Quality Control Environment of Statutory Audit in India

Quality control policies and procedures adopted by accounting firms are significant in ensuring quality of audit. In pursuance to the Standard on Quality Control (SQC)-1 and Standard on Auditing (SA)-220 issued by the Institute of Chartered Accountants of India (ICAI), quality control for statutory audit is conducted in India. The study is an attempt to review these two standards with respect to a particular engagement and measures taken by the Council of Institute of Chartered Accountants of India to enforce those standards. The study observes that quality control framework in India is quite comprehensive and in line with international requirements. However, more initiatives are to be taken to enforce these standards to institute a better quality control environment and avoid corporate scams like Satyam in future. Read on to know more…

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Introduction

Corporate enterprises often opt for earnings management using ambiguities in financial reporting framework and depict a gleaming financial status of the company to bring about their goal. This lop-sidedness in information between management and stakeholders often provide the erroneous notion about the future of company's financial position spoiling their interest. Truly speaking, statutory audit of financial statements reduces this information asymmetry in protecting stakeholders' interest (Becker, et al, 1998). It involves corroboration of financial statements of the corporate enterprise by a skilled authority independent to the organisation. Statutory auditors form an independent view about financial statements based on sufficient and appropriate audit evidences and report the same to the shareholders of the company. Professional skepticism or a questioning mindset of the auditors is very significant in this respect. An audit is presumed to be a quality audit if the auditor is able to perceive and expose any questionable accounting practices and infringement of applicable accounting regulation in the financial statements. If misreporting on the part of the management is revealed, the corporate entity would face problems in the capital market. Hence, quality audit is more likely to make out earnings management as well as accounting fraud and uphold stakeholders' interest and vice versa (Deis & Giroux, 1992). Professional institutes and other regulatory bodies governing statutory audit operations in different countries have issued certain regulatory pronouncements to ensure audit quality. Compliance with fitting professional and ethical standards and issuing report which is apt in particular situation is the basic pre-requisite of audit quality. However, in recent corporate failures [e.g. Enron, Com Road, Satyam, etc.], it has been proved repeatedly that statutory auditors failed to perform quality audit to their client companies and hence failed to protect stakeholders' interest to some extent. With a view to motivating this declining trend in audit quality, a significant number of regulatory processes have been taken over the years (Francis, 2004). Accounting firms which are accountable for providing audit services took radical role in controlling audit quality. They formulated quality control policies and implemented them for all their professional engagements.

India, being one of the fast growing countries of the world in terms of their GDP has a well-structured regulatory framework. It witnessed a constant growth in industrial sector as well as in service sector. Indian businesses are spreading their arms in the international arena. So, it becomes imperative for the Indian regulators to look into the interests of global stakeholders.

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Hence, the Institute of Chartered Accountants of India (ICAI) issued Standard on Quality Control-1 (SQC-1) to monitor quality control policies of Indian accounting firms. According to the Chartered Accountants (Amendment) Act, 2006, the Central Government constituted a Quality Review Board to review quality of services provided by the members of the ICAI and to steer them in improving quality of service and to suggest Council of the Institute of Chartered Accountants of India to take necessary action (Agarwal, 2015). In this backdrop, the current study is an attempt to conceptually review the regulatory environment governing quality control procedures for statutory financial audit in India.

Quality Control Procedures in India

In India, responsibilities of the firm's personnel regarding quality control procedures for specific types of engagements are set out in accordance with Standards on Auditing (SAs) issued by Auditing and Assurance Standards Board (AASB) under the direction of the Institute of Chartered Accountants of India (ICAI). In addition to that the Companies Act, 2013, the Chartered Accountants Act, 1949 (Amended in 2006), Code of Ethics also comprise the other legal and regulatory requirements to be fulfilled by an accounting firm and its members. In case of auditing, a system of quality control provides a reasonable assurance that the accounting firm and its human resources have complied with applicable professional standards, and other legal and regulatory requirements and the reports issued by the engagement partner are appropriate in circumstances. A system of quality control basically encompasses 'Policies' designed to achieve the aforementioned objectives and the 'Procedures' necessary to monitor compliance with those policies. In order to bring consistency in policies and procedures of different accounting firms registered under the ICAI, a Standard on Quality Control (SQC) –1 titled *'Quality Control for firms that perform Audits and Reviews of Historical*

