and whether they achieved the intended objective(s).
4. **The firm deals appropriately with complaints and allegations.** Single-office CPA Firm implements this policy through the following procedures—
- a. Having the managing partner inform personnel that they may raise any concerns regarding complaints or allegations about noncompliance with professional standards, regulatory and legal requirements, or the firm's system of quality control with any partner without fear of reprisals.
 - b. Having a partner who is not otherwise involved in the engagement investigate the following—
 - (1) Complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements.
 - (2) Allegations of noncompliance with the firm's system of quality control.

- (3) 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, as identified during the investigations into complaints and allegations.
- c. Documenting complaints and allegations and the responses to them.
5. **The firm prepares appropriate documentation to provide evidence of the operation of each element of its system of quality control.** Single-office CPA Firm implements this policy by designing its summary monitoring report to provide evidence of the operation of each element of its system of quality control, including the following—
- a. Monitoring procedures, including the procedure for selecting completed engagements to be inspected.
- b. A record of the evaluation of the following—
- (1) 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 appropriately applied so that reports that are issued by the firm or engagement partners are appropriate in the circumstances.
- c. Identification of the deficiencies noted, an evaluation of their effects, and the basis for determining whether further action is necessary and what that action should be.
6. **The firm retains documentation providing evidence of the operation of the system of quality control for an appropriate period of time.** Single-office CPA Firm implements this policy by requiring retention of the summary monitoring report for a period of time sufficient to meet the firm's peer review or other regulatory requirements.

* * *

Included in Exhibit 2-2 are two scenarios illustrating how a firm monitors compliance with its QC policies and procedures. Scenario 1 illustrates how a firm monitors compliance by reviewing selected engagements throughout the year, whereas Scenario 2 illustrates how a firm monitors compliance by inspecting a sample of engagements during a designated period of the year.

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

AICPA Peer Review Program Manual. To enable an understanding of the areas a peer reviewer will emphasize, it is recommended that all practitioners involved in designing a monitoring QC system scan the peer reviewers' checklists included in the *AICPA Peer Review Program Manual (PRPM)*. The PRPM provides quality control policies and procedures questionnaires for firms to complete prior to the commencement of an AICPA peer review. (The firm need only complete one questionnaire.) Section 4400 of the PRPM presents the questionnaire for firms with more than ten professional staff (summarized in Exhibit 2-3) and Section 4300 of the PRPM provides the questionnaire for firms with ten or fewer professionals (summarized in Exhibit 2-4). It is recommended that all practitioners involved in designing a quality control system for monitoring scan the quality control policies and procedures questionnaire for their firm size found in the PRPM. *However, this course also wants to caution against relying exclusively on the current AICPA PRPM material, as it does not yet reflect the new quality control requirements of SQCS No. 7.*

Exhibit 2-3

Attributes of Monitoring QC System or Review Steps Emphasized in Peer Review Checklist (Firms with More Than Ten Professional Staff)

- Does the firm have a partner or a manager-level individual who is responsible for its quality assurance?

- Does the firm consider the following quality assurance matters:
 - The need to review the relevance and adequacy of the firm's audit methodology for the following factors:
 - Mergers and divestitures of portions of the practice?
 - Changes in professional standards or other regulatory requirements applicable to the firm's practice?
 - Results of annual inspections and peer reviews?
 - Review of litigation and regulatory enforcement actions against the firm and others?
 - The impact that changes in technology may have on clients' methods of doing business?
 - Changes in clients' industries that impact their operations?
 - Changes in applicable AICPA membership requirements?
 - The need to see whether personnel have been appropriately informed of their responsibilities for maintaining the firm's standards of quality?
 - The need to check the compliance, effectiveness, and appropriateness of the other elements of quality control in the firm's practice?
- Does the firm have policies and procedures to assure that the firm's practice aids, such as audit programs, forms, and checklists, are updated for new professional pronouncements and are effective for the firm's practice?
- Does the firm inform and provide guidance to its personnel, regarding new professional standards, regulatory requirements, and related changes to firm policy or practice aids?
- Does the firm monitor its professional development programs?
- Does the firm perform timely inspections to evaluate its compliance with its policies and procedures?
- Does the firm perform preissuance or postissuance reviews of selected engagements as part of its monitoring procedures?
- Does the firm test compliance with its policies and procedures through other monitoring procedures not described above?

* * *

Exhibit 2-4

Attributes of a Monitoring QC System or Review Steps Emphasized on Peer Review Checklist (Firms with Ten or Fewer Professionals)

- Does the firm revise its policies and procedures that are ineffective due to changes in professional standards?
- Does the firm improve its compliance, as needed, with its policies and procedures?
- Does the firm review its practice aids to determine that they are up-to-date on a regular basis?
- Does the firm review its CPE records to determine that the courses its professional personnel have taken are appropriate considering the firm's practice?
- Does the firm review its CPE records to determine compliance with the requirements of the AICPA and other regulatory bodies?
- Does the firm perform a timely preissuance, postissuance, or inspection to evaluate its compliance with its policies and procedures?
- Does the firm determine if existing policies and procedures should be modified so any deficiencies noted do not reoccur?
- Does the firm, on an ongoing basis, review its compliance with its policies and procedures for independence, integrity, and objectivity; personnel management; acceptance and continuance of clients and engagements; and engagement performance?
- When reviewing the firm's compliance with its policies and procedures for personnel management, does the firm consider the results of the firm's monitoring procedures to ensure that it possesses the necessary knowledge, skills, and abilities (competencies) to allow it to fulfill its responsibilities relating to its accounting, auditing, and attestation engagements?

* * *

When reviewing the monitoring quality control policies and procedures questionnaire for the appropriate firm size found in the PRPM, practitioners need to understand that the size and other unique characteristics of each firm will dictate the QC needs of a specific firm and, therefore, not all questions apply to all CPA firms. Also, there is always the alternative procedure that is equally acceptable for a given firm. However, the questions should be considered by a firm when designing or revising its QC system. Having a general understanding of what is suggested by the AICPA for the monitoring QC system may be helpful when drafting the firm's policies and procedures.

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. In developing QC policies and procedures, firms should consider various factors such as the—

- Size of the firm.
- Number of firm locations.
- 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's illustrative policies and procedures include multiple policy statements for each QC element with procedures related to each policy. Firms should 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.* An important factor to keep in mind while developing policies and procedures related to the monitoring element of quality control is that they 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 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. While this is indeed a key element of monitoring, monitoring procedures should cover all of the firm's documented QC procedures as 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. 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 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, post-issuance 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. Additionally, 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.

SELF-STUDY QUIZ

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

35. The single-office CPA firm of Kidd & Nash is assigning responsibility for someone to monitor their processes. Kidd & Nash are looking to assign the responsibility to a partner or another qualified individual. What is one procedure Kidd & Nash must perform to start the process?
- Designate a checklist to be used to monitor the QC system.
 - Appoint an experienced employee to be responsible for quality assurance.
 - Establish a timetable for performing inspection procedures.
 - Follow up on any planned action to determine if any actions have been taken as a result of a deficiency.
36. The single-office CPA firm of Gibson & Brown should perform which of the following procedures to appropriately deal with a complaint from an outside source that the work performed by Gibson & Brown does **not** comply with professional standards?
- Provide information regarding any new standards at the staff meetings.
 - Instruct the managing partner to inform personnel to raise any concerns regarding complaints involving noncompliance with professional standards.
 - Prepare a summary report for the partners to evaluate.
37. For firms with more than ten professional staff, certain questions need to be addressed when monitoring the QC system or review steps emphasized in a peer review checklist. Which of the following is one question that should be addressed by firms with more than ten professional staff that is **not** mentioned on the firms with ten or fewer professionals list?
- Does the firm need to revise inadequate policies and procedures because of changes in professional standards?
 - Does the firm update and improve its compliance with its policies and procedures?
 - Does the firm update its practice aids regularly?
 - Does the firm have a manager-level staff member who is responsible for its quality assurance?
38. A firm prepares documentation that is suitable to provide evidence of the operation of each element of its system of quality control. The firm would implement this by designing a summary monitoring status to provide evidence of the operation of each element of its system of quality control including which of the following?
- Identifying all noted deficiencies, noting their effects, and determining a basis for whether additional action is necessary.
 - Solicit information from the firm's personnel during staff meetings regarding the effectiveness of training programs.
 - Inspect other administrative and personnel records pertaining to the QC elements.
 - Communicate noted deficiencies to all professional personnel.

39. Which of the following statements is **least** accurate regarding the initial considerations relating to developing monitoring procedures and policies?
- a. Monitoring does not apply to sole practitioners.
 - b. Monitoring consists of more than a review of engagement documentation.
 - c. Monitoring is best performed when the workload is the lightest.
 - d. Policies and procedures that are related to the monitoring element of quality control is that it allows a firm to determine if its policies for all the other elements of the firm's quality control system are adequately designed and being applied effectively.
40. Which of the following statements is most accurate regarding the initial considerations relating to developing monitoring procedures and policies?
- a. SQCS No. 7 makes no indication regarding how monitoring procedures address a firm's allegations.
 - b. SQCS No. 7 states that firms must implement policies and procedures for adequate documentation of monitoring.
 - c. SQCS No. 7 states that a firm need not worry as much with designing procedures that can be easily monitored, just easily evaluated.

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.)**

35. The single-office CPA firm of Kidd & Nash is assigning responsibility for someone to monitor their processes. Kidd & Nash are looking to assign the responsibility to a partner or another qualified individual. What is one procedure Kidd & Nash must perform to start the process? **(Page 127)**
- a. Designate a checklist to be used to monitor the QC system. [This answer is incorrect. Designating checklists to be used during the engagement is a procedure performed when the firm performs monitoring procedures that are sufficiently comprehensive to enable the firm to assess compliance with all applicable professional standards and the firm's quality control policies and procedures.]
 - b. Appoint an experienced employee to be responsible for quality assurance. [This answer is correct. Kidd & Nash should designate a partner or senior personnel to be responsible for quality assurance, including ensuring that the firm's quality control policies and procedures and its methodologies remain adequate.]**
 - c. Establish a timetable for performing inspection procedures. [This answer is incorrect. Kidd & Nash would establish an approach and timetable to perform the inspection procedures and determine the forms and checklists to be used during the inspection and the extent of documentation required if they were monitoring by inspecting a sample of engagements during a designated period of the year.]
 - d. Follow up on any planned action to determine if any actions have been taken as a result of a deficiency. [This answer is incorrect. This procedure would occur if Kidd & Nash needed to communicate any deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action to relevant engagement partners and other appropriate personnel and the results of the monitoring of its quality control system process to relevant firm personnel at least annually.]
36. The single-office CPA firm of Gibson & Brown should perform which of the following procedures to appropriately deal with a complaint from an outside source that the work performed by Gibson & Brown does **not** comply with professional standards? **(Page 127)**
- a. Provide information regarding any new standards at the staff meetings. [This answer is incorrect. Although providing any updated authoritative literature to the staff during meetings is a procedure to be performed by the firm, it is not the best solution for this issue at this time.]
 - b. Instruct the managing partner to inform personnel to raise any concerns regarding complaints involving noncompliance with professional standards. [This answer is correct. To deal appropriately with complaints and allegations, Gibson & Brown should have the managing partner inform personnel that they may raise any concerns regarding complaints or allegations about noncompliance with professional standards, regulatory and legal requirements, or the firm's system of quality control with any partner without fear of reprisals.]**
 - c. Prepare a summary report for the partners to evaluate. [This answer is incorrect. Gibson & Brown prepare a summary report for the partners that evaluates the overall results of the monitoring and sets forth any recommended changes that should be made to the firm's policies and procedures when communicating deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action to relevant engagement partners and other appropriate personnel and the results of the monitoring of its quality control system process to relevant firm personnel at least annually.]

37. For firms with more than ten professional staff, certain questions need to be addressed when monitoring the QC system or review steps emphasized in a peer review checklist. Which of the following is one question that should be addressed by firms with more than ten professional staff that is **not** mentioned on the firms with ten or fewer professionals list? **(Page 131)**
- a. Does the firm need to revise inadequate policies and procedures because of changes in professional standards? [This answer is incorrect. This affects firms with more than ten professional staff, as well as firms with ten or fewer professionals.]
 - b. Does the firm update and improve its compliance with its policies and procedures? [This answer is incorrect. This affects firms with ten or fewer professional staff.]
 - c. Does the firm update its practice aids regularly? [This answer is incorrect. This affects firms with ten or fewer professional staff.]
 - d. Does the firm have a manager-level staff member who is responsible for its quality assurance? [This answer is correct. For a firm with more than ten professional staff, an appropriate question to ask when monitoring a QC system or review steps emphasized in a peer review checklist would be if the firm has a partner or management-level individual not previously associated with the engagement to perform either a preissuance or postissuance review of the engagement.]**
38. A firm prepares documentation that is suitable to provide evidence of the operation of each element of its system of quality control. The firm would implement this by designing a summary monitoring status to provide evidence of the operation of each element of its system of quality control including which of the following? **(Page 131)**
- a. Identifying all noted deficiencies, noting their effects, and determining a basis for whether additional action is necessary. [This answer is correct. Others include monitoring the procedures, including the procedures for selecting the completed engagements to be inspected, and recording the evaluation of adherence to professional standards and regulatory and legal requirements; if the quality control system has been appropriately designed and effectively implemented; and if the firm's quality control policies and procedures have been appropriately applied so that reports that are issued by the firm or engagement partners are appropriate in the circumstances.]**
 - b. Solicit information from the firm's personnel during staff meetings regarding the effectiveness of training programs. [This answer is incorrect. Soliciting information from the firm's personnel during staff meeting regarding the effectiveness of training programs is a procedure performed when a firm inspects a sample of engagements during a designated period of the year using monitoring.]
 - c. Inspect other administrative and personnel records pertaining to the QC elements. [This answer is incorrect. Reviewing other administrative and personnel records pertaining to the quality control elements is a procedure performed when a firm inspects a sample of engagements during a designated period of the year using monitoring.]
 - d. Communicate noted deficiencies to all professional personnel. [This answer is incorrect. Communicating to all professional personnel the deficiencies noted and the related changes in QC procedures is a procedure performed when the firm communicates deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action to relevant engagement partners and other personnel.]

39. Which of the following statements is **least** accurate regarding the initial considerations relating to developing monitoring procedures and policies? **(Page 134)**
- a. **Monitoring does not apply to sole practitioners. [This answer is correct. 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. 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.]**
 - b. Monitoring consists of more than a review of engagement documentation. [This answer is incorrect. Some practitioners continue to believe that monitoring is only concerned with a review of engagement documentation to determine if engagements conform to professional standards. While this is indeed a key element of monitoring, monitoring procedures should cover all of the firm's documented QC procedures.]
 - c. Monitoring is best performed when the workload is the lightest. [This answer is incorrect. 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.]
 - d. Policies and procedures that are related to the monitoring element of quality control is that it allows a firm to determine if its policies for all the other elements of the firm's quality control system are adequately designed and being applied effectively. [This answer is incorrect. An important factor to keep in mind while developing policies and procedures related to the monitoring element of quality control is that they 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.]
40. Which of the following statements is most accurate regarding the initial considerations relating to developing monitoring procedures and policies? **(Page 134)**
- a. SQCS No. 7 makes no indication regarding how monitoring procedures address a firm's allegations. [This answer is incorrect. Monitoring policies and procedures that address handling a firm's complaints and allegations is another new QC system requirement by SQCS No. 7.]
 - b. **SQCS No. 7 states that firms must implement policies and procedures for adequate documentation of monitoring. [This answer is correct. 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.]**
 - c. SQCS No. 7 states that a firm need not worry as much with designing procedures that can be easily monitored, just easily evaluated. [This answer is incorrect. It is in the best interest of the firm to design procedures that can be easily monitored by the firm and can eventually be assessed by a practice monitoring unit.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (GQCTG101)

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.

21. Prior to the issuance of SQCS No. 7, which of the following monitoring activities could be included in a firm's monitoring procedures?
- a. Engagement quality control review (EQCR).
 - b. Inspection.
 - c. Pre-issuance review.
 - d. Post-issuance review.
22. Match the following monitoring activity with the appropriate characterization.

A. Engagement quality control review	1. Not specifically defined by SQCS No.7.
B. Post-issuance review	2. Is defined 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."
C. Inspection	3. The Standard no longer makes reference to it.
D. Pre-issuance review	4. Assesses significant judgments made by the engagement team.

- a. A 1; B 2; C 3; D 4.
 - b. A 2; B 4; C 1; D 3.
 - c. A 4; B 1; C 2; D 3.
 - d. A 3; B 1; C 4; D 2.
23. Which of the following engagement monitoring procedures replaced the pre-issuance review as the preferred monitoring activity?
- a. Inspection.
 - b. EQCR.
 - c. Post-issuance review.
 - d. Concurring review

24. It is critical that the team assigned the responsibility for the firm's monitoring process is experienced and knowledgeable. Certain factors should be considered when developing the policies for selecting the team. Which of the following is **not** included in this selection process?
- Technical requirements.
 - Workload.
 - Team size.
 - Independence.
25. Which of the following monitoring procedures includes methods that address the appropriateness of materials and forms that the firm uses?
- Administrative and other monitoring procedures.
 - Engagement monitoring procedures.
 - Evaluating independence.
 - Detering timing of procedures.
26. The firm of Dexter & Frank is a member of the AICPA Governmental Audit Quality Center. Dexter & Frank is undergoing an inspection of their governmental audit practice and compliance with the Center's membership requirements. Dexter & Frank should make the results of the internal inspection of its governmental audit engagements available to the peer reviewer. According to the Membership's requirements, Dexter & Frank are allowed to perform which of the following?
- Substitute peer review for monitoring procedures.
 - Conduct a peer review under AICPA standards as a substitute for some or all inspection procedures for the period covered by the peer review.
 - Conduct the inspection using persons without knowledge of accounting and auditing practices specific to governmental audits.
 - Include in the inspection, engagements representative of the firm's employee benefit plan audit practice.
27. Which of the following is **not** considered a challenge that firm's face when maintaining an effective quality control system?
- Personnel turnover.
 - Changing of authoritative guidance.
 - Employee error.
 - Repetitive procedures.
28. Certain deficiencies identified during the monitoring process may depict significant deficiencies that warrant prompt corrective action. Who determines what corrective actions should be implemented as a result of a significant deficiency?
- Individual responsible for managing the firm's quality control system.
 - Human resource manager.
 - AICPA Governmental Audit Quality Center.
 - Peer review committee.

29. The firm of Duke & Wayne has determined that a quality control deficiency has occurred as a result of the lack of training of one of their staff. All of the following steps are most likely considered appropriate corrective action **except**:
- Communicate findings to professional development personnel.
 - Provide counseling to the individual responsible.
 - Initiate disciplinary action.
 - Review hiring procedures.
30. Which of the following statements best explains the required purpose of communicating the monitoring results?
- It allows the firm to make timely decisions regarding any actions that need to be taken in accordance with the firm's personnel's defined roles and responsibilities.
 - It allows the firm to report identified deficiencies at the engagement level to individuals who are not pertinent engagement partners.
 - The communication is more beneficial to small firms than larger firms.
 - It allows engagement partners an opportunity to change their procedures on future engagements before findings are made known through a peer review.
31. According to SQCS No. 7, firms need to establish policies and procedures requiring proper monitoring documentation. The QC standard states that appropriate documentation consist of proof of the monitoring procedures performed, a description of deficiencies found during the monitoring process, and a record of the firm's evaluation regarding all of the following **except**:
- If the QC system is properly designed and implemented.
 - If the firm's QC policies and procedures are operating effectively.
 - If the firm's QC policies and procedures follow all authoritative standards and regulatory requirements.
 - If the firm's decisions were made from the perspective of the client relationship and specific engagements.
32. Which of the following can serve as a *memory jogger* when identifying changes to the QC system?
- Memorandum.
 - Checklist.
 - Evaluation.
 - Monitoring questionnaire.
33. When identifying clients in monitoring documentation, this course suggests doing which of the following to protect the confidentiality of client information?
- Use the client's birthdays.
 - Use the client's identification employee identification numbers.
 - Assign codes to the clients.
 - Do not include the client's names.

34. Firms could encourage their clients to direct any complaints to which of the following?
- a. State boards of accountancy.
 - b. Directly to the firm.
 - c. Clients.
 - d. Peer review committee.
35. What is one good reason (listed in this course) for a firm to extend the channels of communication for complaints and allegations to clients?
- a. Encourage parties outside the firm to file complaints.
 - b. Prevent them from having to post the information on the firm's website.
 - c. To discourage any basic complaints to parties outside the firm.
 - d. Do not select this answer choice.
36. Generally, what is the first step a firm should take when investigating complaints and allegations?
- a. Perform an investigation.
 - b. Involve legal counsel.
 - c. Initiate damage control procedures.
 - d. Determine if the allegation or complaint is credible.
37. Which of the following is a procedure, used by a single-office CPA firm when reviewing engagements throughout the year by monitoring processes?
- a. Choosing a cross-section of engagements at the start of the monitoring year for preissuance or postissuance review and reevaluating that selection throughout the year as circumstances dictate.
 - b. Determining how long to retain detailed inspection documentation.
 - c. Inspecting any reports regarding consultation on independence.
 - d. Inspecting the resolution of matters reported by professional staff regarding independence.
38. Which of the following is a procedure, used by a single-office CPA firm when monitoring by inspecting a sample of engagements during a designated period of the year?
- a. Implement an approach to perform preissuance or postissuance reviews.
 - b. Review recommended courses of action and final conclusions reached about the actions to be taken.
 - c. Appoint a partner who is not previously associated with the engagement to perform a preissuance or postissuance review of the engagement.
 - d. Do not select this answer choice.

39. Which of the following quality control policies designed to achieve overall objectives of the QC system does **not** relate to monitoring policies and procedures?
- a. Number of firm locations.
 - b. Knowledge and experience of firm personnel.
 - c. Experience with similar engagements.
 - d. Operating characteristics of the firm.
40. According to Exhibit 2-3 and 2-4, which of the following questions does **not** apply when a firm with ten or less professionals monitors its QC system or review steps emphasized in a peer review checklist?
- a. Does the firm inspect its CPE files for compliance with the AICPA requirements?
 - b. Does the firm notify and provide guidance to its staff regarding new professional standards?
 - c. Does the firm inspect its compliance with its policies and procedures for independence on an on-going basis?
 - d. Does the firm determine if current policies and procedures should be modified?

GLOSSARY

AR 100.64: 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.

AU 390: Discusses the considerations and procedures necessary when auditors conclude, subsequent to the release of their report, that one or more required audit procedures were omitted.

AU 561: Discusses the procedures to follow when auditors, subsequent to the release of their report, discover facts that may have existed at the report date that cause them to believe the financial statements may be misleading.

Bridging Document: A document used to summarize the procedures to be performed in every audit.

Deep Pocket Syndrome: 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.

Engagement performance quality control (QC) system: Encompasses the unique planning, performing, supervising, reviewing, documenting, and communicating decisions required on each engagement.

Engagement quality control review: 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.

Engagement team: All nonpartner staff assigned to an engagement team.

Inspection: 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.

Monitoring: 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.

