

AUDIT PRACTICE BULLETIN NO. 2 OF 2012

**QUALITY CONTROL FOR FIRMS THAT PERFORM AUDITS AND REVIEWS
OF FINANCIAL STATEMENTS, AND OTHER ASSURANCE AND
RELATED SERVICES ENGAGEMENTS (PART 2)**

(A) RELEVANT ETHICAL REQUIREMENTS

**(B) ACCEPTANCE AND CONTINUANCE OF CLIENT RELATIONSHIPS AND
SPECIFIC ENGAGEMENTS**

18 SEPTEMBER 2012

1. Part 2¹ of the series of Audit Practice Bulletins on Singapore Standard on Quality Control (SSQC) 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*² discusses ACRA's inspection observations on the second and third element of SSQC 1 – Relevant Ethical Requirements and Acceptance and Continuance of Client Relationships and Specific Engagements respectively.

(A) Relevant Ethical Requirements

2. Auditor independence is a critical foundation of audit quality and public confidence in audit reports.
3. SSQC 1.21 states that firms shall establish policies and procedures designed to provide them with reasonable assurance that the firms and their personnel, including those subject to independence requirements (such as network firm personnel) maintain independence where required by relevant ethical requirements.
4. In Singapore, the ethical and independence requirements applicable to public accountants and public accounting entities can be found in the Code of Professional Conduct and Ethics for Public Accountants and Accounting Entities (the Code) which is included under the Fourth Schedule of the Accountants (Public Accountants) Rules³.
5. The Code applies to the provision of public accountancy services by public accountants, accounting firms, accounting corporations and accounting LLPs. It provides guidance to public accountants on how to apply principles and independence rules, and places an

¹ Part 1 was published on 13 August 2012 and can be found at: <http://www.acra.gov.sg/NR/rdonlyres/8116555C-B143-4F97-A91E-5B7C962EC749/0/AuditPracticeBulletin1of2012.pdf>

² SSQC 1, which is issued by the Institute of Certified Public Accountants of Singapore (ICPAS), is based on the equivalent of the International Standard on Quality Control 1 issued by the International Federation of Accountants, with amendments as were considered appropriate for local adoption. SSQC 1 is available for download at: <http://www.icpasca.org.sg/wp-content/uploads/2010/06/SSQC-1-R.pdf>.

³ The Accountants (Public Accountants) Rules is available for download at: <http://www.acra.gov.sg/NR/rdonlyres/70B1C579-55DA-4635-B74A-D0638E7BEABA/0/AccountantsPublicAccountnatsRules.pdf>

expectation on public accountants to pro-actively identify and eliminate potential threats to independence.

6. SSQC 1.21 also provides that firms need to establish policies and procedures to communicate their independence requirements to their personnel and identify and evaluate circumstances and relationships that create threats to independence, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards.
7. Based on inspections of firms that audit public interest entities, ACRA noted that these firms generally have put in place an appropriate framework of policies and procedures to ensure the compliance with auditor independence and other ethical requirements. Apart from establishing preventive controls to monitor such compliance, these firms also pro-actively monitor the compliance through their internal monitoring and reporting mechanisms.
8. Through the inspections, ACRA has noted a number of common deficiencies in the implementation of the firms' policies and procedures. The principles of these findings would also be applicable to all firms.

Key Observations

(a) *Policies and procedures*

9. ACRA noted that some firms have adopted their global independence policies which may be more stringent than the requirements under the Code. Whilst the violations noted by some of these firms in such a situation may not relate to breaches of the Code (given the more stringent policies), it would still be in the firms' interest and responsibility to ensure that the policies/standards that they have established are complied with.

(b) *Listing of restricted investments*

10. ACRA noted that some firms do not maintain a complete listing of their clients. For example, in some firms, the restricted entities list only included listed clients. It is important that firms maintain and make available to all staff a complete listing of their clients since compliance with independence requirements extend beyond economic interests in listed clients. The list should include non-listed clients, entities which are subsidiaries or associates of overseas listed entities as well as global clients of the network firms worldwide to enable the firm to fully ascertain independence concerns during the client acceptance/continuance process.
11. ACRA also noted instances of untimely updates to the firm's restricted entities list. A listing that is not updated on a timely basis is not effective in enabling the firm or staff to self-monitor, report independence/ethical conflicts should such a situation arise and to take appropriate remedial or corrective action on a timely basis.