Financial Information, and other Assurance and related Services Engagements' has been issued which is appropriate to all accounting firms. The nature of policies and procedures formulated by individual firms based on SQC-1 depends upon their dimension and functioning characteristics. It is obvious that SQC-1 plays a major responsibility in guiding an accounting firm to devise quality control policies and procedures for all its engagements. From stakeholders' standpoint, audit and review of historical financial information is the most important engagement undertaken by an accounting firm. Hence, policies and procedures developed in accordance with SQC-1 apply to it as well. Accounting firms put those policies into practice with the help of the Engagement Partner appointed as statutory financial auditor in a particular company. Select SAs including SA-220 titled *'Quality Control for an Audit of Financial Statements'* provide guidance to the Engagement Partner with respect to implementation of quality control policies and procedures.

Quality Control by Procedure enforced Accounting Firm in the light of SQC-1

Standard on Quality Control (SQC)-1 titled, *'Quality Control for Firms that Performs Audits and Reviews of Financial Statement, and Other Assurance and Related Service Engagements*' issued by the ICAI provides a complete directive to an accounting firm for formulation of quality control policies and procedures. The firm refers to all sole practitioners, proprietorship or partnership firm or any entity of professional accountants. SQC-1 is designed based on International Standard on Quality Control (ISQC)-1 issued by International Auditing and Assurance Standards Board (IAASB) under the International Federation of Accountants (IFAC) keeping in mind specific requirements of Indian economic setting. Therefore, SQC-1 has some differences from its mother standard in terms of its extent and select provisions. Major differences include:

- ISQC-1 defines a firm as 'sole practitioner, partnership, corporation etc. In the definition of SQC-1, a new section as 'proprietor' has been included and 'corporation' has been deleted;
- ISQC-1 has some separate provisions for public sector entities. SQC-1 does not have such provisions.

Other differences between these two standards are discussed while discussing each of the fundamental elements of SQC-1. Provisions of SQC -1 are applicable irrespective of the nature, extent and degree of operation of the entity. Policies and procedures formulated by an accounting firm based on SQC-1 address some elements: (a) Leadership responsibilities for quality within the firm; (b) Relevant ethical requirements; (c) Acceptance and continuance of client relationship and specific engagements; (d) Human resources; (e) Engagement performance; (f) Monitoring; (g) Documentation of the System of Quality Control. Now, let us talk about these issues individually in the light of SQC-1.

Standard on Quality Control (SQC)-1 titled, *'Quality Control for Firms that Performs Audits and Reviews of Financial Statement, and Other Assurance and Related Service Engagements'* issued by the ICAI provides a complete directive to an accounting firm for formulation of quality control policies and procedures. The firm refers to all sole practitioners, proprietorship or partnership firm or any entity of professional accountants.

3.1 Leadership Responsibilities for Quality within the Firm

The main responsibility of a Chief Executive Officer (CEO) or managing partner of a firm are imparting inner culture and delegating operational responsibilities to other members to fulfill with quality control policies and procedures of the firm.

3.2 Relevant Ethical Requirements

The firm should set up policies and procedures designed to provide it with logical assertion that the firm and its personnel observe pertinent ethical requirements laid down under the Code of Ethics issued by the ICAI. The Code establishes the elementary principles of professional ethics, which include (a) Integrity; (b) Objectivity; (c) Professional competence and due care; (d) Confidentiality; and (e) Professional behaviour.

A theoretical approach to independence for assurance engagements along with aspects such as threats to independence, accepted safeguards and the public interest are included in the Code. The firm should ensure observance with independence obligation as per the ICAI Code of Ethics in all of its engagements. Specific responsibilities of a firm in relation to observance with independence

> **A firm before accepting an engagement should acquire essential information about an audit client and judge whether it can perform the engagement with required capability and sovereignty.**

requirement which forms the foundation of policy formulation are cited as follows:

- Communication of independence requirement to engagement teams;
- Requiring engagement teams to provide necessary information on the audit client to the firm to recognise possible threats to independence;
- Applying suitable safeguards to decrease these threats to satisfactory level;
- Dealing with contravention of independence requirement; and
- Obtaining written substantiation from all engagement partners about observance with independence requirement.