Other Appropriate Individuals: Professional personnel responsible for applying any changes made in the quality control system to future engagements.

SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit*: Superseded SAS No. 60 and was effective for audits of financial statements for periods ending on or after December 15, 2006. SAS No. 112 requires all significant deficiencies and material weaknesses noted during the audit to be communicated in writing to management and those charged with governance even if they were communicated in previous audits.

SAS No. 115, *Communicating Internal Control Related Matters Identified in an Audit*: Supersedes SAS No. 112, of the same name, was issued to align the definitions of the various kinds of deficiencies in internal control and the related guidance for evaluating such deficiencies with the definitions and guidance in PCAOB Auditing Std. No. 5. In addition to changes in terminology and definitions, the internal control communication letters of SAS No. 112 were modified in SAS No. 115 to incorporate the new definitions and add a statement about the auditor's responsibility for identifying control deficiencies in an audit.

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COMPANION TO PPC'S GUIDE TO QUALITY CONTROL**COURSE 2****The Ethics and Client Acceptance and Continuance
Elements of SQCS No. 7 (GQCTG102)****OVERVIEW**

COURSE DESCRIPTION: This interactive self-study course discusses the ethical and client acceptance and continuance elements of SQCS No. 7 (which has replaced all existing SQCSs). Lesson 1 describes the six fundamental principles of professional ethics and has an in-depth discussion of issues related to independence. Lesson 2 covers issues and considerations that should be part of a firm's client acceptance and continuance decisions. Both lessons cover drafting policies and procedures that can be included in a firm's QC system.

PUBLICATION/REVISION DATE: March 2010

RECOMMENDED FOR: Users of *PPC's Guide to Quality Control*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of quality control systems.

CPE CREDIT: 6 QAS Hours, 6 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.

Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).

FIELD OF STUDY: Business Management & Organization

EXPIRATION DATE: Postmark by **March 31, 2011**

KNOWLEDGE LEVEL: Basic

Learning Objectives:**Lesson 1—Independence, Integrity, and Objectivity**

Completion of this lesson will enable you to:

- Identify the six fundamental ethics principles and relevant independence requirements of SQCS No. 7.
- Develop QC policies and procedures to address independence and ethics issues.

Lesson 2—Acceptance and Continuance of Client Relationships and Specific Engagements

Completion of this lesson will enable you to:

- Develop an evaluation of the client's integrity.
- Prepare an evaluation of risks associated with the nature of an engagement and whether the firm has the appropriate competence, capabilities, and resources to accept an engagement.
- Identify issues related to client acceptance and continuance, including obtaining an understanding with the client, evaluating the client list, and withdrawing from an engagement.
- Design QC policies and procedures for client acceptance and continuance.

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
GQCTG102 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: Independence, Integrity, and Objectivity

INTRODUCTION

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.

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. If applicable, independence of another firm that performs part of the engagement should be confirmed.
- 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.
- The firm should withdraw from specific engagements if threats to independence cannot be mitigated through the application of effective safeguards.

This course uses the phrase *relevant ethical requirements* and *ethical requirements* 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. SQCS No. 7 supersedes all existing SQCSs and is applicable to a CPA firm's system of quality control for its accounting and auditing practice as of January 1, 2009. This course has been written to reflect that new guidance.

Upcoming Changes to SQCS No. 7

In June 2009, the Auditing Standards Board (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. Additionally, the ASB issued the exposure draft, Quality Control for an Audit of Financial Statements, which would supersede SAS No. 25, The Relationship of Generally Accepted Auditing Standards to Quality Control Standards.

Those two standards are being redrafted to apply the ASB's clarity drafting conventions and to converge with the international standards ISQC 1 and ISA 220. 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 SAS is expected to be effective for audits of financial statements for periods beginning on or after December 15, 2010. The proposed SQCS does not change or expand SQCS No. 7 in any significant respect. However, changes affecting the relevant ethical requirements QC element deemed more than minor by the authors that are expected to result from the proposed SQCS and SAS have been discussed where applicable throughout this course.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the six fundamental ethics principles and relevant independence requirements of SQCS No. 7.
- Develop QC policies and procedures to address independence and ethics issues.

BECOMING FAMILIAR WITH RELEVANT ETHICAL REQUIREMENTS

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 (such as the GAO, DOL, etc.) set forth ethical rules and regulations for their members or for CPAs who practice before them. 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 section 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."
- *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 within the *Code* of current AICPA ethics requirements.

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, consulting service, or valuation 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. Each of the fundamental principles is discussed in more detail in the following paragraphs.

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 at ET 101
Rule 102—Integrity and Objectivity	AICPA Code at ET 102
Interpretations under Rule 102: Interpretations 102-1 through 102-6	AICPA Code at ET 102
Ethics Rulings on Independence, Integrity, and Objectivity: Ethics Ruling Nos. 1–114	AICPA Code 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

* * *

Responsibilities

As members of the AICPA, practitioners are expected to be cognizant 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 among 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. A practitioner can make an inadvertent mistake and have honest differences of opinion and maintain integrity. However, a practitioner 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 "... 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 auditing and other attestation services should be independent in both fact and appearance. In providing all other services, members should maintain objectivity and avoid conflicts of interest.

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. This course recommends that the firm not include procedures in the engagement work programs or questions in questionnaires regarding this aspect of the objectivity principle.

Secondly, 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 can be found in the SSARs, SASs, 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 found in the SSARs, SASs, 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: <ul style="list-style-type: none"> • Compilations • Reviews • Audits 	The accountant may issue a standard compilation report, but must include a statement about the lack of independence (AR 100.23). The accountant may not issue a review report if he is not independent, but he may step down to a compilation (AR 100.53). The auditor should issue a disclaimer of opinion and specifically state that he is not independent (AU 504.08–.10).
Prospective Financial Information: <ul style="list-style-type: none"> • Compilations • Examinations • Agreed-upon Procedures 	The accountant may issue a compilation report, but must include a statement about lack of independence (AT 301.23). The accountant is precluded from issuing a report (AT 301.33). The accountant is precluded from issuing a report (AT 301.52).
Other Attestation Engagements: <ul style="list-style-type: none"> • Reviews • Examinations • Agreed-upon Procedures 	The accountant is precluded from issuing a report (AT 101.35). The accountant is precluded from issuing a report (AT 101.35). 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 Fundamental Principles of integrity, objectivity and independence, and due care. Members should do the following:

- Practice in firms with quality control systems.
- Determine whether the nature and scope of nonaudit services provided to an audit client would create a conflict of interest in the audit.
- Assess, in their individual judgments, whether an activity is consistent with their role as professionals.

GAO Ethical Principles

The *Government Auditing Standards* (Yellow Book) discusses the fundamental ethical principles that are the foundation for all work performed under these standards. The Yellow Book provides the following ethical principles to guide auditors in conducting audits in accordance with the Yellow Book:

- The public interest.
- Integrity.
- Objectivity.
- Proper use of government information, resources, and position.
- Professional behavior.

Guide for Complying with Certain Ethics Rules

In 2008, the AICPA and the Professional Ethics Executive Committee (PEEC) issued the Guide for Complying With Rules 102-505. The guidance 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. 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. The AICPA *Code of Professional Conduct* (the *Code*) and SQCS No. 7 include six fundamental principles of professional ethics. Which of those principles is described in the quote below?

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.

- a. Integrity.
 - b. Responsibilities.
 - c. Due care.
 - d. Quality.
2. How does the *Code* describe *objectivity*?
 - a. Being intellectually honest, impartial, and without conflicts of interest.
 - b. Being candid and honest while respecting client confidentiality.
 - c. Performing services to the best of the member's ability.
 - d. Being free from obligation to or interest in their clients.
 3. Kay is not independent from her client, Medical Interns. According to the independence rules found in professional standards, which of the following engagement types could she perform for Medical Interns and issue a report?
 - a. A review of historical financial statements.
 - b. A compilation of prospective financial information.
 - c. An agreed-upon procedures engagement.
 - d. An examination of prospective financial information.

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. The AICPA *Code of Professional Conduct (the Code)* and SQCS No. 7 include six fundamental principles of professional ethics. Which of those principles is described in the quote below? **(Page 156)**

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.

- a. Integrity. [This answer is incorrect. The *Code* says the following about the principle of integrity: "To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity."]
 - b. Responsibilities. [This answer is incorrect. The *Code* defines the principle of responsibilities as follows: "In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their activities."]
 - c. **Due care. [This answer is correct. The *Code* describes the fundamental principle of due care in the quote above. A firm should become familiar with all of the fundamental principles of professional ethics before it begins the process of designing policies and procedures for all ethical requirements relevant to the firm's practice.]**
 - d. Quality. [This answer is incorrect. Neither the *Code* nor SQCS No. 7 includes quality in their list of fundamental principles of professional ethics.]
2. How does the *Code* describe *objectivity*? **(Page 158)**
 - a. **Being intellectually honest, impartial, and without conflicts of interest. [This answer is correct. These values are an obligation of a member's objectivity, as discussed in the *Code*. Additionally, the *Code* describes objectivity as a state of mind members can have that will add value to their services.]**
 - b. Being candid and honest while respecting client confidentiality. [This answer is incorrect. This is how the *Code* describes the principle of integrity. It would be possible for a practitioner to make an inadvertent mistake or have honest differences of opinions, but still maintain his or her integrity.]
 - c. Performing services to the best of the member's ability. [This answer is incorrect. This is how the *Code* describes due care. Due care also requires a member to have competence and diligence in performing services.]
 - d. Being free from obligation to or interest in their clients. [This answer is incorrect. This is the basic concept of independence. Independence requirements are found in the SSARs, SASs, and SSAEs.]

3. Kay is not independent from her client, Medical Interns. According to the independence rules found in professional standards, which of the following engagement types could she perform for Medical Interns and issue a report? **(Page 159)**
- a. A review of historical financial statements. [This answer is incorrect. An accountant cannot issue a review report without being independent of the client.]
 - b. A compilation of prospective financial information. [This answer is correct. Kay can issue a compilation report for this engagement, even though she is not independent from Medical Interns. However, in the report, Kay must include a statement about her lack of independence.]**
 - c. An agreed-upon procedures engagement. [This answer is incorrect. Kay would be precluded from issuing a report on an agreed-upon procedures engagement by professional standards, as she is not independent from Medical Interns.]
 - d. An examination of prospective financial information. [This answer is incorrect. Because she is not independent from Medical Interns, Kay is precluded from issuing a report for this type of engagement.]

A DISCUSSION OF INDEPENDENCE REQUIREMENTS

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, SASs, 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, SASs, and SSAEs are met.

Practitioners should be aware that independence standards of state boards of accountancy, state CPA societies, the PCAOB, the SEC, the DOL, the GAO, 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 organizations' 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 audit 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, a 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 had 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.

Proposed Interpretation 101-17. In August 2007, PEEC issued an exposure draft of Interpretation 101-17, "Networks and Network Firms," which proposes that when firms join associations with other firms (a) for the purpose of enhancing the firm's capability to provide professional services and (b) share one or more certain characteristics, they are considered to be a network and must be independent of certain attest clients of the other network (association) firms. Under the proposal, those shared characteristics include the following:

- A common brand name in the firm name.
- Common control among the firms through ownership, management, or other means.
- Shared profits or costs.
- A common business strategy.
- Significant part of professional resources.
- Common quality control policies and procedures.

PEEC originally anticipated that a final version of Interpretation 101-17 would be issued in May 2009. However, that project, while still active on PEEC's "Exposure Drafts/Standard Setting" listing, currently has no further information available. Practitioners can monitor the status of this project for new information at www.aicpa.org. (Select "Professional Resources/Professional Ethics" from the homepage and then click on the "Exposure Drafts/Standard Setting" link.)

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 section 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 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 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. For example:
 - The spouse of a member of the attest engagement team holds a key position at the client.
 - A partner of the firm has provided attest services to the client for a prolonged period.
 - A member performs insufficient procedures when reviewing the results of a nonattest service because the service was provided by his or her firm.
 - A member of the firm was recently an officer or director of the client.
 - A member of the attest engagement team has a close friend in a key position at 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. For example, by:
 - Threatening to replace the member or the member's firm because of a disagreement over application of an accounting principle.
 - Exerting pressure to reduce necessary audit procedures in order to reduce audit fees.
 - Providing a gift to the member that is other than clearly insignificant to 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. For example, by:
 - Having a direct or material indirect financial interest in the client.

- Having a loan from the client, an officer or director of the client, or an individual who owns 10% or more of the client's outstanding equity securities.
- Having excessive reliance on revenue from a single attest client.
- Having a material joint venture or other material joint business arrangement with the 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. For example, by:
 - Serving as an officer or director of the client.
 - Establishing and maintaining internal controls for the client.
 - Hiring, supervising, or terminating employees for the 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. The nature and extent of safeguards depend on many factors, including the size of the firm and whether the client is a public interest entity. For purposes of the *Conceptual Framework*, a public interest entity is one of the following (ET 100.20):

- An entity subject to SEC reporting requirements.
- A financial institution, credit union, or insurance company.
- An employee benefit or health and welfare plan subject to ERISA audit requirements.
- A governmental retirement plan.
- An entity or program subject to the Single Audit Act OMB Circular A-133 requirements or similar program oversight.

The effectiveness of a safeguard depends on many factors, including (ET 100.21):

- The facts and circumstances specific to the situation.
- The proper identification of threats.
- Whether the safeguard is suitably designed to meet its objectives.
- The party or parties that will be subject to the safeguard.
- How the safeguard is applied, the consistency with which it is applied, and who applies it.

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 previously.

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 SEC, PCAOB, GAO, DOL, and state boards of accountancy) to which the member is subject constitutes a violation of the Interpretation. For example, the SEC and PCAOB rules are more restrictive with respect to providing nonattest services that impair the independence of auditors of public companies. Additionally, the independence rules in the GAO's *Government Auditing Standards* (also known as the Yellow Book) are more restrictive with respect to providing nonattest services that impair the independence of auditors of governmental organizations and nonprofit organizations that receive federal financial assistance or are otherwise subject to GAO Yellow Book requirements.

Before CPAs perform nonattest services for attest clients, they 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 should then be in a position to approve the journal entries and accept responsibility for the financial statements. The client would 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, audit committee, or management, as appropriate. The Interpretation does not specify any particular form of documentation, such as an engagement letter, but leaves the form to the member's discretion as long as the documentation clearly articulates the matters required to be documented.

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 evidences 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.

Exhibit 1-3 reprints examples from Interpretation 101-3 of nonattest services that would and would not impair independence.

Exhibit 1-3

Impact on Independence of Performance of Nonattest Services^a

Type of Nonattest Service	Independence Would Not Be Impaired	Independence Would Be Impaired
Bookkeeping	<ul style="list-style-type: none"> • Record transactions for which management has determined or approved the appropriate account classification, or post coded transactions to a client's general ledger. • Prepare financial statements based on information in the trial balance. • Post client-approved entries to a client's trial balance. • Propose standard, adjusting, or correcting journal entries or other changes affecting the financial statements to the client, provided the client reviews the entries and the member is satisfied that management understands the nature of the proposed entries and the impact the entries have on the financial statements. 	<ul style="list-style-type: none"> • Determine or change journal entries, account codings or classification for transactions, or other accounting records without obtaining client approval. • Authorize or approve transactions. • Prepare source documents. • Make changes to source documents without client approval.
Non tax disbursement	<ul style="list-style-type: none"> • Using payroll time records provided and approved by the client, generate unsigned checks, or process client's payroll. • Transmit client-approved payroll or other disbursement information to a financial institution provided the client has authorized the member to make the transmission and has made arrangements for the financial institution to limit the corresponding individual payments as to amount and payee. In addition, once transmitted, the client must authorize the financial institution to process the information. 	<ul style="list-style-type: none"> • Accept responsibility to authorize payment of client funds, electronically or otherwise, except as specifically provided for with respect to electronic payroll tax payments. • Accept responsibility to sign or cosign client checks, even if only in emergency situations. • Maintain a client's bank account or otherwise have custody of a client's funds or make credit or banking decisions for the client. • Approve vendor invoices for payment.

Type of Nonattest Service	Independence Would Not Be Impaired	Independence Would Be Impaired
Benefit plan administration ^b	<ul style="list-style-type: none"> • Communicate summary plan data to plan trustee. • Advise client management regarding the application or impact of provisions of the plan document. • Process transactions (e.g., investment/benefit elections or increase/decrease contributions to the plan; data entry; participant confirmations; and processing of distributions and loans) initiated by plan participants through the member’s electronic medium, such as an interactive voice response system or Internet connection or other media. • Prepare account valuations for plan participants using data collected through the member’s electronic or other media. • Prepare and transmit participant statements to plan participants based on data collected through the member’s electronic or other medium. 	<ul style="list-style-type: none"> • Make policy decisions on behalf of client management. • When dealing with plan participants, interpret the plan document on behalf of management without first obtaining management’s concurrence. • Make disbursements on behalf of the plan. • Have custody of assets of a plan. • Serve a plan as a fiduciary as defined by ERISA.
Investment—advisory or management	<ul style="list-style-type: none"> • Recommend the allocation of funds that a client should invest in various asset classes, depending upon the client’s desired rate of return, risk tolerance, etc. • Perform recordkeeping and reporting of client’s portfolio balances including providing a comparative analysis of the client’s investments to third-party benchmarks. • Review the manner in which a client’s portfolio is being managed by investment account managers, including determining whether the managers are (a) following the guidelines of the client’s investment policy statement; (b) meeting the client’s investment objectives; and (c) conforming to the client’s stated investment styles. • Transmit a client’s investment selection to a broker-dealer or equivalent provided the client has authorized the broker-dealer or equivalent to execute the transaction. 	<ul style="list-style-type: none"> • Make investment decisions on behalf of client management or otherwise have discretionary authority over a client’s investments. • Execute a transaction to buy or sell a client’s investment. • Have custody of client assets, such as taking temporary possession of securities purchased by a client.

Type of Nonattest Service	Independence Would Not Be Impaired	Independence Would Be Impaired
Corporate finance—consulting or advisory	<ul style="list-style-type: none"> • Assist in developing corporate strategies. • Assist in identifying or introducing the client to possible sources of capital that meet the client's specifications or criteria. • Assist in analyzing the effects of proposed transactions including providing advice to a client during negotiations with potential buyers, sellers, or capital sources. • Assist in drafting an offering document or memorandum. • Participate in transaction negotiations in an advisory capacity. • Be named as a financial advisor in a client's private placement memorandum or offering documents 	<ul style="list-style-type: none"> • Commit the client to the terms of a transaction or consummate a transaction on behalf of the client. • Act as a promoter, underwriter, broker-dealer, or guarantor of client securities, or distributor of private placement memoranda or offering documents. • Maintain custody of client securities.
Executive or employee search	<ul style="list-style-type: none"> • Recommend a position description or candidate specifications. • Solicit and perform screening of candidates and recommend qualified candidates to a client based on the client-approved criteria (e.g., required skills and experience). • Participate in employee hiring or compensation discussions in an advisory capacity. 	<ul style="list-style-type: none"> • Commit the client to employee compensation or benefit arrangements. • Hire or terminate client employees.
Business risk consulting	<ul style="list-style-type: none"> • Provide assistance in assessing the client's business risks and control processes. • Recommend a plan for making improvements to a client's control processes and assist in implementing these improvements. 	<ul style="list-style-type: none"> • Make or approve business risk decisions. • Present business risk considerations to the board or others on behalf of management.
Information systems—design, installation, or integration	<ul style="list-style-type: none"> • Install or integrate a client's financial information system that was not designed or developed by the member (e.g., an off-the-shelf accounting package). • Assist in setting up the client's chart of accounts and financial statement format with respect to the client's financial information system. • Design, develop, install, or integrate a client's information system that is unrelated to the client's financial statements or accounting records. • Provide training and instruction to client employees on an information and control system. 	<ul style="list-style-type: none"> • Design or develop a client's financial information system. • Make other than insignificant modifications to source code underlying a client's existing financial information system. • Supervise client personnel in the daily operation of a client's information system. • Operate a client's local area network (LAN) system.

Notes:

- a This exhibit is adapted from the AICPA Ethics Interpretation 101-3, "Performance of Nonattest Services".
- b When auditing plans subject to the Employee Retirement Income Security Act (ERISA), Department of Labor (DOL) regulations, which may be more restrictive, must be followed. The DOL rules are discussed in *PPC's Guide to Audits of Employee Benefit Plans*.

* * *

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.
 - The individual is authorized to sign and file the return.
 - The individual has reviewed the return, including accompanying schedules, and it is true, correct, and complete to the best of his or her knowledge and belief.
 - 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.

The tax compliance services provisions discussed previously are the result of revisions to Interpretation 101-3 that became effective on February 28, 2007. Independence is not impaired for the more restrictive provisions outlined in those paragraphs if (1) the services are pursuant to an engagement that commenced prior to February 28, 2007, and completed prior to January 1, 2008, and (2) the CPA complied with all applicable independence interpretations and rulings in effect on February 28, 2007.

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 needs to be aware of all services being performed for that client (including, if applicable, services performed by entities closely aligned through common employment). 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 completed before each nonattest and attest engagement is performed, including compilation engagements. (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.)

In most cases, partners in many local firms will have knowledge of all services performed for each client for which they perform attest and compilation services; thus, a formal system to prepare and maintain a list of such services is believed unnecessary. However, larger and multi-office firms may need to maintain such a list. Firms using a time and billing system may have already developed such a list. Firms desiring to perform this review may choose to incorporate such a procedure in their quality control system.

The independence rules in the *Government Auditing Standards* also restrict nonaudit services that can be performed for an audit client. In several respects, those rules are more restrictive than the AICPA rules just discussed.

The GAO Government Auditing Standards rules are discussed in *PPC's Guide to Single Audits* and *PPC's Guide to Audits of Local Governments*.

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, this course maintains that amounts that are trivial would not impair independence.)

The engagement partner assigned to each client needs to be aware of not only the status of uncollected fees, but also of unbilled fees applicable to that client. Accordingly, best practices indicate that the engagement partner (or the accountant in charge under the partner's supervision) should 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. 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 system policies and procedures needs to include consideration of the unpaid client fees on independence.

Applicability of Independence Rules on Alternative Practice Structures

ET Interpretation 101-14 (ET 101.16), "The Effect of Alternative Practice Structures on the Applicability of Independence Rules," clarifies the application of the Code to members who choose to practice public accounting in various alternative (nontraditional) forms. PEEC believes that the Interpretation provides adequate safeguards to protect the public interest of the profession and ensures the equitable application and enforcement of the AICPA independence rules. The following paragraphs discuss the Interpretation and its applicability of the independence rules on alternative practice structures.

Definition of Covered Member for a Traditional Firm. Ethics Rule 101, "Independence," and its related rulings and interpretations, collectively called the independence rules, generally apply only to a covered member. The definition of covered member outlined previously clearly covers the traditional CPA firm structure. However, many practitioners have questioned the applicability of the independence rules to CPAs who are members of nontraditionally structured firms also known as alternative practice structure firms.

