

**AUDIT PRACTICE BULLETIN NO 1 OF 2012**

**QUALITY CONTROL FOR FIRMS THAT PERFORM AUDITS AND REVIEWS  
OF FINANCIAL STATEMENTS, AND OTHER ASSURANCE AND RELATED  
SERVICES ENGAGEMENTS (PART 1)**

***LEADERSHIP RESPONSIBILITIES FOR QUALITY WITHIN THE FIRM***

**13 AUGUST 2012**

**Introduction**

1. The purpose of 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*<sup>1</sup> is to establish basic principles and essential procedures and provide guidance regarding a firm's responsibilities for its system of quality control.
2. The requirement for quality control is also provided in Singapore Standard on Auditing 220 *Quality Control for an Audit of Financial Statements* which deals with the specific responsibilities of the auditor regarding quality control procedures for an audit of financial statements and addresses the responsibilities of the engagement quality control reviewer.
3. SSQC 1 is applicable to **all** firms and requires that the firm "*establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements, and that reports issued by the firm or engagement partners are appropriate in the circumstances.*"
4. Having a system of quality control will provide a sustainable structure for ensuring consistency in audit quality without depending on any single individual to maintain the level of audit quality. Firms that invest in a robust system of quality control will be better positioned to maintain audit quality when faced with ongoing recruitment and retention challenges; and to respond to significant audit risks associated with increased complexity in financial reporting and a changing economic environment.

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<sup>1</sup> 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.

5. ACRA expects the system of quality control adopted by firms to comply with the requirements of SSQC 1. The nature and extent of the policies and procedures developed by an individual firm will depend on various factors such as the size<sup>2</sup> and operating characteristics of the firm, and whether it is part of a network.
6. SSQC 1 requires that the personnel within the firm responsible for establishing and maintaining the firms' system of control understand the requirements and objectives of SSQC 1 and to apply these requirements properly.
7. Because of the importance of a firm's quality controls, policies and procedures to audit quality, in the proposed amendments to the Accountants Act<sup>3</sup>, a firm may only perform audit or review of financial statements for public interest entities (PIEs<sup>4</sup>) if, in ACRA's opinion, it fulfils certain obligations and criteria and continues to meet such conditions. Further, a public accountant may only conduct a PIE engagement through a firm that meets such conditions.
8. One of the proposed pre-conditions in assessing a firm's capacity and preparedness to conduct a PIE engagement is the demonstrated compliance with SSQC 1. This approach is in line with international practice where audit regulators license and supervise firms that serve the capital markets. Firms may perform such audits only after the regulator has assessed their quality controls and other areas.
9. ACRA believes that the new conditions of approval would enhance the existing safeguards in place to ensure that PIEs appoint appropriate auditors on behalf of investors, thereby protecting the public interest and enhancing investor protection.

### **Objective of this publication**

10. ACRA has planned a series of Audit Practice Bulletins (APBs) to provide useful information to aid firms in the implementation of the system of quality control in each

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<sup>2</sup> SSQC 1.A75 states that "Smaller firms may use more informal methods in the documentation of their systems of quality control such as manual notes, checklists and forms."

<sup>3</sup> The public consultation paper on the Accountants Act review, which was issued in May 2012, can be accessed at <https://www.acra.gov.sg/legislation/legislative-reform/listing-of-consultation-papers/public-consultation-on-proposed-amendments-to-the-accountants-act>

<sup>4</sup> The proposed amendments to the Accountants Act seek, amongst other proposed amendments, to refine the definition of PIE.

of the six overlapping SSQC 1 elements<sup>5</sup>. Each APB will discuss some of the observations based on ACRA's inspection of firms which audit PIEs and also highlight areas for improvement in line with best practices. Whilst the findings are based on the inspection of firms which audit PIEs, the principles behind such findings would apply to all firms.

11. This APB will discuss the first element of SSQC 1 – *Leadership Responsibilities for Quality within the Firm*.

### **Key Observations**

#### **(a) *Commitment to Achieving High Quality Audit Work***

12. SSQC 1.18 provides that policies and procedures should be designed to promote an internal culture recognising that quality is essential in performing engagements. Leadership's commitment to and emphasis on quality audit work is a central element in creating the necessary "tone at the top".
13. During inspections, ACRA noted that the leaders of the firms generally expressed their commitment to achieving high audit quality. However, in some instances, ACRA observed that the internal management meetings were focused on practice development, financial indicators, staff utilisation and collection efforts.
14. To evident leadership's commitment to achieving high audit quality, ACRA would like to see that firms include as a standing agenda item, discussion of audit quality matters in internal management meetings. Such discussions should be led by the firm's senior management group to establish the appropriate tone at the top and demonstrate the leadership's commitment towards audit quality within the firm along with other important priorities. Minutes of these internal management meetings should also be taken to facilitate subsequent monitoring and progress of the matters discussed.