SQC-1 considers familiarity threat to be a significant threat to the independence of engagement partners. Engagement partners should be rotated after a period of 7 years apart from situations where the audit client is a listed entity and the engagement partner is a sole practitioner or proprietor. SQC-1 differs from ISQC-1 on this point. Moreover, SQC-1 also mandates peer review of specific engagements to lessen likelihood of familiarity threat which is not mandatory as per ISQC-1.

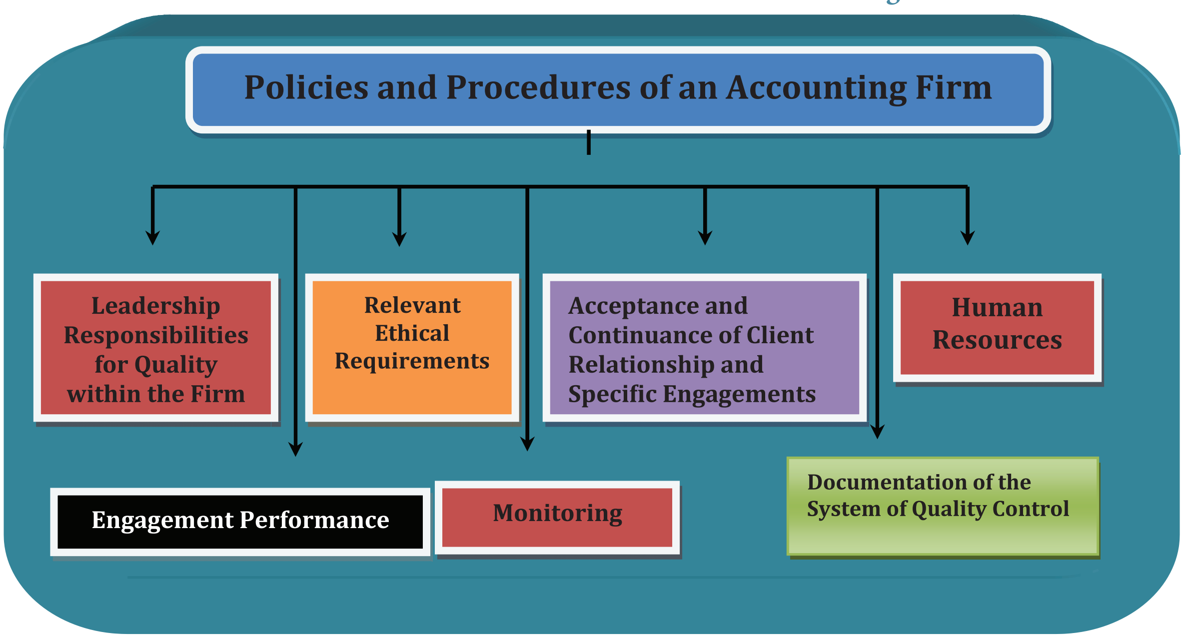
3.3 Acceptance and Continuance of Client Relationship and Specific Engagements

A firm before accepting an engagement should acquire essential information about an audit client and judge whether it can perform the engagement with required capability and sovereignty. If there is any conflict of interest between the firm and audit client (as per the provision of Code of Ethics and Guidance Note on Independence of Auditors), it should be properly resolved before accepting the engagement. Where the firm obtains information that would have caused it to turn down an engagement if that information had been obtainable in advance, the firm is required to report to the person or persons who made the appointment or in some cases, to regulatory authorities and think about whether it is possible to depart from the engagement.

3.4 Human Resources

Each engagement team should be able to carry out their responsibilities with necessary competence, skill and independence. Therefore, the firm needs to employ suitable people and develop them for their role. The firm should assess performance of their partners and members keeping in mind their obligation towards quality.