Definition of Alternative Practice Structure Firms. In many alternative practice structure (APS) firms, a substantial portion (generally the nonattest portion) of the practice is conducted under public or private ownership, and the attest portion of the practice is conducted through a separate firm operated and majority-owned by CPAs. These structures must comply with the applicable state laws and regulations as well as Ethics Rule 505, "Form of Organization and Name." In complying with these rules and regulations, many elements of quality control are required to ensure that the public interest is adequately protected. In an effort to further protect that public interest, PEEC has established additional independence rules in its Interpretation for APS firms. The independence rules for APS firms are intended to be conceptual and applicable to all structures where the traditional firm engaged in attest services is closely aligned with another organization that performs other professional services.

APS Illustrative Model. To help practitioners understand the applications of the Interpretation, the following example of an APS firm is used to illustrate and explain various concepts of the Interpretation:

An existing traditional CPA practice (Old CPA) is sold to another entity (Parent Co). Parent Co has various subsidiaries (such as an insurance company, a bank, etc.) and it also has several professional service subsidiaries that offer client nonattest professional services (such as estate, tax, and financial planning services). The owners and employees of Old CPA became employees of a subsidiary of Parent Co and provide all nonattest services through that subsidiary. In addition, the owners of Old CPA form a new CPA firm (New CPA) to provide all attest services. CPAs (including the prior owners of Old CPA) own a majority of New CPA. The attest services are performed by New CPA and are supervised by its owners. The arrangement between New CPA

and Parent Co includes leasing employees, office space, and various services such as advertising, marketing, etc. New CPA pays a negotiated fee for these services.

APS Independence Rules for APS Covered Members. According to Interpretation 101-14, a covered member in an APS firm (APS covered member) includes both employed and leased individuals. Covered members and the firm are subject to Rule 101 and its interpretations and rulings. (In the illustration above, the APS covered member would be in New CPA.) Thus, for example, a covered member may not have a direct financial interest in, or loan to or from, an attest client of New CPA.

When determining who is considered an APS covered member, the Interpretation addresses the question of when an owner in one APS would be a covered member in another APS for purposes of applying the independence rules. According to the Interpretation (using the APS illustration presented above), the owners of New CPA generally would not be considered APS covered members with respect to the attest clients of another related CPA firm within the APS (New CPA 2) except in situations where (a) the owners of New CPA perform services for New CPA 2 or (b) there are significant shared economic interests between the firms. For example, if owners in New CPA perform attest services in New CPA 2, those owners would be considered to be owners of both firms for purposes of applying the independence rules.

APS Independence Rules for Individuals and Entities Other Than APS Covered Members. The independence rules and interpretations generally apply only to those individuals and entities included in the definition of covered member (including APS covered members), as defined at the beginning of this section. However, because of the close alignment in most APS situations between the individuals and entities considered APS covered members and the other non-member individuals and entities, Interpretation 101-14 includes additional restrictions for those "other individuals and entities." The following paragraphs discuss those restrictions and provide illustrations using the APS example.

APS Independence Rules for Direct Superiors. Direct superiors are defined to include individuals who are so closely associated with an owner or manager who is a covered member that such individuals can directly control the activities of the partner or the manager. [Interpretation 101-14 considers a person who can directly control as "the immediate superior of the owner or manager who has the power to direct the activities of that person so as to be able to directly or indirectly (e.g., through another entity over which the direct superior can exercise significant influence) derive a benefit from that person's activities."] The Interpretation states that individuals who are considered direct superiors and entities over whose activities direct superiors can exercise significant influence are subject to Rule 101 and its interpretations and rulings.

APS Independence Rules for Indirect Superiors and Other Entities. Interpretation 101-14 defines indirect superiors and other entities as follows:

- Indirect superiors are individuals who are one or more organizational levels above those individuals identified as direct superiors. (Although PEEC believes that there should be certain restrictions placed on indirect superiors, they further believe that indirect superiors are sufficiently removed enough from those included as covered members that the standards should be somewhat less restrictive.) The definition of indirect superior includes the immediate family of an indirect superior.
- Other entities include the parent company and all entities consolidated in the parent company's financial statements that are not subject to Rule 101 and its interpretations and rulings. (The other entity in the previous illustration would be Parent Co.)

The rules for indirect superiors and other entities are as follows:

- a. Indirect superiors and other entities may not have a relationship that impairs independence as described in Interpretation 101-1 (for example, investments, loans, etc.) with an attest client that is material. To determine materiality in an indirect superior's relationship, all of the financial relationships with an attest client held by the indirect superior are aggregated and assessed in relation to the indirect superior's net worth. To determine materiality for other entities, all of the financial relationships with an attest client held by such entities are aggregated and assessed in relation to the consolidated financial statements of the parent company. In addition, any other entities where an indirect superior has direct responsibility cannot

have a financial relationship with an attest client that is material in relation to that entity's financial statements.

- b. The financial relationship of indirect superiors or other entities should not allow such individuals or entities to exercise *significant influence* (as defined in ET 92) over the attest client. To determine significant influence, financial relationships of all indirect superiors and other entities are aggregated.
- c. Neither the entities nor their employees should be connected with an attest client of the covered member firm (New CPA in the previous illustration) as a promoter, underwriter, director, officer, or voting trustee.
- d. Except as previously noted in item c., indirect superiors and other entities may provide services to an attest client of the covered member firm (New CPA in the example) that would impair independence if the services were performed, for example, by a covered member. (For example, trustee services in the ordinary course of business by a bank subsidiary of the parent company would be acceptable as long as the bank was not included in the definition of a covered member or subject to the same independence requirements of a covered member.)

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 from their 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 2009 alert, released in July 2009, can be ordered at www.cpa2biz.com, or is available on Checkpoint for those 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.

Independence under Government Auditing Standards. The general standard in the *Government Auditing Standards* (Yellow Book) relating to independence, at Paragraph 3.02, states that:

In all matters relating to the audit work, the audit organization and the individual auditor, whether government or public, must be free from personal, external, and organizational impairments to independence, and must avoid the appearance of such impairments of independence.

As indicated above, the Yellow Book recognizes three general classes of impairment to independence: (a) personal, (b) external, and (c) organizational. Each of these classes of impairment can impact whether an auditor may perform the specified audit work. In addition, the independence requirements vary depending on whether the audit organization is a government or nongovernment organization. Yellow Book independence standards and implementation guidance are discussed in detail in *PPC's Guide to Audits of Local Governments*, *PPC's Guide to Nonprofit Organizations*, and *PPC's Guide to Single Audits*.

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 respectively. Additional guidance, including practice aids, is provided on those rules in *PPC's Guide to Single Audits* and *PPC's HUD Audits*.

Special Audit Considerations

Others Subject to the Firm's Independence Requirements. The firm's independence requirements are to be communicated to others subject to those requirements. The others referred to will generally be another auditor who is engaged to perform services for a principal auditor. SAS No. 1 at AU 543 provides guidance when another auditor audits a subsidiary, division, branch, component, or investment that is consolidated (either by a full consolidation or by the equity method) into the financial statements audited by the principal auditor. According to SAS No. 1 at AU 543.10, when a principal auditor makes use of the work and report of another auditor, whether reference to the other auditor is or is not made, the principal auditor should do the following:

- a. Inquire about the professional reputation and standing of the other auditor by communication with the AICPA, applicable state society, other practitioners, or bankers and other credit grantors.
- b. Obtain a representation on the other auditor's independence under AICPA requirements.
- c. Communicate with the other auditor and determine that he or she:
 - (1) is aware of the intended use of the financial statements under audit,
 - (2) is familiar with GAAP and GAAS and any other applicable standards,
 - (3) has knowledge of the relevant financial reporting requirements for statements and schedules to be filed with any regulatory agencies, and
 - (4) has reviewed matters affecting the elimination of any intercompany transactions and accounts and, as appropriate, has reviewed the uniformity of the accounting practices among the components included in the financial statements.

Regardless of whether the principal auditor decides to make reference to the other auditor, an independence representation is necessary. [The decision of whether to make reference to another auditor is beyond the scope of this course. However, a comprehensive discussion of when to refer to another auditor's work can be found in *PPC's Guide to Auditor's Reports*. Also, *PPC's Guide to Audits of Nonpublic Companies* and *PPC's Guide to Audits of Local Governments* contain sample independence confirmation requests and replies for commercial entities and governmental units. These guides can be ordered by calling (800) 323-8724 or through the website at ppc.thomsonreuters.com.]

The Use of Another Auditor Occurs More Frequently on Governmental Audits. Engagements where a local firm uses another auditor to audit a subsidiary are unusual. However, the general purpose or basic financial statements of a governmental unit often require the inclusion of the financial statements of a component unit, such as a hospital district, library, or airport. AICPA Ethics Interpretation 101-10, "The Effect on Independence of Relationships With Entities Included in the Governmental Financial Statements [Revised]," specifically addresses this point and provides independence guidance for auditors of governmental financial statements.

Applicability of AU 543 for Other Auditor Procedures on Elements of a Financial Statement. AU 543 applies only to another auditor engaged to audit the financial statements of a subsidiary, division, branch, component, or investment. AU 543 does not apply to engagements where another auditor performs procedures on an element, account, or item of a financial statement. For example, if another auditor is engaged to observe inventory at an off-site location, AU 543 would not apply and, technically, the requirements set forth in items a.–c. above would not be required.

However, despite the lack of applicability of AU 543 to other auditors who perform procedures on only a part of a financial statement, it is doubtful that the principal auditor can justify that he does not assume full responsibility for the work of the other auditor. As an example, the other auditor who observes inventory for the principal auditor is serving as a temporary member of the principal auditor's staff. Accordingly, as a staff member, the other auditor would be subject to the quality control standard even though SAS No. 1, AU 543, technically does not apply. Therefore, the firm's quality control procedure for confirming the independence of another auditor should be enforced any time another auditor is used, regardless of how he or she is used. [*PPC's Guide to Audits of Nonpublic*

Companies provides a sample independence confirmation request and reply for these types of engagements. That guide can be ordered by calling (800) 323-8724 or through the website ppc.thomsonreuters.com.]

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. If the confirmation is oral, documenting it is suggested.

Can Another Firm Be Substituted When the Firm Is Not Independent? Another question concerning using the work of other auditors occasionally is raised in connection with an accounting firm that is not independent with respect to a client and desires to retain another public accounting firm to supervise the engagement and issue an opinion on the financial statements. Unless the newly retained firm applies all the procedures necessary to form an opinion on the financial statements itself, this course maintains that it would not be appropriate for the firm to issue such an opinion. This position is supported by an AICPA Technical Practice Aid at TIS 9120.06 which states that the work and reports of a nonindependent auditor cannot be used in the manner discussed in AU 543. That is, the newly retained firm cannot simply perform the steps listed previously in items a.–c. and then rely on the work of the nonindependent firm. Instead, the responsibility for the audit report rests solely with the newly retained firm. The newly retained firm can, however, use the work of the nonindependent firm as it would the work of internal auditors. SAS No. 65 (AU 322), *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, provides guidance on using the work of internal auditors.

In addition, Ruling No. 71 (ET 191.142-.143) makes it clear that a firm's independence would be considered to be impaired (and thus, it would not be able to issue an unqualified opinion on the financial statements) if partners or professional employees of a nonindependent CPA firm were to participate in the engagement. Based on the discussion in the preceding paragraph, it is believed that as long as the newly retained firm does not use the work of the personnel of the nonindependent firm beyond that permitted for internal auditors, the owners or professional employees of the nonindependent firm are not considered to have participated in the engagement. Thus, the independence of the newly retained firm would be negated.

SELF-STUDY QUIZ

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

4. Which of the following statements about independence is most accurate?
 - a. Little additional information about this principle exists to help firms develop useful independence policies and procedures.
 - b. Complying with the Code's independence requirements means all other organization's requirements will be met.
 - c. Independence is required for a type of service only if the standards for that specific type of service require the practitioner to be independent.
 - d. Not having independence from a client when it is required will have little to no negative ramifications for a firm.

5. Whammy Inc. is an attest client of the firm of Michaels & Tait. Jessica is one of the firm's professional staff, and she serves on the attest engagement team. Harrison is the partner in charge of the attest team. Gertrude is Harrison's direct manager. Leroy is a partner in the firm, and he provided seven hours of nonattest services to Whammy within the last fiscal year. List all of the members of the firm who qualify as a *covered member* with respect to Whammy under Interpretation 101-1.
 - a. Harrison.
 - b. Harrison and Jessica.
 - c. Harrison, Jessica, and Gertrude.
 - d. Harrison, Jessica, Gertrude, and Leroy.

6. Assume that all the following CPAs performed nonattest services for their clients. In which of the following scenarios has the practitioner retained his or her independence under Interpretation 101-3?
 - a. Jonathon makes management decisions and performs management functions for his client.
 - b. Bea does not believe her client can make informed judgments on the results of nonattest services.
 - c. Leslie does not have written documentation of her understanding with the client.
 - d. Grady has the power to authorize, execute, and consummate transactions on behalf of his client.

7. Performance of which of the following nonattest services would impair a practitioner's independence?
 - a. Using client-approved records to process payroll.
 - b. Performing recordkeeping and reporting of portfolio balances.
 - c. Designing the client's financial information system.
 - d. Assisting with development of corporate strategies.

8. The traditional CPA firm of Milton-Harris is sold to MegaCo. MegaCo has various subsidiaries, including several that offer nonattest professional services to clients. The owners and employees of Milton-Harris become employees of a subsidiary of MegaCo and perform all nonattest services through that subsidiary. The owners of Milton-Harris also form a new CPA firm, Audit Time, that provides all attest services. CPAs (including the owners of Milton-Harris) own a majority of Audit Time, and Audit Time's attest services are supervised by its owners. An arrangement between MegaCo and Audit Time allows for the leasing of employees, office space, and other services (e.g., advertising and marketing), for which Audit Time pays a negotiated fee. MegaCo has another CPA firm subsidiary, Audits 'R Us, that performs attest services, but there are no shared employees or economic interests between Audit Time and Audits 'R Us. Based on Interpretation 101-14, which of the following statements is accurate in this scenario?
- Only the former owners of Milton-Harris are considered covered members with respect to Audit Time's attest engagements.
 - MegaCo employees leased by Audit Time will be considered covered members with respect to Audit Time's attest engagements.
 - The owners of Audit Time will be considered covered members with respect to Audits 'R Us's attest clients.
9. Assume the same details as in the question above. Jackson is one of the CPA owners of Audit Time. Who would be considered his indirect superior with respect to applying the independence rules of Interpretation 101-14?
- The senior partner of Audit Time who supervises his work.
 - The owners of Audit's 'R Us who perform audits in similar areas.
 - The vice president of MegaCo to which Audit Time Reports.
 - MegaCo and all entities consolidated into MegaCo's financial statements.
10. Ralph performs audits under *Government Auditing Standards* (the Yellow Book). Which of the following independence requirements applies specifically to this aspect of his practice?
- Three classes of independence impairment are recognized—personal, external, and organizational.
 - The requirements are the same whether Ralph audits governments or nonprofit organizations.
 - If Ralph's state board of accountancy adopted the AICPA rules, he has no other requirements to meet.
 - Ralph cannot retain his independence if he uses another auditor during a governmental audit.
11. Judy engages another auditor, Carl, to audit a subsidiary of her audit client that has been consolidated into its financial statements. What must Judy do if she makes use of Carl's work?
- Reference Carl's work auditing the subsidiary in the auditor's report provided to the client.
 - Make inquiries of other practitioners and elsewhere about Carl's professional reputation.
 - Though she could use Carl when performing a review, Judy cannot use Carl during an audit.
 - Can use another auditor who is not independent with respect to her client.

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.)**

4. Which of the following statements about independence is most accurate? **(Page 164)**
 - a. Little additional information about this principle exists to help firms develop useful independence policies and procedures. [This answer is incorrect. The fundamental principle of independence has traditionally received the most attention, and it has generated the majority of all readily available additional information.]
 - b. Complying with the Code's independence requirements means all other organization's requirements will be met. [This answer is incorrect. Adhering to the Code's requirements will ensure that a practitioner meets the requirements of the SSARs, SASs, and SSAEs; however, other organizations, such as the PCAOB, SEC, or state boards of accountancy, may have more restrictive independence requirements. AICPA members must also adhere to these requirements, if they apply to the engagement.]
 - c. Independence is required for a type of service only if the standards for that specific type of service require the practitioner to be independent. [This answer is correct. According to the Code, if the standards for a type of service do not require independence, then the practitioner does not have to be independent to perform that service. For example, the standards for audit services require independence, but the standards for consulting services do not.]**
 - d. Not having independence from a client when it is required will have little to no negative ramifications for a firm. [This answer is incorrect. Both the firm and the practitioner who is not independent (but should have been) can face significant negative ramifications.]

5. Whammy Inc. is an attest client of the firm of Michaels & Tait. Jessica is one of the firm's professional staff, and she serves on the attest engagement team. Harrison is the partner in charge of the attest team. Gertrude is Harrison's direct manager. Leroy is a partner in the firm who offices in a separate office from where the attest engagement is performed, and he provided seven hours of nonattest services to Whammy within the last fiscal year. List all of the members of the firm who qualify as a covered member with respect to Whammy under Interpretation 101-1. **(Page 166)**
 - a. Harrison. [This answer is incorrect. Harrison does qualify as a covered member as described in Interpretation 101-1; however, he is not the only covered member at Michaels & Tait with respect to attest services provided to Whammy.]
 - b. Harrison and Jessica. [This answer is incorrect. Based on the guidance in Interpretation 101-1, the firm has more covered members with respect to the attest engagement with Whammy.]
 - c. Harrison, Jessica, and Gertrude. [This answer is correct. Both Jessica and Harrison serve on the attest engagement team; therefore, they are both covered members in this scenario. Because Gertrude is Harrison's manager, she is in the position to influence the attest engagement; therefore, she is also a covered member.]**
 - d. Harrison, Jessica, Gertrude, and Leroy. [This answer is incorrect. Because Leroy does not office where the attest engagement is performed, he would not be considered a covered member in this scenario. If he had provided ten or more hours of non-attest services to Whammy, he would qualify as a covered member under Interpretation 101-1.]

6. Assume that all the following CPAs performed nonattest services for their clients. In which of the following scenarios has the practitioner retained his or her independence under Interpretation 101-3? **(Page 171)**
 - a. Jonathon makes management decisions and performs management functions for his client. [This answer is incorrect. Jonathon could not make these decisions or perform these functions and retain his independence from his client.]

- b. Bea does not believe her client can make informed judgments on the results of nonattest services. [This answer is incorrect. One of the general requirements of Interpretation 101-3 is that the practitioner must be satisfied that the client is in a position to make an informed judgment on the results of any nonattest services that were performed. Among other things, the client must be able to accept responsibility for the results of any nonattest services that the practitioner performed. Because Bea is not confident that her client can fulfill this requirement, if she performs the nonattest services, she will not be independent from the client.]
- c. **Leslie does not have written documentation of her understanding with the client. [This answer is correct. Before performing nonattest services, the practitioner is required to establish an understanding with the client and document it in writing. In this scenario, Leslie's lack of documentation is a violation of Rule 202, *Compliance With Standards*. However, per footnote 6 in Interpretation 101-3, she has not impaired her independence with respect to this client. Additionally, if the nonattest services consisted of routine activities (such as providing advice) or nonattest services performed before the client became an attest client, Leslie would not be required to follow the documentation requirement.]**
- d. Grady has the power to authorize, execute, and consummate transactions on behalf of his client. [This answer is incorrect. Just having the power to exercise such authority on behalf of the client impairs Grady's independence. Even if Grady does not use this power, his independence will still be impaired with respect to this client.]
7. Performance of which of the following nonattest services would impair a practitioner's independence? **(Page 172)**
- a. Using client-approved records to process payroll. [This answer is incorrect. As long as the records have been provided and approved by the client, performing payroll processing and generating unsigned checks will not impair a practitioner's independence. However, accepting the responsibility to sign or cosign client checks, even in an emergency, will impair the practitioner's independence.]
- b. Performing recordkeeping and reporting of portfolio balances. [This answer is incorrect. Performing this task would allow a practitioner to retain his or her independence, even if the practitioner provided a comparative analysis of the investments to third-party benchmarks. Making investment decisions on the client's behalf, on the other hand, would impair the practitioner's independence.]
- c. **Designing the client's financial information system. [This answer is correct. Performing this service would impair a practitioner's independence; however, the practitioner could install an off-the-shelf accounting package for the client and still retain his or her independence.]**
- d. Assisting with development of corporate strategies. [This answer is incorrect. A practitioner who performs this task will still be independent with respect to the nonattest client; however, if the practitioner commits the client to the terms of a corporate financial transaction, his or her independence would be impaired.]

8. The traditional CPA firm of Milton-Harris is sold to MegaCo. MegaCo has various subsidiaries, including several that offer nonattest professional services to clients. The owners and employees of Milton-Harris become employees of a subsidiary of MegaCo and perform all nonattest services through that subsidiary. The owners of Milton-Harris also form a new CPA firm, Audit Time, that provides all attest services. CPAs (including the owners of Milton-Harris) own a majority of Audit Time, and Audit Time's attest services are supervised by its owners. An arrangement between MegaCo and Audit Time allows for the leasing of employees, office space, and other services (e.g., advertising and marketing), for which Audit Time pays a negotiated fee. MegaCo has another CPA firm subsidiary, Audits 'R Us, that performs attest services, but there are no shared employees or economic interests between Audit Time and Audits 'R Us. Based on Interpretation 101-14, which of the following statements is accurate in this scenario? **(Page 178)**
- Only the former owners of Milton-Harris are considered covered members with respect to Audit Time's attest engagements. [This answer is incorrect. It is possible that other CPAs could be considered covered members with respect to Audit Time's attest clients, depending on the circumstances. For example, if Audit Time's CPA owners included practitioners who were not part of Milton-Harris, they would also be considered covered members.]
 - MegaCo employees leased by Audit Time will be considered covered members with respect to Audit Time's attest engagements. [This answer is correct. Both employed and leased individuals are included in the definition of a covered member when dealing with alternative practice structures, such as the one described above.]**
 - The owners of Audit Time will be considered covered members with respect to Audits 'R Us's attest clients. [This answer is incorrect. In the situation described above, Audit Time and Audits 'R Us are separate entities, and owners of one subsidiary would not be covered members with respect to the attest clients of the other subsidiary. However, if the owners of one subsidiary performed services for the other or if the subsidiaries shared significant economic interests, practitioners might be considered owners of both subsidiaries when applying the independence rules.]
9. Assume the same details as in the question above. Jackson is one of the CPA owners of Audit Time. Who would be considered his indirect superior with respect to applying the independence rules of Interpretation 101-14? **(Page 178)**
- The senior partner of Audit Time who supervises his work. [This answer is incorrect. This would be Jackson's direct superior.]
 - The owners of Audits 'R Us who perform audits in similar areas. [This answer is incorrect. Based on the relationship between Audits 'R Us and Audit Time, owners of Audits 'R Us would not be an indirect superior of an owner of Audit Time.]
 - The vice president of MegaCo to which Audit Time Reports. [This answer is correct. An indirect superior is defined by Interpretation 101-14 as being individuals that are one or more levels above individuals that would be considered direct superiors. This definition also includes family members of the indirect superior. The PEEC believes that such indirect superiors are far enough removed from covered members, such as Jackson, that the less restrictive standards should be applied to them.]**
 - MegaCo and all entities consolidated into MegaCo's financial statements. [This answer is incorrect. This is Interpretation 101-14's definition for an other entity, not an indirect superior.]