(c) *Monitoring of independence compliance*

12. Most firms have in place a process which requires partners and staff to complete an annual personal independence confirmation to declare if they or their spouse/spousal equivalents and their financial dependents hold shares in any of the restricted entities as well as a process to test, on a sample basis, the completeness and accuracy of the information declared.
13. In respect of the annual independence compliance testing carried out by firms, ACRA noted that the testing process is structured and makes use of a standard work program and checklist to ensure the uniform application and quality of the testing methodology utilised. The testing samples are mostly restricted to senior management and do not extend to staff below the managerial level. This is inadequate given that the rules for financial interests under paragraph 290.106 of the Code apply to members of the assurance team. As such, firms should consider a policy of extending the annual independence compliance testing to all professional staff. This could be implemented while still retaining the testing bias towards senior management. Having such a policy will help to send a message to all professional staff that they should be cognizant of independence policies at all times.
14. From the firm's compliance testing, ACRA observed that the reported violations include a partner candidate holding a restricted financial interest which was prohibited under the firm's more stringent independence policy, prohibited interests held by spouses and failure to update purchases and disposals of financial interests held by spouses in the firm's independence monitoring system on a timely basis. The firms in these cases have taken actions according to their firms' policies and issued warnings and reprimand letters to those with violations and followed-up on the rectification of the violations. In one instance, it was noted that the disposal of prohibited investment was not completed within the firm's stipulated timeline. Firms should ensure that their policies and procedures are adhered to by all staff including partners and enforce the policy of requiring the disposal of prohibited interests on a timely basis.
15. ACRA noted that in some firms, monetary sanctions were imposed on independence violations. In another firm, a partner's promotion was delayed due to independence violations. As discussed in APB No. 1 of 2012, the "tone at the top" is an important element of a strong quality control within a firm. It is important that firms recognise that adherence to professional independence and ethics requirements are fundamental in upholding high audit quality.
16. In respect of independence checks on audit proposals, ACRA noted that such checks were sometimes performed after the audit proposals were issued due to time pressures. In such situations, firms should reflect their obligations on ethics and independence requirements in audit proposals which should state that the acceptance of the client/engagement is subject to fulfilment of independence checks and professional clearances. This would help to protect the firm's reputation and minimise embarrassment should the subsequent independence checks/professional clearances turn out to be unsatisfactory.
17. To enhance accountability and partner engagement in complying with independence and ethics, ACRA suggests, as a best practice matter, that status updates on matters relating to compliance or non-compliance with independence and ethics matters be communicated

and discussed at partners' and other management's meetings on a regular basis. This formal reporting requirement will foster mutual accountability and responsibility among the different departments and functional groups within the firm.