Exhibit-1: Policies and Procedures of an Accounting Firm



(Source: Compilation based on SQC-1)

3.5 Engagement Performance
Major responsibilities of a firm in relation to engagement performance are as follows:

- Briefing the engagement teams of their objectives, procedure of complying with engagement standards, course of reviewing, supervising and documenting engagement procedure;
- Supervising engagement performance; and
- Reviewing engagement performance.

(a) *Consultation*
The firm or any of its engagement team should take consultation on tricky and controversial matters and apply the conclusion reached from those consultations.

(b) *Engagement Quality Control Review (EQCR)*
Important judgments taken in an audit engagement should be reviewed by an Engagement Quality Control Reviewer. The EQC Reviewer should be duly competent external person. As per SQC-1, he should be a member of the ICAI. But as per ISQC-1, members of other professional bodies certified to offer quality control services are also authorised to be EQC Reviewer. The reviewer should take into deliberation following issues for conducting review:

- Financial and other matters based on which engagement report is issued;
- Compliance with independence requirement;
- Consultation taken on complicated matters;
- Communication with those charged with governance or regulatory bodies;
- Significant judgments made by engagement team.

Apart from fulfilling the criterion of having obligatory competence and independence, the reviewer should be member of the ICAI. This is not an essential condition as per ISQC-1.

(c) *Difference of Opinion*
If engagement team has any argument with consultant or engagement quality control reviewer, they should determine it before publication of the report.

(d) *Documentation*
Each engagement team should complete the final assemblage of engagement files after the engagement report gets published and should take appropriate measures for discretion, safe custody, truthfulness and suitability of the engagement documents. Engagement documents should be able to be retrieved as and when required. As per the provision of this standard, engagement documentations are required to be kept for a period of 7 years whereas it is required to be kept for a period of 5 years as per ISQC-1.

3.6 Monitoring
The firm is required to observe quality control of its engagement based on following set of activities:

- Deciding whether quality control policies of the firm are appropriately designed and implemented;
- Examining whether current developments in the laws have been reflected in the quality control policies;
- Conducting scrutiny of an engagement procedures by an engagement partner on a recurring basis without giving prior allusion to the engagement team;
- Dealing with accusation against the firm or any employees of it of non-compliance with appropriate regulatory requirements by a person within or outside the firm;
- Taking punitive actions against the members who did not conform to quality control policies;
- Examining deficit in the quality control policies and taking remedial actions.

3.7 Documentation of the System of Quality Control
The firm should document following issues pertaining to their quality control procedure:

- Conformity with independence and other regulatory obligation by the engagement teams;
- Issuance of report by engagement teams which are suitable in circumstances;
- Course of monitoring by the accounting firms, etc.

A firm based on the requirements stated above set policies and procedures subject to their firm specific requirements. It may so happen that the firm is required to take supplementary policies in some segment of quality control whereas few requirements could be superfluous for a firm. Based on the policies and procedures taken by the accounting firm, each engagement team devises its quality control policies which are basically governed by SA-220.

Quality Control Procedures enforced by the Engagement Partner in the light of SA-220

An engagement partner maintains quality of an audit engagement subject to the provision of

SA-220 is designed based on ISA-220 keeping in mind the specific requirements of Indian economic environment. Application and other explanatory material of International Standard on Audit (ISA)-220 deals with specific provisions of the standard for public sector companies.

Standard on Audit (SA) –220 titled, *'Quality Control for an Audit of Financial Statement'*. It sets out the responsibilities of an engagement partner and an engagement quality control reviewer in an audit engagement. SA–220 is designed based on ISA–220 keeping in mind the specific requirements of Indian economic environment. Application and other explanatory material of International Standard on Audit (ISA)–220 deals with specific provisions of the standard for public sector companies. But all the standards issued by the ICAI relate equally to all entities irrespective of their nature, form or size. The elements of SA-220 seem to be very much similar to that of the elements of SQC-1. However, their applicability and enforcing authority are completely different. While SQC-1 is applied for the entire accounting firm and enforced by the CEO of the firm, SA-220 is applied to a particular audit engagement and enforced by the lead engagement partner of that engagement. Now, the major elements of this standard are discussed below:

4.1 Leadership Responsibilities for Quality on Audits

Leadership responsibility of the engagement partner in an audit engagement is to take responsibility for the overall quality of each audit engagement.