10. Ralph performs audits under *Government Auditing Standards* (the Yellow Book). Which of the following independence requirements applies specifically to this aspect of his practice? **(Page 179)**
- a. **Three classes of independence impairment are recognized—personal, external, and organizational. [This answer is correct. Each of these impairment classes recognized by the Yellow Book could impact whether Ralph may perform specified audit work.]**
 - b. The requirements are the same whether Ralph audits governments or nonprofit organizations. [This answer is incorrect. Yellow Book independence requirements will vary depending on what type of organization is being audited.]
 - c. If Ralph's state board of accountancy adopted the AICPA rules, he has no other requirements to meet. [This answer is incorrect. Governmental audits can have more restrictive requirements than those established by the AICPA, and in such situations, Ralph should adhere to the more restrictive rules found in the Yellow Book over those established by the AICPA.]
 - d. Ralph cannot retain his independence if he uses another auditor during a governmental audit. [This answer is incorrect. There is no restriction in Yellow Book for using other auditors. Additionally, governmental audits often require that the financial statements of a component unit be included which results in using another auditor more frequently than with other types of audits. Ralph can use the work of another auditor and still be independent from his audit client.]
11. Judy engages another auditor, Carl, to audit a subsidiary of her audit client that has been consolidated into its financial statements. What must Judy do if she makes use of Carl's work? **(Page 180)**
- a. Reference Carl's work auditing the subsidiary in the auditor's report provided to the client. [This answer is incorrect. Judy is not required to reference another auditor when she makes use of his work during the audit, but must receive representation from Carl that he is independent.]
 - b. **Make inquiries of other practitioners and elsewhere about Carl's professional reputation. [This answer is correct. Judy can also make inquiries of the AICPA, Carl's state society, bankers, or other credit grantors.]**
 - c. Though she could use Carl when performing a review, Judy cannot use Carl during an audit. [This answer is incorrect. Judy could use another auditor during an audit and during a review.]
 - d. Can use another auditor who is not independent with respect to her client. [This answer is incorrect. Judy is required to obtain a representation from the other auditor that he/she is independent of the client.]

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 anytime 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 strongly encouraged to treat all ethics violations with equal degrees 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. (See the previous discussion of the *Conceptual Framework* for more information about how to accomplish this.) If effective safeguards cannot be applied, the firm should withdraw from the engagement.

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

- a. The engagement partner is to consider relevant information about engagements, including the scope of services, in order to evaluate the overall effect on independence requirements, if any.
- b. Personnel are to notify the engagement partner and the quality control director (or other designated individual who has the responsibility to oversee the independence aspect of the firm's quality control system) about relationships and situations that create an independence threat so that appropriate action can be taken.
- c. Firms must accumulate and communicate relevant information to appropriate personnel so the firm—
 - (1) And the engagement partner, as well as other firm personnel, 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 that 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. All individuals subject to independence requirements should promptly notify the firm of independence breaches once they become aware that a breach exists.
- b. The firm should promptly communicate identified breaches 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.

Occasionally, the firm may receive notice that a breach of its independence policies and procedures has occurred. When such a situation occurs, the firm promptly communicates relevant information to engagement partners, and others in the firm as appropriate (such as the ethics partner), 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. For example, the PCAOB requires periodic rotation of engagement partners. 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

As discussed at the beginning of this lesson, the ASB has issued two exposure drafts that would supersede SQCS No. 7 and SAS No. 25.

Proposed SQCS. 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.

Proposed SAS. The proposed SAS indicates that the audit engagement partner—

- Should remain alert throughout the engagement (by performing observation and inquiry) for evidence of any non-compliance with relevant ethical requirements by engagement team members.
- In consultation with others in the firm, should determine the appropriate action, if an indication that members of the engagement team have not complied with ethical requirements comes to the engagement partner's attention.
- Has additional responsibilities regarding independence, including forming a conclusion about compliance with independence requirements that apply to the engagement.

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. Making the decision about accepting and continuing client relationships and specific engagements is covered in Lesson 2.

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.

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. As a result, the firm should designate the quality control director or other designated partner to take responsibility for overseeing compliance with ethical requirements (referred to here as the *ethics partner*). The ethics partner needs to have a current and detailed working knowledge of the relevant rules and requirements relating to independence, integrity, and objectivity previously discussed. In addition, the ethics partner may oversee the administration of all firm independence-related matters, including performance of 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, and that is not the situation in larger firms. 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 for the client list to be 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 firms need to establish procedures designed to provide it with reasonable assurance that the firm and its personnel maintain independence where required, firms need 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. The list needs to be updated on an ongoing basis so that independence evaluations are always based on the most current firm client information. Firms 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 both the requirements and prohibited clients (that is, attest clients other than compilation-only clients). 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.

An alternative to the firm communicating prohibited client relationships to personnel might be considered for large and multi-office firms. In such firms, it may be more efficient for each professional employee to periodically (annually, at a minimum) provide a list of all personal investments, interests in partnerships and joint ventures, loans receivable and payable, and family relationships with owners, directors, or officers of any company to the ethics partner. Such a process places the responsibility of matching investments and relationships on the professional employee's list to the client list in the hands of the ethics partner. Additionally, accumulating such information from the professional staff allows the firm to potentially know before an attest engagement is accepted, that such a relationship with the client will create a threat to independence.

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 a large audit engagement, the firm sends notification to professional employees and ask them to communicate back any personal independence conflicts with the prospective client.

Finally, 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 the importance 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.

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 ethics partner is often responsible for evaluating employee responses to identify independence breaches and potential threats to independence. If any threats or breaches are identified based on the evaluation, the ethics partner will then accumulate and communicate 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 ethics 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, it is suggested that the ethics partner be notified and that 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 ethics 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 an independence threat can be mitigated.

Once adequate information is collected about the potential threat, that information needs to be communicated to the engagement partner, firm management, 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, firm management and the ethics 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. As discussed previously, 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 audit 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. (See Lesson 2 for a discussion of the policies and procedures relating to withdrawing from an engagement and client relationship.)

Accordingly, it is recommended that formal procedures be established so that once an independence breach is identified, the engagement partner, the ethics 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 ethics partner needs to consult authoritative literature in resolving the matter. The resolution may range from taking appropriate actions to resolve the problem, or 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 firm management and the ethics 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 occasionally 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. The firm should 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.

SELF-STUDY QUIZ

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

12. Which of the following statements most accurately describes an independence policy or procedure discussed in SQCS No. 7?
 - a. Once every three years, a firm should obtain independence representations from personnel required to be independent.
 - b. Audit and attestation personnel must be rotated every two years in order for the firm to maintain its independence.
 - c. Firm personnel should notify the client promptly if they become aware of an existing independence breach.
 - d. The engagement partner should evaluate all information on the engagement to determine the overall affect on independence.

13. Kale-Bond is a large CPA firm with multiple offices. What would generally be the most efficient way for the firm to ensure that all necessary personnel are independent from attest clients?
 - a. The firm can provide a list of current clients with whom financial or business relationships are prohibited and allow personnel to communicate any issues.
 - b. The firm can require employees to provide the firm's ethics partner an annual list of all personal investments and other necessary information.
 - c. The firm can notify all personnel about new audit or attest clients before an engagement is bid on and require personnel to respond.

14. Which of the following statements about identifying and resolving independence breaches is true?
 - a. Mitigating the independence threat will resolve any independence breach.
 - b. Notification of a breach is considered timely if received by the engagement's conclusion.
 - c. Withdrawing from the engagement is the only response to an independence breach.
 - d. A QC system should include guidelines to determine what went wrong with the system.

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.)**

12. Which of the following statements most accurately describes an independence policy or procedure discussed in SQCS No. 7? **(Page 190)**
- a. Once every three years, a firm should obtain independence representations from personnel required to be independent. [This answer is incorrect. Independence representations should be obtained annually, at a minimum.]
 - b. Audit and attestation personnel must be rotated every two years in order for the firm to maintain its independence. [This answer is incorrect. SQCS No. 7 does not require a firm to rotate its personnel. However, other entities (such as the PCAOB) do have rotation requirements. SQCS No. 7 requires that a firm address any rotation requirements from other entities, if applicable.]
 - c. Firm personnel should notify the client promptly if they become aware of an existing independence breach. [This answer is incorrect. In this instance, personnel should notify the firm, not the client.]
 - d. The engagement partner needs to evaluate all information on the engagement to determine the overall affect on independence. [This answer is correct. This is one of SQCS No. 7's general requirements for maintaining independence. The scope of the services provided in the engagement is one important part of the engagement partner's evaluation.]**
13. Kale-Bond is a large CPA firm with multiple offices. What would generally be the most efficient way for the firm to ensure that all necessary personnel are independent from attest clients? **(Page 192)**
- a. The firm can provide a list of current clients with whom financial or business relationships are prohibited and allow personnel to communicate any issues. [This answer is incorrect. This is the typical way that firms, especially small firms, use client lists to discover possible threats to independence; however, as Kale-Bond is such a large firm, there may be a more efficient way for such threats to be communicated.]
 - b. The firm can require employees to provide the firm's ethics partner an annual list of all personal investments and other necessary information. [This answer is correct. For a large multi-office firm, like Kale-Bond, this may be the more efficient approach. Personnel should include all personal investments, partnership and joint venture interests, loans receivable and payable, and any family relationships with directors, owners, or officers of any company. This puts the responsibility for matching the provided lists with the firm's client list in the hands of the firm's ethics partner.]**
 - c. The firm can notify all personnel about new audit or attest clients before an engagement is bid on and require personnel to respond. [This answer is incorrect. This would be the fastest way for a firm to assess an independence threat for an individual engagement, but not necessarily the most efficient for ensuring independence with all clients. Such notifications would be helpful if the firm wanted to verify any independence threats before making an engagement proposal.]
14. Which of the following statements about identifying and resolving independence breaches is true? **(Page 194)**
- a. Mitigating the independence threat will resolve any independence breach. [This answer is incorrect. Generally, correcting a breach of independence is not as simple as mitigating an identified threat. The firm must carefully consider the appropriate course of action.]
 - b. Notification of a breach is considered timely if received by the engagement's conclusion. [This answer is incorrect. A prompt response should be an important part of the firm's QC procedures and policies related to independence. Personnel with questions or uncertainties about breaches or threats to independence, should not hesitate about contacting the ethics partner.]**

- c. Withdrawing from the engagement is the only response to an independence breach. [This answer is incorrect. Though this is not generally the case, it may be possible to reverse the situation that caused the breach or determine some other solution, such as limiting the services and the report issued for the engagement. Usually, however, the firm will have to withdraw from the engagement.]

- d. A QC system should include guidelines to determine what went wrong with the system. [This answer is correct. When establishing QC policies and procedures to deal with independence, a firm also needs guidelines for establishing what went wrong with the QC system that allowed the breach of independence to occur. Finding out why the breach occurred will allow the firm to correct the breach in the QC system.]**

DRAFTING 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 QC and Peer Review Materials

AICPA Practice Aid. After reviewing authoritative literature, a review of the illustrative examples suggested by the AICPA for designing the relevant ethical requirements element of the quality control system is recommended. 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's Practice Aid).

Exhibit 1-4 is based on a section from one of the sample quality control documents included in the AICPA's Practice Aid. This portion of the quality control document contains suggested policy statements followed by procedures that can be used in designing and documenting a firm's relevant ethical requirements quality control system. This particular document illustrates an ethical requirements quality control system for a local one-office accounting firm (referred to as Single-office CPA Firm). The firm has three partners and ten professionals and uses purchased practice aids that have been subjected to peer review in accordance with AICPA standards. The suggested policies are in bold type, and suggested procedures are in regular type.

Exhibit 1-4

AICPA Illustrative Quality Control Policies and Procedures Related to Relevant Ethical Requirements

1. **Personnel adhere to relevant ethical requirements such as those in regulations, interpretations, and rules of the AICPA, state CPA societies, state boards of accountancy, state statutes, the GAO (U.S. Government Accountability Office), and any other applicable regulators.** Single-office CPA Firm implements this policy through the following procedures—
 - a. Designating a quality assurance partner to review relevant pronouncements relating to independence, integrity, and objectivity; answer questions; determine the circumstances for which consultation with sources outside the firm is required; and resolve matters.
 - b. Providing personnel with access to the AICPA *Professional Standards* service.
 - c. Establishing a system for identifying all services performed for each client and evaluating whether any of these services might impair independence.
2. **The firm's senior management sets a tone for the organization that stresses the importance of ethical values, especially as they pertain to accounting and auditing engagements, and communicates related policies and procedures to firm personnel.** Single-office CPA Firm implements this policy through the following procedures—
 - a. Informing personnel of those entities to which independence policies apply, by doing the following on a timely basis:
 - (1) Preparing and maintaining a list of entities with which firm personnel are prohibited from having a financial or business relationship.
 - (2) Making the list available to personnel so they may evaluate their independence (including personnel new to the firm).
 - (3) Notify personnel of changes in the list.

- b. Providing frequent reminders of professional responsibilities to personnel, such as avoiding behavior that might be perceived as impairing their independence or objectivity.
3. **The firm establishes procedures to identify and evaluate possible threats to independence and objectivity, including the familiarity threat that may be created by using the same senior personnel on an audit or attest engagement over a long period of time, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards.** Single-office CPA Firm implements this policy through the following procedures—
- a. Requiring the engagement partner to consider relevant information about client engagements, including the scope of services, to enable him or her to evaluate the overall impact, if any, on independence requirements.
 - b. Accumulating and communicating relevant information to appropriate personnel so that the following can occur—
 - (1) The firm, the engagement partner, and other firm personnel can readily determine whether they satisfy independence requirements.
 - (2) The firm can maintain and update information relating to independence.
 - (3) The firm and the engagement partner can take appropriate action regarding identified threats to independence.
 - c. Requiring personnel to promptly report circumstances and relationships that create a threat to independence, and independence breaches of which they become aware, so that appropriate action can be taken.
 - d. Establishing criteria to determine the need for safeguards for engagements where the following have taken place—
 - (1) Monitoring procedures or peer review has identified weaknesses in previous years.
 - (2) The same senior personnel have been used for five years or more on an audit or attestation engagement.
 - e. Promptly communicating identified breaches of these policies and procedures, and the required corrective actions, to the following personnel—
 - (1) The engagement partner who, with the firm, needs to address the breach.
 - (2) Other relevant personnel in the firm and those subject to the independence requirements who need to take appropriate action.
 - f. Requiring the engagement partner and the other individuals referred to in the previous list to confirm to the firm that the required corrective actions have been taken.
 - g. Having a partner, or an individual designated by the partner, periodically review unpaid fees from clients to ascertain whether any outstanding amounts impair the firm's independence.
 - h. Establishing additional procedures that provide safeguards when the firm performs audit or other attest work for (1) significant clients or (2) clients at which partners or other senior personnel are offered key management positions, or have accepted offers of employment.
4. **The firm withdraws from the engagement if effective safeguards to reduce threats to independence to an acceptable level cannot be applied.** Single-office CPA Firm implements this policy through the following procedures—
- a. Consulting within the firm, and with legal counsel and other parties if necessary, when the firm believes that effective safeguards to reduce threats to independence to an acceptable level cannot be applied.

- b. Withdrawing from the engagement if effective safeguards to reduce threats to independence to an acceptable level cannot be applied.

5. The firm obtains written confirmation, at least annually, of compliance with its policies and procedures on independence from all firm personnel required to be independent by relevant requirements.

Single-office CPA Firm implements this policy through the following procedures—

- a. Obtaining written representations from personnel, upon hire and on an annual basis, stating that they have read the firm's independence, integrity, and objectivity policies, understand the applicability of those policies to their activities, and have complied with the requirements of those policies since their last representation. (Such written representations are accompanied by the most current list of all entities with which firm personnel are prohibited from having a business relationship.)
- b. Reviewing these independence representations for completeness and resolving reported exceptions.
- c. Requiring the engagement partner to sign a step in the engagement program attesting to compliance with independence requirements that apply to the engagement.

6. The firm establishes procedures for confirming the independence of another firm that performs part of the engagement. Single-office CPA Firm implements this policy through the following procedures—

- a. Using practice aids that prescribe the form and content of independence representations, and frequency with which they are to be obtained.
- b. Requiring that such representations be documented.

* * *

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

AICPA Peer Review Program Manual. Another good source of information for designing relevant ethical requirements policies and procedures for the firm's quality control system are the checklists included in the *AICPA Peer Review Program Manual (PRPM)*.

The PRPM provides quality control policies and procedures questionnaires for firms to complete prior to the commencement of an AICPA system review. (The firm need only complete one questionnaire.) Section 4400 of the PRPM presents the questionnaire for firms with two or more personnel (individuals who perform professional services) (summarized in Exhibit 1-5). Section 4300 of the PRPM provides the questionnaire for a sole practitioner with no personnel (summarized in Exhibit 1-6). Firms that are structured as an APS may want to consider reviewing the questionnaire in Section 5100 of the PRPM, which is outside the scope of this course.

Exhibit 1-5**Attributes of a Relevant Ethical Requirements QC System or Review Steps Emphasized on Peer Review Questionnaire (Firms with Two or More Personnel)^a**

- Describe how the firm documents and communicates its policies and procedures for relevant ethical requirements to its personnel.
- Does the firm have access to current guidance materials regarding the applicable independence, integrity, and objectivity requirements?
- Does the firm employ someone responsible for providing guidance, answering questions, monitoring compliance, and resolving matters with respect to independence, integrity and objectivity?
- Does the firm have a system for identifying all services performed for clients, including services performed by entities closely aligned through common employment and other means, and evaluating whether any of those services might impair independence?
- Does the firm have policies and procedures in place to ensure the independence of the firm as required by the AICPA, state CPA societies, state boards of accountancy, state statute, the Independence Standards Board, the SEC, and other regulatory bodies, if applicable?
- Does the firm provide its personnel with the firm's list of clients and any related entities and inform them on a timely basis as to any changes in the firm's clients and any related entities to which independence policies apply?
- Does the firm obtain written confirmation, upon hire and on an annual basis, of compliance with its policies and procedures on independence from all personnel required to be independent by relevant requirements?
- If the firm has any engagements where it acts as principle auditor or accountant and another firm of CPAs is engaged to perform segments of the engagement, are written confirmations obtained regarding the other firm's independence with respect to audit engagements and either written or oral confirmations obtained for review or attestation engagements?
- Has the firm identified circumstances for which documentation of the resolution of independence, integrity, and objectivity questions is required?
- Has the firm found it necessary within the last year to consult with individuals outside the firm on independence, integrity, or objectivity concerns?
- Does the firm review unpaid fees from clients to ascertain whether any outstanding amounts may impair the firm's independence?
- Does the firm inform its personnel of financial or other relationships that may impair independence and that may be prohibited?

Note:

- ^a These questions reflect the most recent changes made to the AICPA PRPM. At the date of this course, the most recent version of the AICPA PRPM is designated as 00-1 2009.

* * *

Exhibit 1-6

Attributes of a Relevant Ethical Requirements QC System or Review Steps Emphasized on Peer Review Questionnaire (Sole Practitioner with No Personnel)^a

- Describe how the practitioner documents and communicates its policies and procedures for relevant ethical requirements to its per diem personnel.
- Does the practitioner have access to current guidance materials regarding the applicable independence, integrity, and objectivity requirements?
- Does the practitioner document independence annually through a written confirmation or on each engagement on a program step and require all per diem personnel to do the same?
- Does the practitioner review unpaid fees from clients to ascertain whether any outstanding amounts impair the firm's independence?
- Does the practitioner consider financial or other relationships that may impair independence?
- In situations where the firm is not independent, are services for those clients limited to compilation and other nonattest services, and are all compilation reports modified to disclose the firm's lack of independence?
- If the firm has any engagements where it acts as principal auditor or accountant and another firm of CPAs is engaged to perform segments of the engagement, are written confirmations obtained regarding the other firm's independence with respect to audit engagements and either written or oral confirmations obtained for review or attestation engagements?
- If the firm provides nonattest services to accounting and auditing clients, did the firm meet all the requirements of Interpretation 101-3 for each accounting and auditing client for which nonattest services were performed?
- Describe the procedures the practitioner performs in evaluating other possible threats to independence and objectivity and appropriate actions taken to eliminate those threats or reduce them to an acceptable level by applying safeguards.

Note:

- ^a These questions reflect the most recent changes made to the AICPA PRPM. At the date of this course, the most recent version of the AICPA PRPM is designated as 00-1 2009.

* * *

Practitioners involved in designing a QC system for relevant ethical requirements should scan the PRPM quality control policies and procedures questionnaire for their firm size. The size and other unique characteristics of each firm will dictate the quality control needs of a given firm and, therefore, not all questions apply to every firm. Also, there is almost always the alternative procedure that is equally acceptable for a given firm. However, by considering the information in the PRPM when designing or revising its QC system, the firm can obtain a general understanding of what is suggested by the AICPA for the QC relevant ethical requirements element, which may be helpful when drafting the firm's policies and procedures.

Developing Relevant Ethical Requirement 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, the number of firm locations, 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, one policy statement could be developed for each QC element and then appropriate procedures for each element could be designed to implement 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.

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. It is advisable 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 thus, violate its relevant ethical requirements policy. These are commonly referred to as "Prohibited Transactions and Relationships."

Prohibited Transactions and Relationships. An infinite variety of situations can occur that raise questions as to whether the situation is a threat to independence. This is evident in the 100-plus rulings issued by the AICPA's Ethics Division that address actual situations encountered by practitioners. When making independence judgments that are not explicitly addressed anywhere in the *Code*, the guidance contained in the Conceptual Framework should be followed if the firm is not sure whether a situation may violate the *Code*.

It is generally understood that certain transactions and relationships are prohibited. Interpretations of Ethics Rule 101 cite examples of prohibited transactions and relationships. However, many firms may not want to arbitrarily prohibit all such transactions. For example, several of the firm's partners may have invested in a real estate joint venture with the owners of a significant client organization. The firm may be willing to issue a nonindependent compilation report on the client's financial statements rather than withdraw from the engagement. On the other hand, as a firm grows in size and in number of employees (especially as a firm's audit practice grows), it may be impractical to approach each independence question on an ad hoc basis. In this case, the firm may decide to prohibit all transactions that would impair its independence. The decision a firm must make is whether it wants to prohibit some or all transactions and relationships with clients.

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 nonprofit 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 audit 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 auditing services.

Some firms use paraprofessionals to do accounting and review services and to assist in audit 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." This course maintains that a paraprofessional participating in an engagement, in any capacity other than providing administrative support, 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 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. As previously mentioned, a good starting point is to refer to the AICPA illustrative procedures reproduced at Exhibit 1-4.

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. Larger firms may elect to cover all relevant ethical requirements in both the quality control document and 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. It is easy when working with two different documents to inadvertently omit a procedure or to make conflicting statements.

Communicate the Firm's Policies and Procedures to Employees. Regardless of the firm's size, it would be advisable for the firm to communicate its quality control system policies and procedures to its personnel in a written document. By doing so, communicating the firm's policy and procedures is rather easy, as the managing 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. Firms may also maintain a copy of the firm's QC policies and procedures available electronically, perhaps on the firm's network.