(d) *Monitoring process for overdue fees and non-audit fees*

18. Paragraph 290.208 of the Code states that a self-interest threat may be created if fees due from an assurance client for professional services remain unpaid for a long time, especially if a significant part is not paid before the issue of the assurance report for the following year. Generally, the payment of such fees should be required before the report is issued.
19. ACRA found several instances whereby audits were commenced or the audit reports were signed off despite long outstanding engagement fees from the audit clients. ACRA did not regard the responses provided by the firms in some of these instances such as the audit, although commenced, had not yet been signed off; or there were discussions with management and the audit committee on the matter; or the engagement resulting in overdue fee was handled by a different partner, as satisfactory. Firms should exercise vigilance in the area of unpaid fees and should not start audits or reviews for the following year until prior overdue fees are paid.
20. Paragraph 290.206B of the Code states that where a financial statement audit client is a listed entity or a public company, the significance of the threat should be evaluated and safeguards should be considered and applied as necessary to reduce the threat to an acceptable level in all cases where the amount of annual fees received for non-audit services compared to the total annual audit fees from the financial statement audit client is 50% or more or the total size of annual non-audit fees from the financial statement audit client is significant.
21. In most firms, it is the responsibility of the individual engagement teams to assess whether the non-audit fees earned from an audit client exceed 50% of the audit fee or are otherwise significant such that the firm's independence with respect to the client is compromised. The principal control for ensuring that this assessment is carried out lies in the practice that such issues are discussed with the audit committee or those charged with governance. There is generally no internal monitoring process over this assessment other than, for some firms, via the engagement quality control review (EQCR) partner who signs off on the audit checklist indicating that he has reviewed and is satisfied with the independence of the firm.
22. ACRA found numerous instances where there was no evidence of work performed by the engagement teams to review the relative sizes of audit and non-audit fees. In some instances, there was no evidence that the engagement teams had obtained the required information in relation to overseas audit/non-audit fees to evaluate the relative sizes of overall audit and non-audit fees. It is timely that firms reinforce its policies with respect to monitoring of non-audit fees. In this respect, some firms are already in the process of developing practice aids to assist engagement teams in documenting their assessment.

(e) Familiarity threat

23. Paragraph 290.154 of the Code states that using the same engagement partner or the same individual responsible for the EQCR on a financial statement audit over a prolonged period may create a familiarity threat. SSQC 1.25 provides that firms shall establish policies and procedures to set out the criteria for determining the need for safeguards to reduce the familiarity threat to an acceptable level when using the same senior personnel on an assurance engagement over a long period of time.
24. The Code recognizes that the familiarity threat is particularly relevant in the context of financial statement audits of listed entities. For these audits, the Code requires the rotation of the key audit partner (i.e. the engagement partner and the individual responsible for the EQCR) after a pre-defined period, normally no more than 7 years, and provides related standards and guidance. National requirements may establish shorter rotation periods. For example, the Singapore Exchange Listing Rule 713 provides that the audit partner of an issuer must not be in charge of more than 5 consecutive audits for a full financial year.
25. ACRA noted an instance of non-rotation of an engagement partner who had served on a bank/financial institution engagement for more than 7 years. This is despite the fact that the firm was not facing a shortage of financial services partners to apply the partner rotation requirements. ACRA also noted that most firms apply the partner rotation policy not only to listed entities but also to other public interest entities engagements. Firms should also consider other safeguards against familiarity threat such as rotation of senior personnel on the engagements – as provided under paragraph 200.13(f) of the Code and SSQC 1.A13.
26. For the smaller-sized firms which have limited number of partners with the necessary knowledge and experience to serve as engagement or EQCR partner on a listed entity engagement, paragraph 290.157 of the Code provides that rotation may not be an appropriate safeguard for such a situation. In these circumstances, the firm should apply other safeguards to reduce the threat of familiarity to an acceptable level. Such safeguards would include involving an additional professional accountant who was not associated with the assurance team to review the work done. This individual could be someone from outside the firm or someone within the firm who was not associated with the assurance team.

(f) Others

27. Whilst most firms have in place various monitoring and reporting mechanisms, their internal systems generally do not have the ability to detect issues of non-compliance over independence and ethical matters. Existing management information system could be enhanced by developing the capacity to generate ad-hoc or customised internal compliance reports at short notice. Such reports may improve the speed at which relevant and pertinent information is accumulated for internal monitoring and overall evaluation purposes and provide valuable information for future planning. Examples of automated reports for oversight that firms might consider developing include the monitoring of relative fee size and overdue fees.