4.2 Relevant Ethical Requirements

Main objectives of an engagement partner in relation to pertinent ethical requirement in an audit engagement are as follows:

- Recognise cases of non–compliance with applicable ethical requirements and take suitable actions;
- Spot possible threats to independence in an audit engagement and apply fitting safeguards to lessen those threats to satisfactory level;
- Take decision on departure from engagement if threats cannot be reduced to tolerable level.

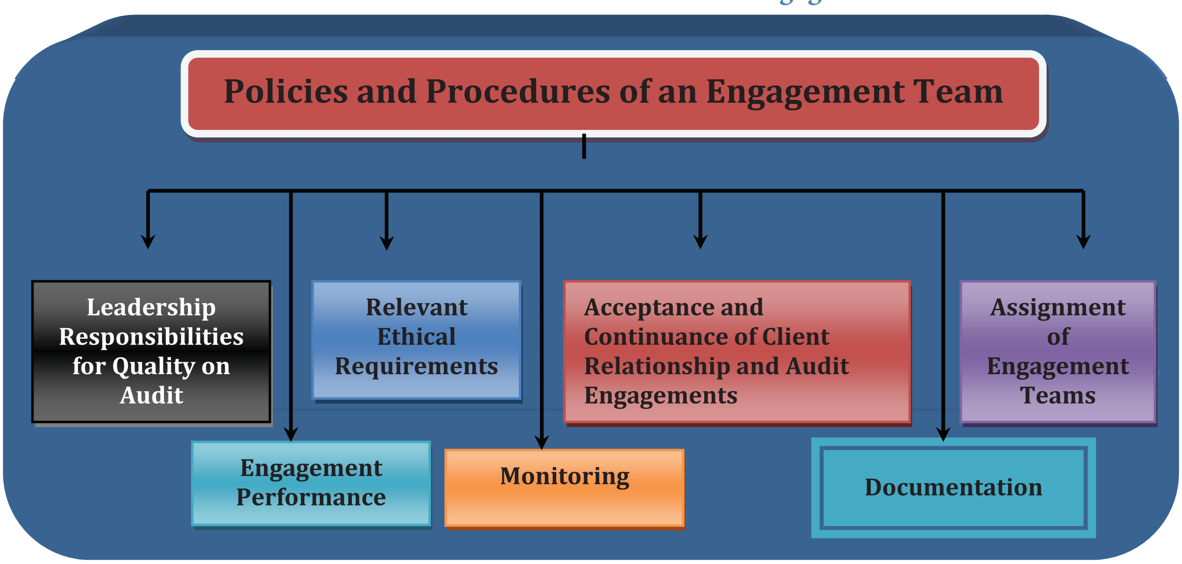
4.3 Acceptance and Continuance of Client Relationship and Audit Engagements

The main responsibility of an engagement partner in this regard is to accept or continue an audit engagement subject to accomplishment of competence and independence requirement.

4.4 Assignment of Engagement Teams

The engagement partner should make sure that all the partners in the engagement team including the auditors' expert and consultant have requisite competence and understanding of the client's business to carry out their role effectively.

Exhibit-2: Policies and Procedures of an Engagement Team



(Source: Compilation based on SA-220)

4.5 Engagement Performance

Precise responsibilities of an engagement partner in relation to performance of an audit engagement are summarised as follows:

- Directing, supervising and performing the engagement fulfilling quality criteria;
- Reviewing audit documentation to guarantee that adequate and suitable audit evidences have been collected;
- Taking consultation on complicated and debatable matters;
- Determining whether Engagement Quality Control Review (EQCR) is required to re-examine noteworthy judgments in an audit engagement before the date of audit report is announced;
- Resolving argument with the consultant or engagement quality control reviewer on significant matters pertaining to engagement.