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 re-emphasize the importance of adherence to the rules.

EVALUATING THE OVERALL ADEQUACY OF THE DESIGN OF THE QUALITY CONTROL SYSTEM

The ideas, recommendations, and suggestions relating to relevant ethical requirements discussed in this course can allow the firm to design a practical quality control system that meets its needs. The ultimate responsibility for the effectiveness of the quality control system, of course, lies with the firm. To help determine whether the relevant ethical requirements policies and procedures meet the firm's needs and provides reasonable assurance that the firm is in compliance with the quality control standards, the quality control system practice aids included in *PPC's Guide to Quality Control* may be used. Those practice aids provide a summary of what the quality control policies and procedures for each quality control element needs to address. Reviewing the questions in the relevant ethical requirements section of the appropriate practice aids will be useful in performing a final assessment of the firm's quality control policies and procedures for this QC element.

Additionally, the firm needs to consider common independence deficiencies noted in peer reviews. Exhibit 1-7 provides examples of some of the more common deficiencies noted in peer reviews.

Exhibit 1-7

Common Independence Deficiencies Noted in Peer Reviews

- Failure to obtain annual independence representations from staff.
- Failure to verify the independence of *per diem* and contract employees or outside concurring reviewers used by a firm.
- Failure to obtain annual independence representations from other auditors performing a segment of the engagement.
- Failure to circulate current lists of clients from whom the firm must be independent.
- Failure to document or to adequately document resolution of independence questions.
- Failure to document the timely review of client accounts receivable agings (billed and unbilled).
- Staff are not familiar with independence requirements of the firm and of professional literature.
- Failure to appropriately modify a compilation report on an engagement in which the accountant was not independent.
- Failure to comply with regulatory independence rules. (For example, the U.S. Department of Labor's and Department of Housing and Urban Development's independence requirements are more stringent than those required by the AICPA's professional standards.)
- Issuance of a review report when the CPA is not independent.
- Issuance of an audit report when the auditor is not independent.
- Failure to document the procedures required by Interpretation 101-3.

* * *

MONITORING COMPLIANCE FOR RELEVANT ETHICAL REQUIREMENTS POLICIES AND PROCEDURES

The firm needs to 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 are to 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. The following is an example policy statement from the AICPA's Practice Aid, *Establishing and Maintaining a System of Quality Control*.

The firm withdraws from the engagement if effective safeguards to reduce threats to independence to an acceptable level cannot be applied.

Which of these example QC procedures from the practice aid would help a firm achieve the objective in the policy statement?

- a. Providing personnel with access to the *AICPA Professional Standards* service.
 - b. Consulting with the firm, and with legal counsel and other parties if necessary, when the firm believes that effective safeguards to reduce threats to independence to an acceptable level cannot be applied.
 - c. Having a partner, or an individual designated by the partner, periodically review unpaid fees from clients to ascertain whether any outstanding amounts impair the firm's independence.
 - d. Reviewing these independence representations for completeness and resolving reported exceptions.
16. The firm of Anderson & Keller has two partners and three professional staff members. Which of the following questions from the *AICPA Peer Review Program Manual* (PRPM) QC questionnaire applies **only** to a firm in this size range?
- a. If the firm has any engagements where it acts as principal auditor or accountant and another firm of CPAs is engaged to perform segments of the engagement, does the firm confirm the independence of the other firm?
 - b. Does the firm review unpaid fees from clients to ascertain whether any outstanding amounts impair the firm's independence?
 - c. Does the firm have access to publications that contain the profession's interpretations related to potential issues or situations related to independence, integrity, and objectivity?
 - d. Does the firm have policies and procedures in place to ensure its independence as required by the AICPA, state CPA societies, state boards of accountancy, state statute, and other regulatory bodies, if applicable?
17. Define *quality control policies*.
- a. They include various factors, such as number of firm locations, firm size, and firm operating characteristics.
 - b. They are designed to provide actions needed to implement and monitor compliance with stated policies.
 - c. They are designed to achieve the overall objectives of the QC system and specific objectives of individual QC elements.

18. The partners of Taylor-Johns, a CPA firm, invested in a real estate joint venture with the owners of Tech Town, one of their significant audit clients. What effect will this have over future engagements Taylor-Johns performs for Tech Town under the independence rules?
- a. The firm must withdraw from all engagements with Tech Town immediately, because independence cannot be determined on an ad hoc basis.
 - b. The firm can choose to perform a nonindependent compilation report on Tech Town's financial statements instead of an independent audit.
 - c. The firm can continue their audit relationship with Tech Town as long as all other independence procedures are followed.
19. Which of the following statements most accurately illustrates the documentation or communication needed for a QC system?
- a. A firm can document its QC policies and procedures in a QC document or with a QC document and a personnel manual.
 - b. If the firm uses both a QC document and a personnel manual, one must be the dominant source in case the two documents conflict.
 - c. Communication of QC policies and procedures must take place in paper format—electronic distribution is not permissible.
20. Which of the following is an independence problem commonly noted in peer reviews?
- a. Failure to properly modify an auditor's report when the auditor was not independent during the engagement.
 - b. Failure to reevaluate continuance decisions annually.
 - c. Failure to obtain annual independence representations from personnel.
 - d. Acceptance of an engagement if the firm does not have the competence to perform the service.

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. The following is an example policy statement from the AICPA’s Practice Aid, *Establishing and Maintaining a System of Quality Control*.

The firm withdraws from the engagement if effective safeguards to reduce threats to independence to an acceptable level cannot be applied.

Which of these example QC procedures from the practice aid would help a firm achieve the objective in the policy statement? **(Page 198)**

- a. Providing personnel with access to the AICPA *Professional Standards* service. [This answer is incorrect. The example policy statement that this procedure would support reads as follows: Personnel adhere to relevant ethical requirements such as those in regulations, interpretations, and rules of the AICPA, state CPA societies, state boards of accountancy, state statutes, the GAO (U.S. Government Accountability Office), and any other applicable regulators.]
 - b. Consulting with the firm, and with legal counsel and other parties if necessary, when the firm believes that effective safeguards to reduce threats to independence to an acceptable level cannot be applied. [This answer is correct. Another example procedure that would support this policy statement reads as follows: Withdrawing from the engagement if effective safeguards to reduce threats to independence to an acceptable level cannot be applied.]**
 - c. Having a partner, or an individual designated by the partner, periodically review unpaid fees from clients to ascertain whether any outstanding amounts impair the firm’s independence. [This answer is incorrect. The example policy statement in the AICPA’s practice aid that this procedure applies to reads as follows: The firm establishes procedures to identify and evaluate possible threats to independence and objectivity, including the familiarity threat that may be created by using the same senior personnel on an audit or attest engagement over a long period of time, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards.]
 - d. Reviewing these independence representations for completeness and resolving reported exceptions. [This answer is incorrect. The example policy statement that this procedure supports reads as follows: The firm obtains written confirmation, at least annually, of compliance with its policies and procedures on independence from all firm personnel required to be independent by relevant requirements.]
- 16. The firm of Anderson & Keller has two partners and three professional staff members. Which of the following questions from the *AICPA Peer Review Program Manual* (PRPM) QC questionnaire applies **only** to a firm in this size range? **(Page 201)**
 - a. If the firm has any engagements where it acts as principal auditor or accountant and another firm of CPAs is engaged to perform segments of the engagement, does the firm confirm the independence of the other firm? [This answer is incorrect. This question is found in the PRPM’s questionnaires for all types of firms; thus, it would not apply only to firms in the same size range as Anderson & Keller.]
 - b. Does the firm review unpaid fees from clients to ascertain whether any outstanding amounts impair the firm’s independence? [This answer is incorrect. Because, according to the PRPM, this question applies to both firms with more than two professional staff and sole practitioners, this question does not apply only to firms in Anderson & Keller’s size range.]
 - c. Does the firm have access to publications that contain the profession’s interpretations related to potential issues or situations related to independence, integrity, and objectivity? [This answer is incorrect. This question from the PRPM applies to all firms; therefore, it would not only apply to Anderson & Keller.]

- d. **Does the firm have policies and procedures in place to ensure its independence as required by the AICPA, state CPA societies, state boards of accountancy, state statute, and other regulatory bodies, if applicable? [This answer is correct. This question from the PRPM applies specifically to firms with over two professional staff; therefore, it would apply to Anderson & Keller, as this firm has five professional staff.]**

17. Define *quality control policies*. (Page 202)

- a. They include various factors, such as number of firm locations, firm size, and firm operating characteristics. [This answer is incorrect. These are considerations that a firm must take into account when developing their QC policies and procedures.]
- b. They are designed to provide actions needed to implement and monitor compliance with stated policies. [This answer is incorrect. This is the definition of *quality control procedures*.]
- c. **Policies that are designed to achieve the overall objectives of the QC system and specific objectives of individual QC elements. [This answer is correct. QC procedures are designed to support and achieve the QC policies.]**

18. The partners of Taylor-Johns, a CPA firm, invested in a real estate joint venture with the owners of Tech Town, one of their significant audit clients. What effect will this have over future engagements Taylor-Johns performs for Tech Town under the independence rules? (Page 203)

- a. The firm must withdraw from all engagements with Tech Town immediately, because independence cannot be determined on an ad hoc basis. [This answer is incorrect. A firm can put QC independence policies in place that prohibit all of independence-impairing relationships; however, this is not one of the independence requirements, so the firm is not obligated to make that choice.]
- b. **The firm can choose to perform a nonindependent compilation report on Tech Town's financial statements instead of an independent audit. [This answer is correct. If the partners want to continue the joint venture and do not want to withdraw from the engagement, this would be an acceptable independence compromise.]**
- c. The firm can continue their audit relationship with Tech Town as long as all other independence procedures are followed. [This answer is incorrect. This relationship would be considered a prohibited relationship; therefore, the firm cannot perform Tech Town's audit under these circumstances.]

19. Which of the following statements most accurately illustrates the documentation or communication needed for a QC system? (Page 204)

- a. **A firm can document its QC policies and procedures in a QC document or with a QC document and a personnel manual. [This answer is correct. Both of these options are permissible. Some firms may prefer a comprehensive QC document, while others may prefer that specific requirements be covered in a personnel manual.]**
- b. If the firm uses both a QC document and a personnel manual, one must be the dominant source in case the two documents conflict. [This answer is incorrect. The biggest danger of having two documents is that they will not be consistent or comprehensive. If the firm chooses to use two documents, it must strive for this consistency.]
- c. Communication of QC policies and procedures must take place in paper format-electronic distribution is not permissible. [This answer is incorrect. An easy way for partners to determine that all employees received a copy of the QC information is to distribute hard copies and put an electronic copy on the firm's network. Electronic distribution can be utilized during the communication phase.]

20. Which of the following is an independence problem commonly noted in peer reviews? **(Page 205)**

- a. Failure to properly modify an auditor's report when the auditor was not independent during the engagement. [This answer is incorrect. If the auditor is not independent, he or she cannot issue a report or opinion on an audit. The commonly noted failure is failure to modify a compilation report if the accountant was not independent.]
- b. Failure to reevaluate continuance decisions annually. [This answer is incorrect. This is a commonly noted client acceptance and continuance problem noted in peer reviews.]
- c. Failure to obtain annual independence representations from personnel. [This answer is correct. Another example of a commonly noted independence issue that is noted on peer reviews is the failure to document the resolution of independence questions that arise.]**
- d. Acceptance of an engagement if the firm does not have the competence to perform the service. [This answer is incorrect. This is a common problem noted in peer reviews about client acceptance and continuance.]

EXAMINATION FOR CPE CREDIT**Lesson 1 (GQCTG102)**

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. Harold, an AICPA member, is performing valuation services for his client. List all of the fundamental principles of professional ethics (from the AICPA *Code of Professional Ethics and SQCS No. 7*) that Harold is required to uphold during this engagement.

i. Responsibilities

v. Independence

ii. The public interest

vi. Due care

iii. Integrity

vii. Scope and nature of services

iv. Objectivity

- a. ii. and vi.
- b. iii., iv., and v.
- c. i., ii., iii., iv., vi., and vii.
- d. i., ii., iii., iv., v., vi., and vii.
2. According to the AICPA, which of the following are included in the accounting profession's public when an AICPA member is serving the public interest?
- a. Clients, governments, and investors.
- b. Other AICPA members and practitioners.
- c. Entities performing peer review.
- d. Related parties.
3. Gordon conducts audits based on *Government Auditing Standards* (the Yellow Book). Which of the following ethical principles applies specifically to a Yellow Book audit?
- a. Due care.
- b. The public interest.
- c. Scope and nature of services.
- d. Responsibilities.

4. In which of the following scenarios has the AICPA covered member's independence been impaired with respect to his or her attest client?
- During the attest engagement period, Tom's wife owned 3% of the client's outstanding equity securities.
 - Rebecca, a former employee of the client, was hired by the firm, but did not serve on the attest engagement team.
 - Jay, a former employee of the client, was hired by the firm and disassociates himself from the client before serving on the attest engagement team.
 - Sharon served as a trustee for a trust with a direct financial interest in the client and had authority to make investment decisions for that trust.
5. The *Conceptual Framework for AICPA Independence Standards* (the *Conceptual Framework*) identifies several broad threats to independence that practitioners should consider when evaluating independence issues. Match the following independence threats with the correct definition.

<u>Threats</u>	<u>Definitions</u>
1. Self-review	i. When a practitioner could benefit from having a financial interest in or another financial relationship with an attest client.
2. Advocacy	ii. When interests or actions between the client and the practitioner are in opposition.
3. Adverse Interest	iii. When, as part of an attest engagement, a practitioner reviews evidence from nonattest work performed by the practitioner or the practitioner's firm.
4. Familiarity	iv. When the management of an attest client or other interested parties try to coerce or use exert excessive influence over the practitioner.
5. Undue Influence	v. When the practitioner knows entities or individuals who provided nonattest services to the client or has a longstanding or close relationship with this client himself.
6. Financial Self-interest	vi. When a practitioner has taken on a role in the client's management or performs management functions on behalf of the attest client.
7. Management Participation	vii. When a practitioner promotes the interests or positions of an attest client.

a. 1., iii.; 2., vii.; 3., ii.; 4., v.; 5., iv.; 6., i.; 7., vi.

b. 1., ii.; 2., i.; 3., iv.; 4., vi.; 5., v.; 6., iii.; 7., vii.

c. 1., i.; 2., vi.; 3., vii.; 4., iii.; 5., ii.; 6., v.; 7., iv.

d. 1., v.; 2., iii.; 3., vi.; 4., ii.; 5., vii.; 6., iv.; 7., i.

6. Which of the following nonattest services would allow a practitioner to retain his or her independence in regards to the nonattest client?
- a. Changing journal entries prior to client approval.
 - b. Approving vendor invoices for payment.
 - c. Making disbursements for a benefit plan.
 - d. Recommend a position description.
7. In which of the following scenarios has the practitioner impaired his or her independence with respect to the nonattest client?
- a. Under client supervision, Jenny prepares and transmits the tax return and payment but does not have control of client funds.
 - b. Annabelle performs ongoing monitoring activities for her client and is referred to as being in charge of the internal audit function.
 - c. Leonard performs actuarial valuations of postemployment benefit liabilities for his client.
 - d. Godfrey performs forensic accounting services by being an expert witness for a large group of plaintiffs that includes his client.
8. As the engagement partner assigned to the Millstone Dryers account, Jeffery is responsible for being aware of all services provided to the client and identifying any resulting independence issues. When should Jeffery perform this independence evaluation?
- a. Before compilation engagements only.
 - b. Before nonattest engagements only.
 - c. Before attest engagements only.
 - d. Before each attest and nonattest engagement.
9. Assume the same details as in the question above. Before the engagement team commences an attest engagement, Jeffery discovers that Millstone Dryers owes the firm a significant amount of unpaid fees. What is the earliest time frame that the unpaid fees would impair independence?
- a. Related services were performed more than one month before the current-year report is released.
 - b. Related services were performed more than six months before the current-year report is released.
 - c. Related services were performed more than one year before the current-year report is released.
 - d. Related services were performed more than three years before the current-year report is released.

10. If a CPA firm is part of an alternative practice structure (APS), which of the following is an independence requirement for indirect superiors of a covered member and other entities of the parent company?
- a. Indirect superiors cannot have a material relationship with a covered member's attest client that would impair independence.
 - b. The parent company is not allowed to lease employees to a subsidiary that performs attest engagements.
 - c. If the indirect superiors are far enough removed, they may serve as underwriters, directors, or voting trustees of the attest client.
 - d. When determining if the financial relationship of indirect superiors or other entities to an attest client is material, each relationship is evaluated on its own.
11. The firm of Hayes & Millsap is not independent with respect to Buggy Bounce, its nonattest client. Buggy Bounce requests that Hayes & Millsap perform an audit of their financial statements. The firm would like to retain another accounting firm to supervise the engagement and issue an opinion on the financial statements. Is this advisable?
- a. Yes, there should be no problems with this scenario.
 - b. Yes, if the client is willing to assume all responsibility for the original firm's audit work.
 - c. Yes, but only if the new firm applies all procedures necessary to form an opinion.
 - d. No, this scenario is a violation of the independence requirements.
12. Which of the following statements about independence is most accurate?
- a. A firm must always be independent from all its clients.
 - b. Sometimes, the firm's best decision is to not be independent from a client.
 - c. Minor independence and other ethics violations can be ignored.
 - d. As long as any violations are eliminated by year-end, the firm faces no repercussions.
13. A CPA firm has appointed its quality control director as its ethics partner (the partner responsible for ensuring the firm complies with all ethical requirements). List all of the following tasks that the ethics partner could be responsible for.
- i. Answering questions about ethical issues.
 - ii. Communicating independence requirements to personnel.
 - iii. Maintaining a current list of clients with whom financial or business relationships are prohibited.
 - iv. Obtaining independence representations from personnel as often as required by the firm's quality control system.
 - v. Accumulating and communicating information about potential independence threat to the firm.
 - vi. Assisting with threat evaluation and breach resolution.

- a. iii.
 - b. i. and ii.
 - c. iv., v., vi., and vii.
 - d. i., ii., iii., iv., v., and vi.
14. Your firm’s ethics partner discovers that a member of the audit engagement team has a close friend who recently accepted a key position in the audit client’s management; therefore, there is a familiarity threat to the firm’s independence with regard to this audit client. What is the best course of action in these circumstances?
- a. The firm may proceed with the audit, as independence requirements have not been violated by this relationship.
 - b. As long as the audit team member in question is not the head of the engagement team, the firm may proceed as planned.
 - c. The firm should remove the audit team member from the engagement to mitigate the independence threat, then proceed with the audit.
 - d. The firm must withdraw from the audit engagement immediately, as independence has been compromised.
15. Match the following QC policy statements with the applicable procedures.

<u>Policy Statements</u>	<u>Procedures</u>
1. Personnel must adhere to relevant ethical requirements including those in regulations, interpretations, and rules of the AICPA, state boards of accountancy, state CPA societies, state statutes, the GAO (U.S. Government Accountability Office), and any other applicable regulators.	i. Designate a quality assurance partner to review relevant pronouncements related to independence, integrity, and objectivity; answer questions; determine the circumstances for which consultation with sources outside the firm is required; and resolve matters.
2. The firm should establish procedures to communicate independence requirements to firm personnel and, when applicable, others who are subject to the requirements.	ii. Require the engagement partner to consider relevant information about client engagements so he or she can evaluate the overall impact, if any, on independence requirements.
3. The firm should establish procedures that will identify and evaluate possible threats to independence and objectivity and take appropriate action to eliminate the threats or reduce them to an acceptable level by applying safeguards.	iii. Preparing and maintaining a list of entities with which firm personnel are not allowed to have a financial or business relationship.
a. 1., i.; 2., ii.; 3., iii.	
b. 1., i.; 2., iii.; 3., ii.	
c. 1., ii.; 2., iii.; 3., i.	
d. 1., iii.; 2., ii.; 3., i.	

16. James Madison CPA is a sole practitioner with no additional professional staff. Which of the following questions from the *AICPA Peer Review Program Manual (PRPM)* QC questionnaires would be most applicable to this firm while it is designing QC policies and procedures related to ethics and independence?
- Does the practitioner document independence on each engagement on a program step and require any per-diem personnel to do so?
 - Does the practitioner have a system for identifying all services performed for clients, including services performed by entities closely aligned through common employment?
 - Does the practitioner employ someone responsible for providing guidance, answering questions, monitoring compliance, and resolving matters with respect to independence, integrity and objectivity?
 - Has the firm found it necessary in the past year to consult with individuals outside the firm on independence, integrity, or objectivity concerns?
17. When Madison Brothers develops its QC policies and procedures, which of the following factors will **not** be included?
- The size of the firm and number of locations.
 - The knowledge and experience of firm personnel.
 - The nature and complexity of the firm's practice.
 - The time and expense for QC policy development.
18. George is the ethics partner at his firm, and he is preparing a list of common transaction types that can impair a practitioner's independence. Which of the following would appear on George's list?
- Making annual donations to a charitable nonprofit organization.
 - Offering or accepting gifts or entertainment to or from a client.
 - Being acquainted with a member of a client's management prior to the engagement.
 - Investing in one of the client's major suppliers or vendors.
19. Which of the following types of personnel would **never** be subject to the firm's independence policies and procedures?
- Members of the attest engagement team.
 - Tax partners.
 - Consulting partners.
 - Paraprofessionals performing routine clerical functions.
20. Your firm has formulated all of its overall policy statements for its QC system. What should be its next step?
- Design procedures to implement and monitor the policies.
 - Design a personnel manual.
 - Communicate the policies to employees.
 - Determine if the QC system functions as designed.

Lesson 2: Acceptance and Continuance of Client Relationships and Specific 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 their 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.

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*. (SQCS No. 7 supersedes all existing SQCSs and is applicable to a CPA firm's system of quality control for its accounting and auditing practice as of January 1, 2009.) 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.

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, QC 10.29 of SQCS No. 7 states that the firm should document how the issues were resolved.

Upcoming Changes to SQCS No. 7

SQCS No. 7, A Firm's System of Quality Control, superseded all existing SQCSs and was applicable to a CPA firm's system of quality control for its accounting and auditing practice as of January 1, 2009. 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. Additionally, the ASB issued the exposure draft, Quality Control for an Audit of Financial Statements, which would supersede SAS No. 25, *The Relationship of Generally Accepted Auditing Standards to Quality Control Standards*.

Those two standards are being redrafted to apply the ASB's clarity drafting conventions and to converge with the international standards ISQC 1 and ISA 220. 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 SAS is expected to be effective for audits of financial statements for periods beginning on or after December 15, 2010. The proposed SQCS does not change or expand SQCS No. 7 in any significant respect. However, changes affecting the acceptance and continuance of client relationships and specific engagements QC element deemed more than minor by the authors that are expected to result from the proposed SQCS and SAS have been discussed where applicable throughout this course.