28. ACRA also noted from the staff interviews conducted that, in some firms, there is a moderately low level of familiarity with independence-related matters. For example staff were not aware of the firm's whistle-blowing policy and staff were unsure of who or which department to approach for clarifications in relation to independence concerns. ACRA is of the view that staff's awareness in respect of the required independence policies and considerations should be heightened. Such awareness could be incorporated as part of the core training to staff.
29. In terms of confidentiality of information, ACRA noted several instances where client confidentiality was compromised. Some of these instances include documents of sensitive nature not kept under lock and key or placed unattended in meeting rooms, staff inadvertently e-mailed information of one client to another client and the loss of a laptop which contained client information. In some firms, ACRA also noted that there were no formal written policies for the inadvertent loss of audit files.
30. Firms should not act as auditors of clients if its partners, employees or employees of its network firm serve as officers⁴ or as directors on the board of the assurance clients as this is in breach of paragraph 290.149 and 290.151 of the Code. Any non-compliance with the Code could result in disciplinary proceedings being instituted against the firms. Whilst routine administrative services to support a company secretarial function or advisory work in relation to company secretarial administration matters is generally not perceived to impair independence (provided client management makes all relevant decisions), ACRA would advise firms to ensure that client management is involved in such services and take due care to ensure compliance with the requirement of the Code.

(B) Acceptance and Continuance of Client Relationships and Specific Engagements
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31. A robust assessment of the risks of accepting or retaining clients is an important element of a strong quality assurance framework. Firms should obtain and assess the information it considers necessary before accepting an engagement with a new client or when deciding whether to continue an existing engagement, and must document the assessment made. Performing proper due diligence procedures during the acceptance and continuance process helps a firm identify and respond on time to significant audit matters. It also enables the firm to assess the risk of serving clients whose management lacks integrity and the risk of serving clients without the necessary professional competence and resources especially in the context of a group audit or when determining the need for an auditor's expert.
32. Whilst many firms reviewed have put in place policies and procedures designed to ensure that careful decisions are made as to whether potential audit clients should be accepted and whether pre-existing audit clients should be retained, there remains opportunities for improvement in the process and procedures performed, quality of documentation and retention of relevant documentation to support the client risk-ratings and client acceptance/continuance/cessation assessments.

⁴ Section 4 of the Companies Act defines officer as “in relation to a corporation, includes (a) any director or secretary of the corporation or a person employed in an executive capacity by the corporation;...”

Key Observations

(a) Retention of supporting documentation

33. SSQC 1.27(a) requires the firm to obtain information as it considers necessary before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client.
34. Most firms' policies require background checks to be completed for all prospective clients. These may include the identification of the directors from filings made by the company with the relevant filing authority, performing media and internet searches on the company to understand its history and reputation and obtaining curriculum vitae of directors and key management personnel, and review of relevant regulatory reports. One firm was noted to have used its network of contacts in the finance and investment community to look for informal positive affirmation of the potential clients/principals.
35. Most firms require some forms (either manual or electronic) to be completed to facilitate the collation of information to support the decision to accept the engagement. Apart from background checks, other information required includes consideration of risk factors (such as whether the prospective client is a public entity, planning initial public offerings or subject to any regulatory or legal actions, or assessment of country and industry risks), professional considerations (such as results of the independence conflict search) and audit considerations (such as predecessor auditors' matters).
36. However, these firms do not, as a matter of policy, retain the supporting documentation or document the work performed to support the background checks on the prospective client. It is important that the supporting documentation on and the results of the evaluation of background checks on the prospective client are retained together with the client acceptance documentation as evidence of proper due diligence performed by the firm. Such a practice would also ensure that the relevant and sufficient information is surfaced to the various evaluating partners who would require the information to perform a robust evaluation for risk management purposes.

(b) Procedural lapses

37. SSQC 1.26 and 1.27 provides that engagements should be accepted only upon the completion of a formal acceptance process. ACRA noted several cases where engagements were accepted before the detailed engagement risk assessment was carried out and documented. This could make it more difficult (though not impossible) for firms to decline the appointment should it subsequently discover unacceptable audit risks.
38. Other findings noted by ACRA include:
 - a. No evidence of work performed for background checks and analysis of financial statements;