If EQCR is considered essential, precise responsibilities of the reviewer as per the provision of this standard can be summarised as follows:

- Discussing important matters with engagement partner and reviewing financial statements and select audit documents based on which considerable judgments have been taken;
- Evaluating aptness of the conclusion reached at Audit Report;
- Considering engagement partner's assessment of independence of engagement team and consultation taken on hard and arguable matters;
- Evaluating whether audit documents selected for review, mirror work performed in relation to major judgments and suitability of conclusion reached.

4.6 Monitoring

As a part of monitoring process, the engagement partner should gather information on firm's monitoring process and judge whether deficiencies found in firm's system of quality control could influence the particular audit engagement.

4.7 Documentation

The engagement partner should document following matters relating to quality control of a particular audit engagement:

- Observance with pertinent ethical and independence requirement by engagement team;
- Foundation for accepting or continuing with an audit engagement;

The basic responsibility of the Quality Review Board is to review the quality of services of the professional accountants and recommending best practices. QRB had initiated the review process in the year 2012.

- Conclusion on consultation;
- The method of EQCR;
- Assertion that EQCR was complete before publication of audit report.

Unsettled matters unknown to the reviewer that would lead the reviewer to consider that important judgments made by the engagement team and conclusion reached were not fitting. The engagement partner formulates policies and procedures to perform aforesaid requirement and maintain quality in overall audit procedure.

Quality Review Board: An Initiative of the ICAI

In pursuance to Section 28A of the Chartered Accountants (Amendment) Act, 2006, a Quality Review Board (QRB) has been constituted by the Central Government. Members of this board are nominated by the Council of Institute of Chartered Accountants of India and the Central Government. The basic responsibility of this board is to review the quality of services of the professional accountants and recommending best practices. QRB had initiated the review process in the year 2012. The review process includes a review of feature of an accounting firm's auditing of financial statements. The major focus of the review is on conformity with technical standards, other laws and regulations, quality of reporting and firm's quality control framework. It also includes firm's practices, policies and procedures on certain aspects. With the help of a 'Quality Review Programme General Questionnaire', QRB gathers data about diverse aspects of a firm, such as quality control, ethical requirement and auditor independence, leadership and responsibilities, assurance practices, client relationships and engagements, human resources, consultation, difference of opinion, engagement quality control review, engagement documentation, audit planning and risk assessment, audit sampling and other selected testing procedures, written representations and auditors' report. QRB on the basis of this data identifies the deficiencies in audit procedures and communicate it to the accounting firm as well as the Council of Institute of Chartered Accountants of India (Agarwal, 2015).

Conclusion

The study observes that a system of quality control for statutory audit of financial statements prevails in India. In line with international standards, the ICAI, premier accounting body, has issued SQC-1 and SA-220 to monitor the quality control practices in Indian accounting firms. However, other SAs, Code of Ethics issued by the ICAI, Indian Companies Act, 2013, Chartered Accountants Act, 1949 in India also facilitate the quality control process and make sure that statutory auditors comply with relevant technical standards and issue reports which are appropriate in diverse situations. In order to achieve a comprehensive system of quality control, the leadership structure of the firm and leadership qualities of an engagement partner is very important. However, appropriate policies can be employed only when they follow the relevant ethical requirements laid down in the Code of Ethics. Policies with respect to acceptance and sustenance of clients are very important to an accounting firm. Engagement teams make their policies through continuous consultation with the firm. The firm also adopts certain policies for the human resource which are also referred by the engagement partner while assigning responsibilities to the engagement team. A firm also has policies for overall engagement performance. If there is need for consultation or EQCR for a particular engagement, the firm monitors them appropriately. Engagement performance follows monitoring. On a recurring basis the policies and procedures are monitored at the firm as well at the engagement level. The entire process of quality control is finally documented. There are a few points of differences between SQC-1 and ISQC-1, while they are almost similar in terms of their provisions. Hence, regulations with respect to quality control are adequate in India though a proper enforcement is necessary. QRB recently set up by the Central Government is doing phenomenal role in this respect under the leadership of the ICAI.

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Be yourself. Everyone else is already taken. - Oscar Wilde