Learning Objectives:

Completion of this lesson will enable you to:

- Develop an evaluation of the client's integrity.
- Prepare an evaluation of risks associated with the nature of an engagement and whether the firm has the appropriate competence, capabilities, and resources to accept an engagement.
- Identify issues related to client acceptance and continuance, including obtaining an understanding with the client, evaluating the client list, and withdrawing from an engagement.
- Design QC policies and procedures for client acceptance and continuance.

EVALUATING A 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, QC 10.27 of SQCS No. 7 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 is believed to include any individuals who have more than just a passing involvement with the business, for example, spouses of owners who are also 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 applying those terms as they are defined in applicable AICPA standards would be a reasonable approach. (For example, when making a decision about an audit client or engagement, consult AU 334, *Related Parties*, and AU 380, *The Auditor's Communication with Those Charged with Governance*.)

Factors to Consider When Evaluating Integrity

When evaluating the integrity of the client, QC 10.30 of SQCS No. 7 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.
- Reasons for the proposed appointment of the firm and nonreappointment of the previous firm.
- Indications that the client may be involved in money laundering or other criminal activities.

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 annual reports, 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.

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.

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 auditors 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; thus, firms should consider performing thorough client screening procedures whenever feasible.

Client screening is performed for the purpose of discovering evidence of questionable behavior. This 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 non-public business; 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 higher-than-normal frequency in changing its tax accountants or auditors? 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 auditors 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, if any, of the prospective client, if any. Is there good customer traffic? Is there community support for the business? Do conversations with customers illicit 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 online 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 first hand 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.moody's.com
National Association of Credit Management (NACM)	www.nacm.org
Online Database Services	
Access Information	www.access-information.com
BRINT Institute	www.brint.com
Choice Point	www.choicepoint.com
Dialog	www.dialog.com
Hoovers, Inc.	www.hoovers.com
LexisNexis	www.lexisnexis.com
P.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 and audit fees will be paid. The firm might consider the following in determining whether a prospective client exhibits fiscal responsibility:

- Even without performing an audit 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, Transunion, 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—

- 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—Audit Engagements

AICPA Practice Alert on Acceptance and Continuance. The Professional Issues Task Force of the AICPA issued Practice Alert 2003-03, "*Acceptance and Continuance of Clients and Engagements*," to provide CPAs with information that may help them improve the effectiveness and efficiency of their engagements and practices. The alert is nonauthoritative, but it may help auditors further understand what they need to consider when establishing policies or procedures for accepting or continuing a client or engagement. The practice alert is available at www.aicpa.org/download/secps/pralert_03_03.pdf.

Predecessor Communications. SAS No. 84 (AU 315), *Communications Between Predecessor and Successor Auditors*, requires a successor auditor to communicate with a predecessor auditor prior to accepting an audit engagement. This communication provides the successor auditor with information about the client and its management's integrity. Some of the inquiries the successor should make of the predecessor include:

- Are there facts that might bear on the integrity of management?
- Were there disagreements with management about accounting principles, auditing procedures, or other similar significant matters?
- Were there any communications to those charged with governance (audit committees or others with similar authority and responsibility such as boards of directors or owners) regarding fraud and illegal acts by clients, or communications to management regarding internal control related matters?
- What is the predecessor's understanding of the reasons for the change in auditors?

As a prerequisite to the communication with a predecessor auditor, the successor auditor should request permission from the prospective client to make the inquiries listed in the previous paragraph. Once permission is obtained, the prospective client instructs the predecessor to respond fully to the inquiries. If management refuses to authorize the predecessor to respond fully to the inquiries or if the predecessor provides a limited response, the successor should consider the implications before accepting the engagement. The information obtained from the predecessor should also be considered in concluding whether to accept the engagement.

Acceptance of an Engagement Near or after Year End. If an auditor is considering accepting an engagement near or after the client's year end and these circumstances limit audit procedures to such an extent that a qualified opinion or disclaimer of opinion may be required, AU 311.06 requires that the auditor discuss this with the client prior to accepting the engagement.

Upcoming Proposed SAS Changes. As previously discussed, the ASB has issued an exposure draft that would supersede SAS No. 25. The proposed SAS indicates that the engagement partner should be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and specific audit engagements have been followed. The engagement partner needs to determine that the conclusions reached are appropriate and document those conclusions.

The proposed SAS indicates that, if the engagement partner learns of information that would have initially caused the firm to decline the audit engagement had such information been known earlier, such information needs to be promptly communicated to the firm so that necessary action can be taken.

Special Considerations—Attestation Engagements

The third general attestation standard in SSAE No. 10 (AT 101.23), *Attest Engagements*, states, “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, “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 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.

SELF-STUDY QUIZ

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

21. Which of the following statements best reflects how a firm should proceed when evaluating a client's integrity?
 - a. It must only accept engagements with clients that have the high, indisputable integrity.
 - b. It must take into account all facts that are known about the client's integrity.
 - c. The firm's economic needs may necessitate taking on a client with questionable integrity.
 - d. A QC system is unnecessary for making a determination of the client's integrity.

22. According to SQCS No. 7, which of the following factors should be considered when evaluating a client's integrity?
 - a. The client's specific business practices and the nature of their operations.
 - b. The client's attitude toward aggressive sales techniques.
 - c. The length of time the client has been in existence as a business entity.
 - d. Any conflicts of interest that the client may have within its industry.

23. Breakwater-Stillman is a small accounting firm. The firm is trying to determine whether to accept an engagement with Riptide Inc., a small retail business. Which of the following statements best describes what Breakwater-Stillman should do while making this decision?
 - a. Because both businesses are small, the firm does not have to evaluate the client's integrity.
 - b. Breakwater-Stillman should consult with legal counsel before performing a client screening on Riptide Inc.
 - c. Because Riptide Inc. is a prospective client and nonpublic, a client screening will be easy and economical for the firm.
 - d. The client's reputation in the community and its fiscal responsibility are the only key areas a client screening should cover.

24. Which procedure would help Breakwater-Stillman evaluate Riptide Inc.'s reputation in the community?
 - a. Visit Riptide Inc.'s store locations.
 - b. Make inquiries of local business associations.
 - c. Evaluate Riptide Inc.'s creditworthiness.
 - d. Review the minutes from board of directors meetings.

25. Which of the following is a special consideration the firm might need to take into account related to attest engagements?
 - a. Whether the firm is accepting the engagement near or after year end.
 - b. Whether the firm must contact the predecessor accountant.
 - c. Whether the client refuses to authorize communication with the predecessor accountant.
 - d. Whether the criteria are too subjective or too vague for consistent measurements.

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.)**

21. Which of the following statements best reflects how a firm should proceed when evaluating a client's integrity? **(Page 220)**
- a. It must only accept engagements with clients that have the high, indisputable integrity. [This answer is incorrect. An important point firms must understand when evaluating a client's integrity is that SQCS No. 7 does not require firms only take on clients who have unquestionably high integrity. SQCS No. 7 gives firms other requirements instead.]
 - b. It must take into account all facts that are known about the client's integrity. [This answer is correct. Instead of requiring a firm to only accept clients with the highest degree of integrity, SQCS No. 7 requires that the firm take all known facts about the client's integrity into account before making the acceptance or continuance decision.]**
 - c. The firm's economic needs may necessitate taking on a client with questionable integrity. [This answer is incorrect. Balancing a firm's economic needs and its integrity can be difficult. However, taking on clients who run their businesses well and who have integrity will only strengthen a firm's abilities to provide good service and lessen their exposure to legal liability.]
 - d. A QC system is unnecessary for making a determination of the client's integrity. [This answer is incorrect. All firms, regardless of their size, will benefit from having a QC system in place to evaluate client acceptance and continuance decisions, including the evaluation of whether the client has integrity.]
22. According to SQCS No. 7, which of the following factors should be considered when evaluating a client's integrity? **(Page 221)**
- a. The client's specific business practices and the nature of their operations. [This answer is correct. QC 10.30 of SQCS No. 7 gives firms three factors to consider when evaluating a client's integrity, and this is one of them. Business practices should be similar to those of other businesses in the same industry and the nature of operations should not be ambiguous.]**
 - b. The client's attitude toward aggressive sales techniques. [This answer is incorrect. According to SQCS No. 7, the firm should evaluate the client's attitude toward internal control matters and aggressive accounting.]
 - c. The length of time the client has been in existence as a business entity. [This answer is incorrect. Based on the guidance found in SQCS No. 7, when deciding whether to continue an engagement with an existing client, the firm should consider the length of its relationship with the client.]
 - d. Any conflicts of interest that the client may have within its industry. [This answer is incorrect. However, according to SQCS No. 7, the firm must consider any conflicts of interest it has with the client when deciding whether to accept or continue an engagement with the client.]

23. Breakwater-Stillman is a small accounting firm. The firm is trying to determine whether to accept an engagement with Riptide Inc., a small retail business. Which of the following statements best describes what Breakwater-Stillman should do while making this decision? **(Page 222)**
- a. Because both businesses are small, the firm does not have to evaluate the client's integrity. [This answer is incorrect. SQCS No. 7 requires that a firm evaluate the integrity of all continuing and potential clients. Though a cost-benefit evaluation should be made before a small firm performs a client screening on a small client, firms should continue performing a thorough screening whenever possible.]
 - b. Breakwater-Stillman should consult with legal counsel before performing a client screening on Riptide Inc. [This answer is correct. There could be federal, state, or local statutes that require a firm to get permission from the prospective client for a screening or disclose the screening to the potential client. Consulting legal counsel is recommended.]**
 - c. Because Riptide Inc. is a prospective client and nonpublic, a client screening will be easy and economical for the firm. [This answer is incorrect. Because the firm does not have past experience with the client to draw on and because the nonpublic prospective client does not have the disclosures of a public company, it will be more difficult for the firm to get the information needed for the screening. However, there are key areas on which the firm can focus to get the needed information.]
 - d. The client's reputation in the community and its fiscal responsibility are the only key areas a client screening should cover. [This answer is incorrect. There are five other key areas the firm should consider, including interactions with CPAs and other professionals, dealings with employees, and formal company communications.]
24. Which procedure would help Breakwater-Stillman evaluate Riptide Inc.'s reputation in the community? **(Page 222)**
- a. Visit Riptide Inc.'s store locations. [This answer is correct. While at the store location, the firm could see if the client has good customer traffic, if the business has community support, and if the store location's appearance demonstrates that the client cares for its customers.]**
 - b. Make inquiries of local business associations. [This answer is incorrect. If Breakwater-Stillman performed this procedure it would give the firm evidence on Riptide Inc.'s profile as a corporate citizen.]
 - c. Evaluate Riptide Inc.'s creditworthiness. [This answer is incorrect. This would help Breakwater-Stillman evaluate Riptide Inc.'s fiscal responsibility.]
 - d. Review the minutes from board of directors meetings. [This answer is incorrect. This procedure would help the firm evaluate formal company communications.]

25. Which of the following is a special consideration the firm might need to take into account related to attest engagements? **(Page 226)**
- a. Whether the firm is accepting the engagement near or after year end. [This answer is incorrect. This would be a consideration if the engagement were an audit, not an attest engagement. If accepting the engagement at that time would limit the audit procedures so much that the auditor might have to modify or disclaim his or her opinion, this should be discussed with the client before the engagement is accepted.]
 - b. Whether the firm must contact the predecessor accountant. [This answer is incorrect. If the engagement in question were an audit instead of an attest engagement, this would be a consideration. For an audit, the firm would be required to communicate with the predecessor auditor.]
 - c. Whether the client refuses to authorize communication with the predecessor accountant. [This answer is incorrect. This would be a consideration if the engagement were either an audit or a compilation or review engagement. If the client refuses the firm's request to contact the predecessor, the firm must consider the client's reasons and how this will affect the engagement.]
 - d. **Whether the criteria are too subjective or too vague for consistent measurements. [This answer is correct. According to AT 101.29, the firm should not accept the engagement under these circumstances. Accepting the attestation engagement when the criteria are not conducive to consistent measurement will be a matter of professional judgment.]**

EVALUATION OF RISK RELATED TO 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 section 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

As discussed in Lesson 1, CPAs are bound 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. However, before accepting or continuing an engagement, firms should consider the significance of the engagement or client to the firm. Additionally, the discovery of any potential conflicts of interest should cause the firm to seriously consider whether an engagement should be accepted or continued. Factors to consider when making this determination include—

- Partner time spent on the engagement.
- The standing of the partner in the firm as a result of the association with the client or engagement.
- How the partner is compensated.
- Impact on the firm should the relationship be terminated.

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 audit services if the firm will only have a small practice with a handful of audit clients. A small practice may not support the time and effort it will take for the firm's audit partners and staff to remain familiar with professional standards. Moreover, the firm's audit personnel might not be able to receive sufficient experience from the small practice to make them technically proficient to handle difficult audit issues as they arise.

Will the Engagement Constitute a Marginal Level of Practice? This course recommends that firms 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 they have 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 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. Among the types of engagements that might present higher risk to the firm—

- Audit engagements.
- Audits of public companies (issuers).
- Prospective financial statement engagements (forecasts and projections).

Firms need not necessarily avoid offering the preceding services. However, at this point in the client acceptance process, the firm needs to be aware that such services often represent higher risk and should take appropriate precautions.

Audit Engagements. Accountants' liability claims arising from audit engagements tend to be relatively common and also serious in terms of potential exposure. Because there is a general public perception that audited financial statements may be freely relied upon in making investment and credit decisions, it is not unusual for a bank or other financial institution suffering a loan loss to seek recourse against the borrower's CPA firm. The liability exposure, combined with the ever-increasing complexity of audit and accounting standards, is so high in fact, that many firms have chosen to abandon their audit practices.

Audits of Public Companies (Issuers). One of the highest risk areas of practice for CPA firms is the audit of public companies (issuers). Such audits entail not only the normal credit risks associated with audit reports of nonpublic companies, but also the possibility of investor lawsuits, each time the client's securities experience a sharp decrease in value not otherwise associated with a market movement.

Prospective Financial Statement Engagements. Because of their inherent weaknesses, prospective financial statement engagements often generate liability claims. Over the past 20 years, many courts have adopted doctrines that tend to minimize the exposure of CPA firms issuing reports on prospective financial statements. Nevertheless, financial forecasts and projections tend to be utilized in making significant investment and credit decisions, with the result that potential damages arising out of this type of service tend to be quite large. This, in turn, forces many firms—whose insurance might not be adequate to cover the potential liability exposure—to settle such claims.

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:

- Real estate or construction companies.
- Financial services companies, including banks, savings and loans, credit unions, and insurance companies.
- Technology 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 down 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 audit an entity in a specialized industry if the firm already has several clients in that industry than to undertake an audit 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.

Additionally, if the prospective audit client denies access to the predecessor auditor's workpapers, the firm needs to carefully consider the acceptance decision. Discussions with the predecessor auditor may reveal important information about engagement risk, particularly if disagreements occurred between the prospective client and the predecessor auditor over accounting principles or practices, financial statement disclosures, or audit scope.

SELF-STUDY QUIZ

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

26. SQCS No. 7 says that a firm should “consider the risks associated with providing professional services in the particular circumstances.” What is this called?
- a. Evaluating a client’s integrity.
 - b. Evaluating the firm’s competence, capabilities, and resources.
 - c. Evaluating risk due to the nature of the engagement.
 - d. Complying with legal and ethical requirements.
27. The Audit Brothers firm has a long-standing relationship with BookCo, and is certain that BookCo has the highest level of integrity. BookCo also operates in an ideal industry for the firm, and the annual audit engagement fits perfectly within the Audit Brother’s profile. What factors should the firm consider when evaluating the risk of the impairment of independence and objectivity for this engagement?
- a. The compensation of partners that serve on this engagement.
 - b. Whether the firm is independent in fact and appearance.
 - c. The impact on the client if the firm were to terminate the engagement.
 - d. Because of the nature of this client relationship, no factors need to be considered.
28. In which of the following scenarios has the firm made the best client acceptance/continuance decision?
- a. Firm A accepts an engagement in a low risk area in which it has little experience.
 - b. Firm B decides to discontinue audit services, as they had very few audit clients.
 - c. Firm C accepts only tax engagements in an attempt to limit the risk of legal liability.
 - d. Firm D relies on court doctrines to avoid legal liability for prospective financial statements.
29. Which of the following industries is expected to generate liability claims in the future?
- a. The financial services industry.
 - b. The real estate industry.
 - c. The e-commerce industry.
 - d. The health care industry.
30. The firm of Dawson & Summers has decided to make a preliminary evaluation of a prospective client’s financial reporting system before accepting the engagement. What purpose would this evaluation serve?
- a. To reveal any well-concealed problems with the system.
 - b. To determine if the engagement can be performed cost-effectively.
 - c. To evaluate any existing scope limitations.
 - d. To determine if more detailed monitoring will be required in the future.

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.)**

26. SQCS No. 7 says that a firm should “consider the risks associated with providing professional services in the particular circumstances.” What is this called? **(Page 233)**
- a. Evaluating a client’s integrity. [This answer is incorrect. When discussing the evaluation of a client’s integrity, SQCS No. 7 says that the firm should design policies and procedures that provide the firm with reasonable assurance that the firm will not accept engagements when it has not considered the client’s integrity.]
 - b. Evaluating the firm’s competence, capabilities, and resources. [This answer is incorrect. A firm must make this evaluation when determining whether to accept a client or engagement, but this is not what is referred to above. SQCS No. 7 says that, among other things, the firm must consider if firm members have requisite industry or subject matter knowledge, and if they do not have it, whether it can be acquired.]
 - c. **Evaluating risk due to the nature of the engagement. [This answer is correct. Some factors that the firm should consider when making this evaluation include evaluating the practice area risk, industry risk, and engagement risk.]**
 - d. Complying with legal and ethical requirements. [This answer is incorrect. This is a something that a firm must do when determining whether to accept the engagement; however, it is not what SQCS No. 7 is referring to in the quote above.]
27. The Audit Brothers firm has a long-standing relationship with BookCo, and is certain that BookCo has the highest level of integrity. BookCo also operates in an ideal industry for the firm, and the annual audit engagement fits perfectly within the Audit Brother’s profile. What factors should the firm consider when evaluating the risk of the impairment of independence and objectivity for this engagement? **(Page 233)**
- a. **The compensation of partners that serve on this engagement. [This answer is correct. Other factors Audit Brothers should consider in this scenario include how much partner time is spent on the engagement and the standing partners who work on the engagement have in the firm.]**
 - b. Whether the firm is independent in fact and appearance. [This answer is incorrect. Determining this could be a slippery slope in this scenario; however, this is not one of the specific factors that the firm should consider when evaluating this risk.]
 - c. The impact on the client if the firm were to terminate the engagement. [This answer is incorrect. In this scenario, Audit Brothers should consider what the impact would be on the firm if the client relationship with BookCo was terminated.]
 - d. Because of the nature of this client relationship, no factors need to be considered. [This answer is incorrect. Not considering this risk would be an unacceptable lapse on the part of the firm, as CPAs must comply with very specific ethical requirements.]

28. In which of the following scenarios has the firm made the best client acceptance/continuance decision? **(Page 234)**
- a. Firm A accepts an engagement in a low risk area in which it has little experience. [This answer is incorrect. Firms dabbling in a practice area will have a higher risk level because of their lack of experience, even if the practice area is generally a low-risk area. It is possible to mitigate this lack of experience by taking continuing education courses or contracting with outside sources; however, it is generally better for firms to commit to providing services in a given area.]
 - b. Firm B decides to discontinue audit services, as they had very few audit clients. [This answer is correct. In this scenario, accepting audit engagements would cost the firm a lot of time (as staff must be familiar with professional standards in this area), but the resulting practice would be small. Firm B has made a good decision after evaluating the practice area risk.]**
 - c. Firm C accepts only tax engagements in an attempt to limit the risk of legal liability. [This answer is incorrect. Though audit engagements would generally have higher damages if legal action were filed, historically, more claims are filed in the areas of tax and accounting. Therefore, Firm C has not limited all risk of legal liability.]
 - d. Firm D relies on court doctrines to avoid legal liability for prospective financial statements. [This answer is incorrect. This type of engagement often generates liability claims. Though courts have adopted doctrines to minimize the exposure of firms that report on prospective financial statements, the settlement in such a case would be quite large and would affect Firm D's malpractice insurance.]
29. Which of the following industries is expected to generate liability claims in the future? **(Page 235)**
- a. The financial services industry. [This answer is incorrect. This industry's risk is its cyclical business trends, which lead more liability exposure during down turns.]
 - b. The real estate industry. [This answer is incorrect. Down turns occur in this industry because of its cyclical nature, which would expose a firm to more liability.]
 - c. The e-commerce industry. [This answer is correct. High-tech companies, as well as companies with significant e-commerce applications, are part of an industry that is expected to generate liability claims in the future; therefore, practicing in this area has a higher level of risk.]**
 - d. The health care industry. [This answer is incorrect. Although companies in this industry may invoke public trust, the healthcare industry can lead to a higher risk engagement for the firm because of their inherent specialized accounting.]
30. The firm of Dawson & Summers has decided to make a preliminary evaluation of a prospective client's financial reporting system before accepting the engagement. What purpose would this evaluation serve? **(Page 235)**
- a. To reveal any well-concealed problems with the system. [This answer is incorrect. A preliminary evaluation might not be able to reveal a problem that is well-concealed; however, it could provide the firm evidence of potential problems or risks with the engagement.]
 - b. To determine if the engagement can be performed cost-effectively. [This answer is correct. Such a determination should be the result of a preliminary evaluation of the financial reporting system. The firm can review both current-year information that is available and the prior-year financial statements.]**
 - c. To evaluate any existing scope limitations. [This answer is incorrect. Scope limitations come from restrictions the client puts on the firm, not from the financial reporting system.]
 - d. To determine if more detailed monitoring will be required in the future. [This answer is incorrect. The firm could discover this by thoroughly analyzing the engagement risk.]

EVALUATION OF A FIRM'S COMPETENCE, CAPABILITIES, TIME, AND RESOURCES

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 the 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 audit, attestation, or compilation and review standards. For example—

- State and local governments are also subject to audits performed under *Government Auditing Standards* (the Yellow Book).
- Nonprofits and state and local governments that receive federal awards are further subject to audits performed under the Single Audit Act and the related Office of Management and Budget Circular A-133.
- Audits of issuers, which includes more than just publicly traded companies, are subject to the auditing standards of the Public Company Accounting Oversight Board (PCAOB) and the regulations of the SEC.

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 needs to 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 a 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.

SELF-STUDY QUIZ

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

31. The Mindleton Firm would like to accept an audit engagement with a construction contractor, but the firm has never performed an engagement in that industry. The firm has enough professional staff to take on the engagement, and specialists are available, if needed. Someone is available to perform an engagement quality control review, and the firm will easily be able to meet the engagement's required deadline. After evaluating the firm's competence, capabilities, and resources, can Mindleton accept this engagement?
- a. Yes.
 - b. Possibly.
 - c. No.
32. Which of the following statements best describes the ethics requirements for using third-party service providers?
- a. It is up to the firm's local licensing board to ensure that third-party providers have safeguards to prevent the release of confidential information.
 - b. The firm must inform clients orally if they plan to use third-party providers to perform professional services for the client.
 - c. The accountant will be responsible for all work performed on the engagement, including that performed by third-party providers.
 - d. Understanding the nature of all deadlines is important when working with third-party service providers.