- b. The approval of the independent reviewer in the client acceptance and engagement continuance decision had not been obtained even though such approval was required under the firm's policies;
 - c. Auditor's consent to act was issued prior to receipt of professional clearance from predecessor auditors; or prior to obtaining the requisite approval; or was not issued to the client;
 - d. The engagement letters were issued prior to the date of formal approval of the client acceptance and engagement continuance decision from the independent reviewer; and
 - e. Audit fieldwork was commenced prior to the completion of acceptance and continuance forms or receipt of client-acknowledged engagement letter.
- (c) ***Robustness of risk analysis***
39. It was noted that firms, in assessing the risks of prospective and continuing clients, do not explicitly consider the country risks and industry risks which may require the involvement of other professional staff within the firm or the need for an auditor's expert with specialised competencies. Although firms may have considered these matters informally, it is important for firms to make a formal assessment and document the assessment in acceptance and continuance forms. The early identification of risks enables the group engagement team to mobilise relevant expertise (internal or external) and seeks to drive the alignment of team resources to an optimal level commensurate with the audit risk(s) undertaken.
- (d) ***Risk rating***
40. ACRA's findings in this area include inadequate guidance on how audit teams should assign risk ratings to the firm's clients to ensure that audit teams consistently apply the guidance within the firm and the use of a risk rating system which is not sufficiently granular to clearly distinct the risk levels of different clients. For example, all listed companies are given the same default risk rating without going into appropriate unique details to identify whether each listed client is of a higher or lower risk when compared to other listed companies within the firm. Intuitively, a listed company with going concern issue or issue over the lack of management integrity should be assigned a higher risk rating as compared to less complex engagements with no known issues. A meaningful risk rating of clients will allow firms to properly assign the right level of partner and staff resources to engagements that require more attention and resources.
- (e) ***Linkage between the risk ratings and the nature, timing and extent of audit procedures***
41. In some firms, it was not evident that there was a clear linkage between the engagement risk ratings (determined during the acceptance process), and assessments and the nature, timing and extent of audit procedures. It is important to link the various risk categories to the nature, timing and extent of audit procedures so as to ensure that the risks identified during the client acceptance and continuance process are adequately addressed.

(f) *Instituting an independent level of review and approval*

42. ACRA noted that for most firms, there is involvement by independent parties such as the risk management partner or assurance leader to provide robust assessment on the acceptance of audit engagement of listed companies. However, the decision for client and engagement continuance for non-listed or “low risks” ratings audit clients or engagements rests entirely with the engagement partner in some firms. There exists a possibility that such engagements or clients would not be independently reviewed. As a best practice matter, firms should also consider involving independent parties in the assessment of client acceptance and continuance even for the non-listed engagements, particularly the sizable ones.

(g) *Client and engagement discontinuance*

43. It was noted in some firms there was no formal documentation on client cessations. In one instance, the firm’s resignation letter and latest client continuance form for client termination/withdrawal of service were not retained. In another instance, formal documentation is not required. As a best practice matter, firms should document significant issues, consultations, conclusions and the basis for the conclusions for all client discontinuance decisions. The duly completed documentation can serve as future references for discontinuance decisions and for risk management purposes.

Conclusion

44. A robust system of controls over the independent monitoring of independence and ethical matters is an important element of a strong quality assurance frame-work. SSQC 1 requires firms to put in place policies and procedures designed to address issues of independence and other ethical requirements. The importance of adherence to the firms’ policies and procedures should be reinforced through regular communication with partners and staff, training, robust compliance monitoring activities and an appropriate sanctions system for violations.

45. From a risk management perspective, it is important for firms to manage the risks associated with accepting and retaining clients. SSQC 1 requires firms to establish policies and procedures designed to provide the firm with reasonable assurance that it will only undertake or continue relationships and engagements where the firm (a) has adequate competencies and resources to perform the engagement; (b) can comply with relevant ethical requirements; and (c) has considered the integrity of the client.

Note: Please note that the contents of the Audit Practice Bulletin are provided for the guidance of public accountants to supplement prescribed professional standards, and include criteria that ACRA considers in evaluating the work of public accountants. They are not rules of ACRA and are not intended to serve as a substitute for the relevant auditing standards. Public accountants must observe, maintain and apply the prescribed professional standards, methods, procedures and other requirements in carrying out the audits of financial statements.