#### **(b) *Organisational Reporting Structure and Responsibilities***

15. SSQC 1.19 states that the person or persons who are assigned the operational responsibility for the firm's system of quality control should have sufficient and

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<sup>5</sup> The six quality control elements set out in SSQC 1 are leadership responsibilities for quality within the firm, relevant ethical requirements, acceptance and continuance of client relationships and specific engagements, human resources, engagement performance and monitoring.

appropriate experience and ability, and the necessary authority, to assume that responsibility.

16. A firm's management and reporting line structure should support the firm's emphasis on the quality of its professional work. In some firms, the Head of Audit has the responsibility for the growth and commercial success of the firms. Under certain circumstances, the assignment of such responsibilities may compromise the objectivity of the Head of Audit and raise the possibility that decisions on audit quality matters could be inappropriately influenced by commercial considerations.
17. ACRA has also noted instances whereby partners who did not pass their practice reviews were either appointed or continued to occupy positions within the firm that decide on technical matters affecting audit quality. This appeared counter-intuitive. It is imperative for firms to set the right tone at the top to affirm that it takes a serious view on unsatisfactory quality review outcomes.

*(c) Setting of growth targets and risk levels*

18. SSQC 1.A5 states that in promoting an internal culture based on quality, there is a need for the firm's leadership to recognise that the firm's business strategy is subject to the overriding requirement for the firm to achieve quality in all the engagements that the firm performs.
19. In principle, the firm's leadership should not set aggressive growth targets that will encourage the partners to grow the practice and increase market share without regard to whether the firm has sufficient personnel with the necessary competence and capabilities to support a quality audit. Inappropriate growth targets may encourage the acceptance and continuance of client relationships at fees below a reasonable level required to enable firms to deliver quality audits to their clients.
20. When reacting to pressures of competitive audit fees and rising operating costs, firms may reduce the resources and extent of audit procedures to maintain profitable practices. At times, such measures are shrouded as efficiency or productivity movements. Firms should continuously invest in recruiting and training audit staff, and should not reduce audit effort even when operating under fee pressure.
21. For risk management purposes, firms should decline appointments or re-appointments in circumstances where the proposed fees are below the level required to deliver a quality audit commensurate with the level of audit risk or where the firm has insufficient

personnel with the necessary competence and capabilities to deliver quality audits to their clients.

**(d) *Communication on the importance of quality***

22. SSQC 1.A4 provides that the promotion of a quality-oriented internal culture depends on clear, consistent and frequent actions and messages from all levels of the firm's management emphasising the firm's quality control policies and procedures.
23. An important factor in support of audit quality lies in the way the firm communicates its commitment to audit quality to its partners and professional staff. Some firms have taken the initiative to engage their staff through town hall sessions, monthly meetings or internal emails to communicate the firm's policies and promote quality audit work or to reward their staff for possessing exemplifying values such as professional scepticism, quality, integrity, respect, teaming and enthusiasm. Such internal communications and initiatives help to reinforce the firm's commitment to quality.
24. Another important factor underpinning the quality of audit work is the image a firm tries to project as evidenced by external documents. Firms should perform audits in accordance with the required auditing standards and avoid making public statements that suggest that audit quality could be tailored to the client's needs. This may give the wrong impression that audit quality could be compromised to meet the client's demands.

**(e) *Putting appropriate resources in place***

25. SSQC 1.A6 states that sufficient and appropriate experience and ability enables the person or persons responsible for the firm's system of quality control to identify and understand quality control issues and to develop appropriate policies and procedures. In ensuring the quality of audit work, it is important that a firm dedicates sufficient resources for the development, documentation, support and monitoring of its quality control policies and procedures.
26. Partners who assume leadership roles in key audit quality functions such as technical, risk management, training and human resources should have sufficient competence, experience and clout to enable them to discharge their responsibilities effectively. In allocating resources to support the quality control functions, the firm should take into account its size and complexity of its engagements and reassess the sufficiency of the resources dedicated to these functions as the firm grows.

27. ACRA noted that some firms set up various internal committees to deal with specific emerging audit risks (e.g. impairment issues during the global financial crisis) and to support the work of the technical department. However, in one instance, one of the technical committees has, in fact, not met for several years. This raises the question of form over substance and the effectiveness and relevance of such an inactive committee.
  28. Some firms have made commendable efforts in instituting annual internal quality reviews. This is even more important for smaller firms which are not subject to any external (e.g. network) monitoring process. Periodic quality reviews will help to sharpen the practice and identify weaknesses that may have gone undetected by the practitioners. Smaller firms should tap on quality review services offered by consultants or professional bodies. More details on the monitoring process will be discussed in the APB on Monitoring.
- (f) Engagement partner and engagement quality control review (EQCR) partner involvement***
29. Enhancing engagement supervision and review is essential to improving audit quality. ACRA would like to emphasise the importance of the active and continuous involvement of the engagement partner in the audit engagements. The engagement partner is responsible for the performance of the audit and the issuance of the auditor's report.
  30. Based on the statistical data collected by ACRA, the recorded time involvement by engagement partners and EQCR partners were generally found to be inadequate and could often be corroborated with the nature and frequency of audit deficiencies identified in sample engagements selected for inspections. The impact of insufficient partner involvement on audit quality is further aggravated in situations where the staff turnover is high, the average years of experience of professional staff is low or inexperienced engagement team members are assigned to audit the more complex or high risk areas without adequate and timely supervision.
  31. In the client allocation process for partners, some firms have adopted quantitative guidelines (such as the total audit fees and maximum number of listed clients with the same financial year-end to be handled by each partner) as a means to ensure that engagement partners have sufficient time to perform the role and that there is no excessive concentration of engagements on any individual partner.