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. The Mindleton Firm would like to accept an audit engagement with a construction contractor, but the firm has never performed an engagement in that industry. The firm has enough professional staff to take on the engagement, and specialists are available, if needed. Someone is available to perform an engagement quality control review, and the firm will easily be able to meet the engagement's required deadline. After evaluating the firm's competence, capabilities, and resources, can Mindleton accept this engagement? **(Page 240)**
- a. Yes. [This answer is incorrect. The guidance available in SQCS No. 7 does not recommend that Mindleton accept the engagement in the circumstances described above.]
 - b. Possibly. [This answer is correct. If the firm members who work on the engagement can acquire the knowledge of the industry and subject matter and the experience with the regulatory and reporting requirements necessary to perform the engagement (perhaps through continuing professional education), Mindleton can accept this engagement. If this is not possible, Mindleton should decline the engagement.]**
 - c. No. [This answer is incorrect. The guidance of SQCS No. 7 does not prohibit Mindleton from accepting the engagement described above under these circumstances.]
32. Which of the following statements best describes the ethics requirements for using third-party service providers? **(Page 240)**
- a. It is up to the firm's local licensing board to ensure that third-party providers have safeguards to prevent the release of confidential information. [This answer is incorrect. The responsibility for ensuring client's confidential information is not released falls to the firm, not a regulatory body.]
 - b. The firm must inform clients orally if they plan to use third-party providers to perform professional services for the client. [This answer is incorrect. The firm is encouraged to inform the client in writing, and if the client objects, the firm must decline the engagement or perform it without the third-party providers.]
 - c. The accountant will be responsible for all work performed on the engagement, including that performed by third-party providers. [This answer is correct. The accountant must ensure that the services meet the general standards and all other technical standards that are applicable.]**
 - d. Understanding the nature of all deadlines is important when working with third-party service providers. [This answer is incorrect. Meeting deadlines is an important consideration while the firm is making its client acceptance or continuance evaluation; however, deadlines are not one of the ethical requirements that apply to using third-party service providers.]

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—

- The Sarbanes-Oxley Act of 2002 (the Act) requires firms that audit issuers to register with the PCAOB. In addition, the Act provides for the PCAOB to inspect each large registered accounting firm (those with more than 100 audit clients who are issuers) annually and each small firm (those with 100 or fewer audit clients who are issuers) at least every three years.
- Engagements that require the auditor 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 (HIPAA). 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. Lesson 1 discusses the ethical requirements of members in public practice.

Statutory or Regulatory Appointment of Auditor

SQCS No. 7 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 in this lesson may not apply. The AICPA suggests, however, that establishing and following the policies and procedures of SQCS No. 7 would help public sector auditors in—

- Gathering information to perform risk assessment procedures.
- Perform reporting responsibilities.

METHODS FOR OBTAINING 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 audits, compilations and reviews of historical financial statements, and attestations all 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—

- SAS No. 108, (AU 311.08) *Planning and Supervision*, requires that the auditor document the understanding through a written communication with the client.

- 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.
- 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.
- 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 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 its suggested quality control system because they are believed the most cost-effective means of providing quality services and minimizing engagement risk.

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. 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 are including the documentation required by Ethics Interpretation 101-3 in their engagement letters.

OTHER ACCEPTANCE AND CONTINUANCE 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, the firm is required to consider whether any significant issues have arisen during the course of the relationship with the client (SQCS No. 7 QC 10.33). 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 billing 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.
- The client has ignored prior firm recommendations, such as recommendations regarding the interpretation of accounting standards or addressing internal control deficiencies.

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 Does This Course Recommend? Either approach to evaluating the ongoing acceptability of a client is an effective technique. Adopting both procedures (a macro review of the client list and a micro review of each engagement) is recommended 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 previously is used, it is advisable for firm management in coordination with the engagement partner to make the ultimate decision to dismiss a current client, 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 suggested. 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.
- 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 it relates 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, "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 will 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 needs to consider—

- Any professional or legal responsibilities of the firm to the client.
- The possibility of either withdrawing from the engagement or 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 of SQCS No. 7 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. The course suggests that the firm's acceptance and continuance QC system also provide guidance for situations that would cause a firm to withdraw.

Responsibility for Approving the Decision to Withdraw. The managing partner is 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 might consider consulting their legal counsel prior to withdrawing from an engagement.) Because a firm may decide to withdraw from an engagement after work has been performed, this course suggest that language be added to engagement letters to defend the firm in the event the client contends the firm is in violation of its contract to provide service. An example of such language follows:

If, for any reason, we are unable to complete the [Type of Engagement] (*or are unable to form or have not formed an opinion*), we may (*decline to express an opinion or to*) not issue a report as a result of this engagement.

Documenting a Withdrawal. Obviously, 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. Any decision to withdraw from an engagement is believed to be subject to those same consultation documentation procedures.

Communicating the Decision to Withdraw or Discontinue Services. Obviously, 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. In most cases, it is believed the communication should be in writing, and PPC's audit and 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—Audit Engagements. The decision to withdraw from an audit engagement is not quite the same as an acceptance or continuation decision. The decision to withdraw from an engagement is usually made after the engagement work has begun since the reasons for withdrawal often include lack of sufficient accounting records, lack of client cooperation, and/or client refusal to accept a modified report. Continuation and acceptance decisions are usually made before the work commences. The auditing literature relating to withdrawal from an engagement includes—

- AU 316, *Consideration of Fraud in a Financial Statement Audit*, and AU 317, *Illegal Acts by Clients*, both of which require the auditor to withdraw from the engagement when a client refuses to accept a modified auditor's report.
- AU 317, *Illegal Acts by Clients*, requiring an auditor to consider withdrawal if the client does not take remedial action with regard to an illegal act.
- AU 333, *Management Representations*, which indicates that client management refusal to provide written representations constitutes a scope limitation on an audit sufficient to preclude an unqualified opinion and is ordinarily sufficient to cause an auditor to disclaim an opinion on the financial statements or to withdraw from the engagement.
- AU 504, *Association with Financial Statements*, requiring an auditor to refuse to be associated with financial statements and to consider withdrawing if a client refuses to revise financial statements or accept a modified auditor's report.

In addition, although audit literature is not specific on this point, it is believed that withdrawal should be considered if the client refuses to grant permission allowing the auditor to request a legal representation letter from the client's legal counsel. SSARS literature at AR 100.89 specifically indicates that accountants should consider withdrawing from the engagement and not perform a lower level of service (that is, a review or a compilation) if the client refuses to allow the auditor to send a request for a legal representation letter or refuses to sign a client representation letter in connection with an audit.

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. In an examination, the practitioner ordinarily would disclaim an opinion or withdraw (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).

SELF-STUDY QUIZ

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

33. The firm of Jones, Smith & Randolph is appointed as a public sector auditor under legal regulations. Which of the following statements applies to the firm's situation?
- a. Normal client acceptance/continuance procedures will apply.
 - b. The policies and procedures in SQCS No. 7 will help with risk assessment.
 - c. The AICPA's *Code of Professional Conduct* will not apply to the engagement.
34. Accountants Ltd., a CPA firm, accepts an engagement performing nonattest services for an attest client. What piece of authoritative literature applies to Accountants Ltd. obtaining an understanding of the new engagement with the client?
- a. SSAE No. 10.
 - b. SSARS No. 1.
 - c. Interpretation 101-3.
35. What is a primary benefit of evaluating the acceptability of an existing client relationship?
- a. Gathering the justification to dismiss marginal clients from the firm's client roster.
 - b. Identifying problem clients and developing procedures to mitigate associated risks.
 - c. Being able to perform the client continuance policies and procedures swiftly and cost effectively.
 - d. Documenting the understanding for the continuing engagement in an engagement letter.
36. In which of the following scenarios has the firm handled the evaluation of an existing client relationship appropriately?
- a. The Rosemont firm gives the responsibility for dismissing current clients to the engagement partner.
 - b. As required by SQCS No. 7, Billings & Berry evaluates client continuance in an annual meeting and while planning each engagement.
 - c. The Wilson and Sons firm documents the evaluation of existing clients in a memorandum that includes all the general factors that were considered.
 - d. The Darlington firm accepts a continuing engagement to perform an audit after discovering that a new conflict of interest has arisen.
37. Your firm has decided to end a client relationship. Which of the following should be documented?
- a. Conclusions and the basis for those conclusions.
 - b. The decision to withdraw.
 - c. Legal requirements to remain associated with the client.
 - d. Any significant unpaid fees.

38. Which of the following statements about withdrawing from an engagement is most accurate?
- a. The firm's QC system should include guidance for withdrawing from an engagement.
 - b. The engagement partner should be responsible for the decision to withdraw.
 - c. Communication of the decision to withdraw should be made orally.
 - d. It is not necessary to document the decision to withdraw from an engagement.

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.)**

33. The firm of Jones, Smith & Randolph is appointed as a public sector auditor under legal regulations. Which of the following statements applies to the firm's situation? **(Page 245)**
- a. Normal client acceptance/continuance procedures will apply. [This answer is incorrect. According to SQCS No. 7, the normal client acceptance and continuance procedures discussed in this lesson may not apply in this type of engagement.]
 - b. The policies and procedures in SQCS No. 7 will help with risk assessment. [This answer is correct. SQCS No. 7's policies and procedures can help the firm gather information for performing risk assessment procedures and perform reporting responsibilities.]**
 - c. The AICPA's *Code of Professional Conduct* will not apply to the engagement. [This answer is incorrect. This type of regulatory appointment will not affect how the firm must comply with the requirements of the AICPA's Code of Professional Conduct.]
34. Accountants Ltd., a CPA firm, accepts an engagement performing nonattest services for an attest client. What piece of authoritative literature applies to Accountants Ltd. obtaining an understanding of the new engagement with the client? **(Page 245)**
- a. SSAE No. 10. [This answer is incorrect. SSAE No. 10 requires accountants document their understanding in the workpapers when they are providing attestation services.]
 - b. SSARS No. 1. [This answer is incorrect. SSARS No. 1 says that a firm should reach an understanding with its client for compilation or review services, and preferably, that understanding should be in writing.]
 - c. Interpretation 101-3. [This answer is correct. Interpretation 101-3 of the AICPA's Code of Professional Conduct requires a written communication with the client in the scenario described above. SQCS No. 7 says the firms QC policies and procedures should direct the firm to obtain understandings with their clients.]**
35. What is a primary benefit of evaluating the acceptability of an existing client relationship? **(Page 246)**
- a. Gathering the justification to dismiss marginal clients from the firm's client roster. [This answer is incorrect. Many firms cannot afford to dismiss marginal clients, and this is one reason that some firms are resistant to establishing formal procedures for evaluating the acceptability of existing client relationships.]
 - b. Identifying problem clients and developing procedures to mitigate associated risks. [This answer is correct. Once the firm has identified a problem continuing client, it can decide to use expanded or alternative procedures to reduce risk, adopt a flexible fee arrangement, or require a down payment on services before work on the engagement is begun.]**
 - c. Being able to perform the client continuance policies and procedures swiftly and cost effectively. [This answer is incorrect. Another reason that firms are resistant to establishing formal procedures for evaluating the acceptability of existing client relationships is that they believe performing the procedures will be both costly and time-consuming. However, such an evaluation program does not have to be a burden to the firm, and in fact it can have benefits.]
 - d. Documenting the understanding for the continuing engagement in an engagement letter. [This answer is incorrect. While documenting the firm's understanding with the client in an engagement letter is required for some engagements and recommended for all engagements, engagement letters are not a benefit of evaluating the acceptability of an exiting client relationship.]

36. In which of the following scenarios has the firm handled the evaluation of an existing client relationship appropriately? **(Page 247)**
- a. The Rosemont firm gives the responsibility for dismissing current clients to the engagement partner. [This answer is incorrect. This responsibility should be shared between the engagement partner and Rosemont's firm management.]
 - b. As required by SQCS No. 7, Billings & Berry evaluates client continuance in an annual meeting and while planning each engagement. [This answer is incorrect. Though this course recommends using both of these approaches for the client continuance evaluation, doing so is not required. A firm should use a method (the macro method, the micro method, or both) that works best in its circumstances.]
 - c. **The Wilson and Sons firm documents the evaluation of existing clients in a memorandum that includes all the general factors that were considered. [This answer is correct. The evaluation should be documented by the firm. The firm can use a memorandum or the minutes of a partners' meeting. Another option for documentation is initialing the evaluation step in the work program.]**
 - d. The Darlington firm accepts a continuing engagement to perform an audit after discovering that a new conflict of interest has arisen. [This answer is incorrect. In this situation, the firm is no longer independent from the client; therefore, it must step down its services to a level that does not require independence or it should not accept the engagement.]
37. Your firm has decided to end a client relationship. Which of the following should be documented? **(Page 249)**
- a. **Conclusions and the basis for those conclusions. [This answer is correct. Other items that should be documented include any consultations and the significant issues that resulted in the firm's decision to end the client relationship.]**
 - b. The decision to withdraw. [This answer is incorrect. According to SQCS No. 7, this is an issue that should be discussed with those charged with governance or the appropriate level of client management.]
 - c. Legal requirements to remain associated with the client. [This answer is incorrect. According to SQCS No. 7, this is an issue that the firm should consider before ending the client relationship. The firm should also determine if there are requirements for the firm to report the withdrawal.]
 - d. Any significant unpaid fees. [This answer is incorrect. This is a consideration the firm would have while evaluating its client list, which takes place before the firm makes the decision to end a client relationship or withdraw from an engagement.]
38. Which of the following statements about withdrawing from an engagement is most accurate? **(Page 249)**
- a. **The firm's QC system should include guidance for withdrawing from an engagement. [This answer is correct. Even if the firm has excellent pre-engagement acceptance procedures in its QC system, sometimes the firm will find itself in the position of having to withdraw from an engagement. Thus, the firm's QC system should include guidance for the withdrawal process.]**
 - b. The engagement partner should be responsible for the decision to withdraw. [This answer is incorrect. The management partner should have this responsibility, as a client may consider the withdrawal a breach of contract.]
 - c. Communication of the decision to withdraw should be made orally. [This answer is incorrect. In most cases, this communication should be made in writing. For example, the firm could draft a resignation letter.]
 - d. It is not necessary to document the decision to withdraw from an engagement. [This answer is incorrect. A QC system should require the documentation of major consultations, and that documentation should be filed in the engagement workpapers. The decision to withdraw is believed to be subject to those same procedures.]

HOW TO DRAFT THE FIRM'S QUALITY CONTROL POLICIES AND PROCEDURES

AICPA QC and Peer Review Materials

AICPA Practice Aid. After reviewing authoritative literature, reviewing the illustrative examples suggested by the AICPA for designing the acceptance and continuance element of the quality control system is recommended. 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).

Shown at Exhibit 2-3 is based on a section from one of the sample quality control documents included in the AICPA Practice Aid. This portion of the quality control document contains suggested policy statements followed by procedures that can be used in designing and documenting a firm's acceptance and continuance quality control system. This example illustrates an acceptance and continuance quality control system for a local one-office accounting firm (referred to as Single-office CPA Firm). The firm has three partners and ten professionals and uses purchased practice aids that have been subjected to peer review in accordance with AICPA standards. The suggested policies are in bold type, and suggested procedures are in regular type.

Exhibit 2-3

AICPA Illustrative Policies and Procedures for Acceptance and Continuance of Client Relationships and Specific Engagements

1. **The firm evaluates factors that have a bearing on management's integrity and considers the risk associated with providing professional services in particular circumstances.** Single-office CPA Firm implements this policy through the following procedures—
 - a. Informing personnel of the firm's policies and procedures for accepting and continuing clients, including those outlined in the firm's practice aids.
 - b. Obtaining and evaluating relevant information such as the following before accepting or continuing a client—
 - (1) The nature and purpose of the services to be provided and management's understanding thereof.
 - (2) The identity of the client's principal owners, key management, related parties, and those charged with its governance.
 - (3) Information obtained from inquiries of the client's bankers, factors, attorneys, credit services, and others who have business relationships with the entity.
 - (4) The nature of the client's operations, including its business practices, from sources such as annual reports, interim financial statements, reports to and from regulators, income tax returns, and credit reports.
 - (5) Information concerning the attitude of the client's principal owners, key management, and those charged with its governance toward such matters as aggressive interpretation of accounting standards and internal control over financial reporting.
 - c. Evaluating the risk of providing services for the following engagements—
 - (1) Engagements for entities operating in highly specialized or regulated industries, including financial institutions, governmental entities, and employee benefit plans.
 - (2) Engagements that require an inordinate amount of time to complete relative to the available resources of the firm.

- d. Communicating with the predecessor accountant or auditor when required or recommended by professional standards. This communication also includes inquiries regarding the nature of any disagreements and whether there is evidence of opinion-shopping.
 - e. Conducting a background check of the business, its officers, and the person(s) in question by using the services of an investigative company and evaluating the information obtained regarding management's integrity. Background checks are conducted when the firm is unable to obtain sufficient information about the prospective client after taking the steps described above, or there is an indication that management or someone affiliated with the prospective client may be less than reputable.
 - f. Evaluating the risk of providing services to significant clients or to other clients for which the firm's objectivity or the appearance of independence may be impaired. In broad terms, the significance of a client to a firm refers to relationships that could diminish a practitioner's objectivity and independence in performing attest services. In determining the significance of a client, the firm considers (a) the amount of time the partner devotes to the engagement, (b) the effect on the partner's stature within the firm as a result of his or her service to the client, (c) the manner in which the partner is compensated, and (d) the effect that losing the client would have on the partner and the firm.
2. **The firm evaluates whether the engagement can be completed with professional competence; undertakes only those engagements for which the firm has the capabilities, resources, and professional competence to complete; and evaluates, at the end of specific periods or upon occurrence of certain events, whether the relationship should be continued.** Single-office CPA Firm implements this policy through the following procedures—
- a. Evaluating whether the firm has obtained or can reasonably expect to obtain the knowledge and expertise necessary to perform the engagement, including relevant regulatory or reporting requirements.
 - b. Evaluating whether the following are in place—
 - (1) The firm has sufficient personnel with the necessary capabilities and competence.
 - (2) Specialists are available if needed.
 - (3) Individuals meeting the criteria and eligibility requirements to perform an engagement quality control review are available, when needed.
 - (4) The firm is able to complete the engagement within the reporting deadline.
 - c. Specifying conditions that trigger the requirement to reevaluate a specific client or engagement. The following are examples of such conditions—
 - (1) Significant changes in the client, such as a major change in senior client personnel, ownership, advisors, the nature of its business, or the financial stability of the client.
 - (2) Changes in the nature or scope of the engagement, including requests for additional services.
 - (3) Changes in the composition of the firm, such as the loss of and inability to replace key personnel who are particularly knowledgeable about a specialized industry.
 - (4) The decision to discontinue services to clients in a particular industry.
 - (5) 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.

- (6) The client's delinquency in paying fees. (This may also affect the firm's independence.)
 - (7) Engagements for entities operating in highly specialized or regulated industries, such as financial institutions, governmental entities, and employee benefit plans.
 - (8) Engagements for entities in which there may be substantial doubt about the entity's ability to continue as a going concern.
 - (9) Engagements in which the client has ignored prior recommendations, such as those that address deficiencies in internal control.
- d. Obtaining relevant information to determine whether the relationship should be continued and establishing a frequency for evaluations (for example, continuance decisions are made at least annually).
 - e. Evaluating the information obtained regarding acceptance or continuance of the client or engagement through the following activities—
 - (1) The engagement partner assesses the information obtained about the client or the specific engagement, including information about the significance of the client to the firm, and makes a recommendation about whether the client or engagement should be accepted or continued.
 - (2) The engagement partner completes a client acceptance form and submits it to the managing partner for approval.
 - (3) The engagement partner signs a step in the planning program noting consideration of client continuance and completes a form documenting the rationale and conclusion regarding client continuance if conditions exist that trigger the requirement to reevaluate a client or engagement between annual audits.
 - (4) The managing partner assesses and approves the recommendation made by the engagement partner. If the managing partner recommends not accepting a client or discontinuing a client relationship, the managing partner discusses his or her reasons for the acceptance or continuance decision with the other partners.
 - f. Establishing procedures for dealing with information that would have caused the firm to decline the engagement if the information had been available earlier.
3. **The firm obtains an understanding with the client regarding the services to be performed.** Single-office CPA Firm implements this policy by requiring that, for all engagements, the firm prepare a written engagement letter documenting the understanding with the client and obtain the client's signature on that letter, thus minimizing the risk of misunderstanding regarding the nature, scope, and limitations of the services to be performed.
4. **The firm establishes procedures on withdrawal from an engagement or from both the engagement and the client relationship.** Single-office CPA Firm implements this policy through the following procedures—
- a. Discussing with the appropriate level of the client's management and those charged with its governance the appropriate action that the firm might take based on the relevant facts and circumstances.
 - b. Considering whether there is a professional, regulatory, or legal requirement for the firm to remain in place or for the firm to report to regulatory authorities the withdrawal from the engagement, or from both the engagement and the client relationship, together with the reasons for the withdrawal.
 - c. Discussing with the appropriate level of the client's management and those charged with its governance withdrawal from the engagement or from both the engagement and the client relationship if the firm determines that it is appropriate to withdraw.

5. **The firm documents how issues relating to acceptance or continuance of client relationships and specific engagements were resolved.** Single-office CPA Firm implements this policy by documenting, in a memorandum to the engagement files, significant issues, consultations, conclusions, and the basis for the conclusions relating to acceptance or continuance of client relationships and specific engagements.

* * *

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 necessary before adopting them. Many firms will find that the suggested policies and procedures may not meet their firm's particular needs.

AICPA Peer Review Program Manual. It is recommended that practitioners involved in designing a QC system for acceptance and continuance scan the questionnaires included in the AICPA Peer Review Program Manual (PRPM).

The PRPM provides quality control policies and procedures questionnaires for firms to complete prior to the commencement of an AICPA system review. (The firm need only complete one questionnaire.) Section 4400 of the PRPM presents the questionnaire for firms with two or more personnel (individuals who perform professional services) (summarized in Exhibit 2-4). Section 4300 of the PRPM provides the questionnaire for a sole practitioner with no personnel (summarized in Exhibit 2-5).

Exhibit 2-4

Attributes of a QC System for the Acceptance and Continuance of Clients or Review Steps Emphasized on Peer Review Questionnaire (Firms with Two or More Personnel)^a

- Describe how the firm documents and communicates its policies and procedures to personnel for accepting prospective clients and the continuance of current clients and specific engagements.
- Do the firm's policies and procedures include obtaining and evaluating the following relevant information before accepting or continuing a client relationship?
 - The nature and purpose of the services to be provided to the client and management's understanding thereof?
 - The identity of the client's principal owners, key management, related parties, and those charged with governance?
 - The nature of the client's operations, including its business practices?
 - Information obtained from third parties?
 - Information concerning the attitude of the client's principal owners, key management, and those charged with governance toward such matters as aggressive interpretation of accounting standards and internal control over financial reporting?
 - The risk of providing services in highly specialized or regulated industries?
 - Engagements that require an inordinate amount of time to complete relative to the available resources of the firm?
 - Communicating with the predecessor accountant or auditor when required by professional standards?

- Conducting background checks of the business, its officers, and so on?
- The risk of providing services to significant clients or other clients for which the firm's objectivity or the appearance of independence may be impaired?
- Does the firm document the necessary communications with predecessor accountants and auditors, including inquiries regarding the nature of any disagreements and other events, and whether evidence of *opinion shopping* exists?
- When issues have been identified, and the firm decides to accept or continue the client relationship or a specific engagement, how does the firm document that the issues were resolved?
- Does the firm evaluate whether it has obtained or can reasonably expect to obtain the knowledge and expertise necessary to perform the engagement, including relevant regulatory or reporting requirements, prior to accepting the engagement?
- Does the firm specify conditions that require evaluation of a specific client or engagement, obtaining relevant information to determine whether the relationship should be continued, and establishing a specific time period to make that evaluation?
- Does the firm designate individuals to evaluate and make a recommendation as to whether a client or specific engagement should be accepted or continued?
- Does the firm document its understanding with the client regarding the services to be performed by obtaining either an engagement letter for all engagements, thus minimizing the risk of misunderstandings regarding the nature, scope, and limitation of the services to be performed, or by documenting the understanding in a memorandum?
- Describe the firm's procedures for withdrawal from an engagement or from both the engagement and the client relationship.
- Did the firm consider discontinuing any audit and accounting client relationships during the year under review but decide to continue?

Note:

- ^a These questions reflect the most recent changes made to the AICPA PRPM. At the date of this course, the most recent version of the AICPA PRPM is designated as 00-1 2009.

* * *

Exhibit 2-5

Attributes of a QC System for the Acceptance and Continuance of Clients or Review Steps Emphasized on Peer Review Questionnaire (Sole Practitioner with No Personnel)^a

- Does the practitioner obtain and evaluate relevant information such as the following before accepting or continuing a client relationship?
 - The nature and purpose of the services to be provided to the client and management's understanding thereof?
 - The identity of the client's principal owners, key management, related parties, and those charged with governance?

- The nature of the client's operations, including its business practices?
 - Information obtained from third parties?
 - Information concerning the attitude of the client's principal owners, key management, and those charged with governance toward such matters as aggressive interpretation of accounting standards and internal control over financial reporting?
 - The risk of providing services in highly specialized or regulated industries?
 - Engagements that require an inordinate amount of time to complete relative to the available resources of the firm?
 - Communicating with the predecessor accountant or auditor when required by professional standards?
 - Conducting background checks of the business, its officers, and so on?
 - The risk of providing services to significant clients or other clients for which the firm's objectivity or the appearance of independence may be impaired?
- Does the practitioner document the necessary communications with predecessor accountants and auditors, including inquiries regarding the nature of any disagreements and other events, and whether evidence of *opinion shopping* exists?
 - Does the practitioner evaluate whether he or she has obtained or can reasonably expect to obtain the knowledge and expertise necessary to perform the engagement, including relevant regulatory or reporting requirements, prior to accepting the engagement?
 - Does the practitioner consider conditions that require evaluation of a specific client or engagement, obtain relevant information to determine whether the relationship should be continued, and establish a specific time period to make that evaluation?
 - Did the practitioner consider discontinuing any audit and accounting client relationships during the year under review but decide to continue?
 - Does the practitioner document his or her understanding with the client regarding the services to be performed by either obtaining an engagement letter for all engagements, thus minimizing the risk of misunderstandings regarding the nature, scope, and limitation of the services to be performed, or by documenting the understanding in a memorandum?
 - Describe the firm's procedures for withdrawal from an engagement or from both the engagement and the client relationship.

Note:

- ^a These questions reflect the most recent changes made to the AICPA PRPM. At the date of this course, the most recent version of the AICPA PRPM is designated as 00-1 2009.

* * *

Practitioners involved in designing a QC system for acceptance and continuance of client relationships and specific engagements scan the quality control policies and procedures questionnaire for their firm size found in the PRPM. Practitioners should understand that the size and other unique characteristics of each firm will dictate the QC needs of a specific firm and, therefore, not all items apply to every firm. Also, there is almost always an alternative

procedure that is equally acceptable for a given firm. However, by considering the information in the PRPM when designing or revising its QC system, the firm can obtain a general understanding of what is suggested by the AICPA for the acceptance and continuance of clients and specific engagements element, which may be helpful when drafting the firm's policies and procedures.

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.
- Number of firm locations.
- 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 firm could 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.

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. Again, a good starting point is to refer to the AICPA illustrative procedures reproduced at Exhibit 2-3.

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.

EVALUATING THE DESIGN OF THE OVERALL ADEQUACY OF THE FIRM'S QUALITY CONTROL SYSTEM

The ideas, recommendations, and suggestions relating to acceptance and continuance in this course should allow the firm to design a practical quality control system that meets its needs. The ultimate responsibility for the effectiveness of the system is, of course, in the firm's hands.

Additionally, the firm can consider common acceptance and continuance deficiencies noted in peer reviews. Exhibit 2-6 provides examples of the significant deficiencies noted in recent peer reviews.

Exhibit 2-6

Common Acceptance and Continuance Deficiencies Noted in Peer Reviews

- Lack of formal policies or inadequate procedures for acceptance and continuance.
- Acceptance of engagement when the firm does not have the competence to perform the service.
- Acceptance decisions are not adequately documented.
- Continuance decisions are not reevaluated annually.
- Failure to communicate and/or document communication with predecessor auditors.

* * *

MONITORING FIRM COMPLIANCE WITH ITS ACCEPTANCE AND CONTINUANCE POLICIES AND PROCEDURES

Firms need to 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.

39. Which of the following procedures for a firm's QC system would be used to fulfill the following QC policy statement from the AICPA's Practice Aid, *Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice*?

The firm establishes procedures on withdrawal from an engagement or from both the engagement and the client relationship.

- a. Discussing with the appropriate level of the client's management and those charged with its governance the appropriate action that the firm might take based on the relevant facts and circumstances.
 - b. Evaluating the risk of providing services for engagements for entities operating in highly specialized or regulated industries, including financial institutions, governmental entities, and employee benefit plans.
 - c. Evaluating whether the firm has sufficient personnel with the necessary capabilities and competence.
 - d. Evaluating whether the firm has obtained or can reasonably obtain the knowledge and expertise necessary to perform the engagement, including relevant regulatory or reporting requirements.
40. Ray Parkman CPA is a sole practitioner with no professional staff. Which client acceptance and continuance consideration from the AICPA's *Peer Review Program Manual* (PRPM) applies to this firm?
- a. Do the firm's policies and procedures require information to be obtained regarding management's integrity?
 - b. Does the firm have documented policies and procedures for accepting prospective clients and the continuance of current clients?
 - c. Does the firm follow all requirements set forth in professional standards related to obtaining an understanding with the client?
 - d. Does the firm inform personnel of its acceptance and continuance policies and procedures?

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.)**

39. Which of the following procedures for a firm's QC system would be used to fulfill the following QC policy statement from the AICPA's Practice Aid, *Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice*? **(Page 257)**

The firm establishes procedures on withdrawal from an engagement or from both the engagement and the client relationship.

- a. **Discussing with the appropriate level of the client's management and those charged with its governance the appropriate action that the firm might take based on the relevant facts and circumstances. [This answer is correct. Another procedure that supports this policy statement is as follows: Considering whether there is a professional, regulatory, or legal requirement for the firm to remain in place or for the firm to report to regulatory authorities the withdrawal of the engagement, or from both the engagement and the client relationship, together with the reasons for the withdrawal.]**
 - b. Evaluating the risk of providing services for engagements for entities operating in highly specialized or regulated industries, including financial institutions, governmental entities, and employee benefit plans. [This answer is incorrect. This procedure supports the following policy statement: The firm evaluates factors that have a bearing on management's integrity and considers the risk associated with providing professional services in particular circumstances.]
 - c. Evaluating whether the firm has sufficient personnel with the necessary capabilities and competence. [This answer is incorrect. This procedure supports the following policy statement from the AICPA practice aid: The firm evaluates whether the engagement can be completed with professional competence; undertakes only those engagements for which the firm has the capabilities, resources, and professional competence to complete; and evaluates, at the end of the specific periods or upon occurrence of certain events, whether the relationship should be continued.]
 - d. Evaluating whether the firm has obtained or can reasonably obtain the knowledge and expertise necessary to perform the engagement, including relevant regulatory or reporting requirements. [This answer is incorrect. This procedure supports the following policy statement: The firm evaluates whether the engagement can be completed with professional competence; undertakes only those engagements for which the firm has the capabilities, resources, and professional competence to complete; and evaluates, at the end of the specific periods or upon occurrence of certain events, whether the relationship should be continued.]
40. Ray Parkman CPA is a sole practitioner with no professional staff. Which client acceptance and continuance consideration from the AICPA's *Peer Review Program Manual* (PRPM) applies to this type of firm? **(Page 261)**
- a. Do the firm's policies and procedures require information to be obtained regarding management's integrity? [This answer is incorrect. This consideration is applicable to a firm that has two or more professional staff members.]
 - b. Does the firm have documented policies and procedures for accepting prospective clients and the continuance of current clients? [This answer is incorrect. According the PRPM, this consideration is applicable to firm that have two or more professional staff.]
 - c. **Does the firm follow all requirements set forth in professional standards related to obtaining an understanding with the client? [This answer is correct. As Ray Parkman is a sole practitioner with no professional staff, this consideration from the PRPM applies to this firm.]**
 - d. Does the firm inform personnel of its acceptance and continuance policies and procedures? [This answer is incorrect. Firms with two or more professional staff would use this consideration from the PRPM.]

EXAMINATION FOR CPE CREDIT**Lesson 2 (GQCTG102)**

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.

21. According to SQCS No. 7, a firm should establish QC policies and procedures that ensure it only accepts and continues relationships with clients with what attribute?
- a. Independence.
 - b. Integrity.
 - c. A functional QC system.
 - d. The ability to pay for services.
22. From the following choices, select who should be evaluated when a firm is examining a client's integrity.
- | | |
|-------------------------|-----------------------------------|
| i. The principal owners | iv. Key management |
| ii. Client's attorneys | v. Client vendors or customers |
| iii. Client's customers | vi. Those charged with governance |
- a. i. and iv.
 - b. i., iv., and vi.
 - c. i., ii., iii., iv. and vi.
 - d. i., ii., iii., iv., v., and vi.
23. J.T. is investigating the integrity of Baltimore Parks, a potential client for J.T.'s firm. Which procedure would help J.T. evaluate the client's attitude toward aggressive accounting and internal control matters?
- a. Determining if business practices differ from those of others in the same industry.
 - b. Reviewing tax returns, financial statements, and financial statement notes.
 - c. Comparing the amount of knowledge about the company to the length of the relationship.
 - d. Ensure that the potential client's sources and disbursements of cash flow are easy to identify.
24. When evaluating a client's integrity, why would a firm want to examine the client's profile as a corporate citizen?
- a. To determine how a client presents itself to employees, customers, and others.
 - b. To determine the client's ability to meet financial obligations.
 - c. To determine that the client deals with employees in an equitable manner.
 - d. To determine the character of a client's leadership.

25. Jacob is evaluating the integrity of his firm's potential client. While performing a walk-through of the client's facilities, he notices that the bulk of the property is in need of repair. What could this indicate?
- a. The client has a bad reputation in the community.
 - b. The client is trying to hide things from the firm.
 - c. The client cannot meet its financial obligations.
 - d. Issues the client has with employees have become public.
26. Which of the following statements most accurately describes a firm's evaluation of risk due to the nature of the engagement?
- a. Engagements for new ventures have a lower inherent risk than engagements with established clients.
 - b. If the firm understands the risk associated with a client before accepting the engagement, liability is reduced.
 - c. If firm members have appropriate knowledge of appropriate subject matter, risk due to the nature of the engagement is reduced.
 - d. Evaluation of financial statements and the financial reporting system will not help the firm evaluate risk associated with the engagement.
27. What type of engagement historically has the highest severity of damages per claim if the client files a claim against the firm?
- a. A tax engagement.
 - b. An accounting engagement.
 - c. An audit engagement.
 - d. All of these engagement types have the same risk of damages if a claim is filed.
28. Which of the following industries does **not** have a level of risk that is higher than normal?
- a. Construction companies.
 - b. Educational institutions.
 - c. Technology companies.
 - d. Health care institutions.
29. Allen-Black, a CPA firm, has tentatively decided to accept an engagement. Which of the following questions will help the firm consider practice area risk?
- a. Will the firm's personnel have the requisite experience to perform the engagement?
 - b. Is the client's industry, as a whole, in recession?
 - c. Are the client's books and records in good order?
 - d. Is the industry undergoing deregulation?

- 30. Allen-Black realizes that the time frame that the client has imposed for fieldwork is too short for the firm to perform all procedures that will be necessary, and no alternative procedures can be performed that will overcome this problem. What is this called?
 - a. Engagement risk.
 - b. Scope limitation.
 - c. Practice area risk.
 - d. Aggressive accounting.

- 31. What is the most frequently assumed qualification of *competence*?
 - a. The ability to make sound decisions.
 - b. Having integrity and objectivity.
 - c. Having up-to-date licenses.
 - d. Technical proficiency.

- 32. In which scenario has the firm made the best client acceptance decision?
 - a. Firm A accepts its first engagement in the petroleum industry without the ability to take CPE or otherwise gain needed specialized knowledge.
 - b. Firm B uses a third-party service provider without entering into a confidentiality agreement with them or obtaining client consent.
 - c. Firm C’s staff members are familiar with the Yellow Book and the Single Audit Act and accept an engagement to audit a nonprofit organization receiving federal funds.
 - d. Firm D will be able to complete the potential engagement by one week after the client’s debt covenant deadline, so it accepts the engagement.

- 33. Match the following laws or authoritative literature with the requirement it addresses. (Hint: more than one requirement may be addressed by a law or authoritative literature listed, and more than one law may address a requirement listed.)

<u>Law/Literature</u>	<u>Requirement Addressed</u>
1. Sarbanes-Oxley Act of 2002	i. The PCAOB will perform inspections of registered firms.
2. Health Insurance Portability and Accountability Act	ii. Requires members in public practice to maintain integrity and objectivity, and to be independent in both fact and appearance.
3. State Security Breach Notification Laws	iii. Firms that audit issuers must register with the PCAOB.
4. AICPA’s <i>Code of Professional Conduct</i>	iv. Sets requirements for firms that collect and examine personal information associated with a client’s customers

- a. 1., iii. and i.; 2. and 3., iv.; 4., ii.
 - b. 1., i.; 2., iv.; 3., ii.; 4., iii.
 - c. 1., ii.; 2., iii. and i.; 3. and 4., iv.
 - d. 1. and 2., iv.; 3., i. and iii.; 4., ii.
34. Which of the following statements best describes using an engagement letter to obtain an understanding with a client?
- a. Engagement letters are required for all audit, attest, and consulting engagements.
 - b. Engagement letters are a cost-effective way to provide good service and minimize risk.
 - c. Engagement letters are not examined during the peer review process.
 - d. An oral understanding with the client is always preferable to an engagement letter.
35. Based on the guidance in SQCS No. 7, when should a firm have gathered all necessary information about a client or an engagement?
- a. Before the engagement letter is signed.
 - b. By the time fieldwork begins.
 - c. Before a new client is accepted.
 - d. Before an engagement is complete.
36. There are two approaches firms can use to evaluate the acceptability of existing client relationships. One is to evaluate all clients in an annual meeting. What is the second?
- a. To evaluate the client during the planning stage of each engagement.
 - b. To evaluate the client at the conclusion of the prior year engagement.
 - c. To evaluate the client when a significant change occurs at the firm.
 - d. To evaluate the client when significant changes occur for the client.
37. Rose & Bloom, a CPA firm, accepts an engagement with a new client. After accepting the engagement, the firm discovers that more time will be needed to perform the engagement than the firm can provide, so Rose & Bloom will not be able to meet the client's deadline. According to SQCS No. 7, what should the firm consider under these circumstances?
- a. The possibility of postponing the engagement to a later date.
 - b. Changes in the nature or scope of the engagement.
 - c. Whether the client has ignored the recommendations of prior accountants.
 - d. Professional or legal responsibilities owed to the client by the firm.

38. The Nolan firm is auditing Baker's Dozen. When the firm requests client approval to ask the client's legal counsel for a legal representation letter, the client refuses. What should the firm do next?
- Step the engagement down to a compilation or review.
 - Withdraw from the engagement.
 - Present a modified opinion in the auditor's report.
 - Proceed with the audit, but document the refusal in the workpapers.
39. The Gloom & Gust accounting firm has five partners and six professional staff. Which of the following considerations from the PRPM checklist would be applicable to this firm?
- Does the firm designate individuals to evaluate and make a recommendation as to whether a client or engagement should be accepted or continued?
 - Does the firm obtain information on the nature and purpose of the services to be provided to the client by making inquiries of client management?
 - Does the firm evaluate the information obtained regarding management's integrity?
 - Does the firm obtain information regarding the client and its management by making inquiries of third parties?
40. Which of the following is a common problem noted in peer reviews about firms' client acceptance and continuance procedures?
- Failure to document the procedures required by Interpretation 101-3.
 - Acceptance decisions are not adequately documented by the firm.
 - Failure to circulate current client lists with whom firm members should be independent.
 - Continuance procedures are not evaluated at least once every three years.

GLOSSARY

AICPA's Code of Professional Conduct (the Code): According to SQCS No. 7, the *Code* establishes the fundamental principles of professional ethics. These principles include responsibilities, the public interest, integrity, objectivity and independence, due care, and scope and nature of services. The Code is comprised of articles, rules, interpretations, and rulings.

AICPA Peer Review Program Manual (PRPM): The PRPM provides quality control policies and procedures questionnaires for firms to complete prior to the commencement of an AICPA peer review. Its checklists are a good source of information for designing relevant ethical requirements policies and procedures for a firm's quality control system.

Alternative practice structure (APS): In many APS firms, a substantial portion (generally the nonattest portion) of the practice is conducted under public or private ownership, and the attest portion of the practice is conducted through a separate firm operated and majority-owned by CPAs. These structures must comply with the applicable state laws and regulations as well as Ethics Rule 505, "Form of Organization and Name." In complying with these rules and regulations, many elements of quality control are required to ensure that the public interest is adequately protected.

Client acceptance and continuance: CPA firms should establish policies and procedures for determining the acceptance of a potential client or continuing with an existing client to minimize the risk of being associated with a client whose management lacks integrity.

Competence: The Conduct requires that members agree to perform only those professional services that the member or the firm can reasonably expect to complete with professional competence. This includes the ability to make sound decisions in the performance of an engagement, but the most frequently assumed qualification of competence is technical proficiency.

Engagement letter: A letter written by the CPA to the client that represents the contractual understanding between the CPA and the client of the work to be performed, signed by both the CPA and the client.

Engagement risk: This area (also called transaction risk) must be assessed after a tentative client acceptance or continuance decision has been made. A thorough analysis of the engagement should indicate the experience level and industry competence needed to properly staff the engagement.

Ethics partner: The quality control director or another partner designated by the firm to take responsibility for overseeing compliance with ethical requirements. The designated ethics partner should have a current and detailed working knowledge of the relevant rules and requirements relating to independence, integrity, and objectivity and may oversee the administration of all firm independence-related matters.

Government Auditing Standards (the Yellow Book): Generally accepted government auditing standards (GAGAS) are set forth in the *Government Auditing Standards* issued by the comptroller general of the United States.

Health Insurance Portability and Accountability Act (HIPAA): HIPAA was enacted in 1996 and is designed to protect health insurance coverage for workers and their families when they change or lose their jobs and establish national administrative standards for the electronic transmission of health care transactions and records, as well as standards for the security and privacy of patient information.

Independence: To be free from conflicts of interest and bias, self-governing, impartial, not subject to control by others, not requiring or relying on something else, not contingent, and acting with integrity and objectivity (i.e., with judgment that is unimpaired and without bias or prejudice). It is subject to Ethics Rule 101.

Integrity: An unimpaired condition or firm adherence to a code of especially moral or artistic values. Additionally, integrity is an essential component of independence and is also a quality which all CPAs, even those who are not independent, must possess. It is the subject of Article III of the Code.

Objectivity: Being impartial, intellectually honest, and free of conflicts of interest. It is the ability to maintain an impartial attitude in both fact and appearance based on one's actions and relationships. The quality of objectivity

is required of *all* CPAs, not just those in public practice. It is a state of mind that is essential to the maintenance of the public's trust. It is the subject of Article IV and Rule 102.

Paraprofessional: Some firms use paraprofessionals to do accounting and review services, and to assist in audit engagements. A paraprofessional participating on an engagement in this way is acting as a professional, and, therefore, the ethical requirements of a covered member would apply. Other firms use paraprofessionals to perform only routine clerical functions, such as word processing and photocopying, and the ethical requirements would not apply.

Practice area risk: An evaluation of how much of the firm's resources an engagement will utilize and the firm's level of experience in a practice area. If possible, a firm should avoid having a marginal level of practice in a particular area by either fully committing to that practice area or eliminate pursuing clients in that area.

Public Company Accounting Oversight Board (PCAOB): The PCAOB was founded under the provisions of Title I of the Sarbanes-Oxley Act of 2002. It oversees the audits of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors.

Quality control: Quality control refers to the reasonable assurance that policies and procedures are in place during an audit engagement to be in compliance with GAAS (generally accepted auditing standards).

Quality control policies: QC policies are designed to achieve the overall objectives of the QC system and the specific objectives of the individual QC elements.

Quality control procedures: QC procedures are designed to provide the actions necessary to implement and monitor compliance with the stated QC policies.

Scope limitation: Attest engagement in which the scope has been restricted, whether imposed by the client or by such other circumstances as the timing of the work or the inability to obtain sufficient evidence; may require the practitioner to qualify the assurance provided, disclaim any assurance, or withdraw from the engagement—the decision depends on an assessment of the effect of the omitted procedures on the ability to express assurance, affected by the nature and magnitude of the matters in question, by their significance to the presentation of assertions, and by whether the engagement is an examination or a review.

Statements on Quality Control Standards (SQCS): Standards established by the AICPA to provide CPA firms with guidance in establishing quality control standard policies. SQCS technically applies to auditing, attestation, and accounting services for which professional standards have been established by the AICPA. Practically, SQCS applies to every aspect of practice. SQCS No. 7 is the newest standard and has had sweeping effects over quality control guidance.

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TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Quality Control—Course 1—Engagement Performance and Monitoring (GQCTG101)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

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Companion to PPC's Guide to Quality Control—Course 1—Engagement Performance and Monitoring (GQCTG101)

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3. Does the examination consist of clear and unambiguous questions and statements?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
4. Were the stated learning objectives met?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
5. Were the course materials accurate and useful?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
7. Was the time allotted to the learning activity appropriate?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
8. If applicable, was the technological equipment appropriate?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
10. If applicable, how well did the audio/visuals contribute to the program?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
 (Please print legibly):

Additional Comments:

1. What did you find **most** helpful? _____
2. What did you find **least** helpful? _____
3. What other courses or subject areas would you like for us to offer? _____
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _____
5. How many employees are in your company? _____
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes/No**

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