32. There was an instance where a partner was allocated 16 listed companies, in breach of the firm's own allocation guidelines, and he was also the EQCR partner for another 5 companies (14 out of the 21 companies had the same financial year-end). This raised serious concerns about the ability of the partner to spend adequate time on each of the engagements assigned to him either as an engagement partner or an EQCR partner. The firm was advised to monitor the situation and reduce the partner's portfolio to a reasonable level.

33. ACRA would advise that the client allocation decision should take into consideration any existing functional responsibility for the firm's system of quality controls assigned to each partner to ensure that partners responsible for the quality control functions of the firm have sufficient time and resources to perform their management and oversight roles as well as client work.

**(g) *Linking quality and partner compensation***

34. SSQC 1.A5(a) states that promoting an internal culture based on quality includes the establishment of policies and procedures that address performance evaluation, compensation, and promotion with regard to its personnel. A strong and well understood linkage between audit quality and partner performance evaluations and compensation can be an effective tool in driving up audit quality within the firm.

35. Whilst some firms may have implicit consideration of audit quality during the evaluation/compensation process, incorporating audit quality indicators and giving them clear and sufficient weightings in the partner evaluation and appraisal processes will ensure partners are adequately motivated to upkeep high audit quality.

36. Without a clear set of assessment criteria based on drivers of audit quality, performance behaviours may be driven towards meeting minimum standards to avoid negative outcomes and unlikely to be driven towards achieving high quality audit. For example, there should be a clear linkage between the outcome of the various monitoring reviews (e.g. internal reviews, network reviews, ACRA's practice reviews) conducted on the individual partners and their compensation.

37. ACRA noted several instances where it was not evident that the effectiveness of the functional responsibilities, assigned to partners responsible for firm level system of quality controls, had been performed as part of the performance appraisal for these partners. The absence of such assessments may not encourage operating effectiveness of the quality control function as well as accountability towards audit quality.

38. From the review of a sample of performance appraisals for partners, ACRA noted that the partner evaluation process in some firms appeared rather informal. For example, there were numerous instances where the partners' appraisal forms had no or little documentation to support the performance ratings. Just as performance appraisals are important for the professional staff development, similar principles should be applied to partners who take personal responsibility for ensuring the quality of audits performed. Firms should ensure that partner performance appraisals are performed and properly documented.
39. In principle, audit quality should be an important component of an audit partner's performance assessment and the partner's overall performance assessment should not be overshadowed by non-audit factors. As a best practice, firms could also consider implementing a policy that requires functional leaders of the firm to provide peer appraisal inputs on how effective each partner was performing in each of the six SSQC 1 elements.
40. It is common for smaller firms to have a less formal partner performance appraisal process in place and the partners to share profit based on partnership agreements. To ensure accountability towards audit quality and to protect partners from poor audit practices, these firms should consider incorporating audit quality as a component in the profit sharing arrangements as well.
41. The EQCR partner plays an important role in upholding audit quality in audit engagements where such involvement is required. An effective appraisal system should be in place to monitor and assess the involvement and quality of the work performed by the EQCR partner. Linking the results of such EQCR evaluations to the EQCR partner's compensation could be an effective tool for promoting and enhancing the important contribution of the EQCR partner to audit quality.

**(h) *New partners admission***

42. When admitting new partners, appropriate consideration should be given to the partner candidates' ability to deliver audit quality, to comply with ethical principles of the profession, and to coach and mentor professional staff. In most firms, ACRA noted that the forms supporting a candidate's admission to the partnership had little or no comments and did not specifically address the audit quality consideration. There should be a robust documentation in the performance appraisal of a partner candidate to support the case for his promotion to partner.

43. As a best practice matter, firms could consider implementing a policy to expose potential partner candidates to performing quality control functions on a rotation basis so that they could benefit from such professional development before their intended promotion. The work experience on quality controls is likely to benefit these candidates when they are promoted to partner grade and are expected to perform as engagement partners for audits.

### **Conclusion**

44. Leadership Responsibilities for Quality within the Firm, which is referred to as “tone at the top” is an important element of a strong quality control system within a firm. ACRA encourages firms to continuously demonstrate their commitment to quality by putting in place the necessary policies and procedures to support audit quality.

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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.