Benefits of Effective Quality Control Systems in Accounting Firms

Seeing the Big Picture

By Catherine Allen

Whether small or large, accounting firms should strive to see beyond the simple compliance achieved through effective quality control (QC). AICPA Statement on Quality Control Standards (SQCS) 7 (recently clarified as SQCS 8) states that an effective QC system provides reasonable assurance that a firm's accounting and auditing practice and its personnel comply with professional standards, follow laws and regulations, and issue appropriate attest reports. The value of a strong, effective QC system is often viewed solely through the lens of professional and regulatory compliance. Nevertheless, robust QC provides other considerable benefits that strengthen a firm financially and promote continual growth.

An effective QC system consists of the following elements:
- Leadership responsibilities for quality within the firm (i.e., "tone at the top")
- Compliance with relevant ethical requirements

■ Acceptance and continuance of client relationships and specific engagements
■ Human resources
■ Engagement performance
■ Monitoring.

While all of the elements are critical to having an effective QC system, the sixth element—monitoring—is indispensible, because monitoring controls test the firm's QC system to ensure that underlying controls are appropriately designed and working properly.

Real-Life Experiences

To obtain insight into the real-life experiences of practitioners, the author conducted one-hour telephone interviews with professionals from nine accounting firms who are responsible for maintaining or overseeing their firms' QC systems. Practitioners were affiliated with firms ranging from the 79th- to the fifth-largest in the United States in terms of revenue (according to *Accounting Today*). These firms may be larger than most, but professionals from organizations of all sizes should take note: The survey firms have prospered through the last several years' economic highs and lows. Leading the way in terms of growth and QC, they share instructive experiences, relevant to all.

Though all six elements of QC were discussed during the interviews, the second element—compliance with relevant ethical requirements—provided a focal point. As expected, participant experiences illustrate significant benefits—in addition to compliance with professional and other regulatory standards—that accrue to firms with effective QC systems. These benefits may be categorized as follows:

■ Greater competitiveness and client retention
■ Superior risk management
■ More informed decision making
■ Enhanced firm culture and internal communications
■ Stronger sense of accountability and inclusiveness
■ Greater adaptability and preparedness
■ Enhanced employee recruiting, retention, and morale
■ Increased profitability.

Competitiveness and Client Retention

Having an excellent QC system may not land every desired client. On the other hand, firms compete for the best clients and a deficient QC system (among other things) can greatly diminish competitiveness in the marketplace (see the *Sidebar*, "Consequences of QC Deficiencies"). One participant noted that successful peer reviews and other regulatory reviews contribute to confirming that a firm does quality work. Government Auditing Standards (GAS) require firms to provide their most recent peer review report to prospective clients, and a proposed provision also requires the firm to provide any subsequent peer review reports received during the contractual period. Competition is fierce, and more clients are seeking those reports—even when a requirement (such as GAS) does not exist. Another participant said: "We didn't have a letter of comment last year. That's been a real positive for us. Some of these clients are in small communities and word gets around—who are the quality firms?"

The tenuous economic environment of the last few years has made getting and keeping the best clients even more critical. With fee pressures mounting and client loyalty diminishing, the best clients want to know they are getting good value and quality for their money. Wendy Stevens, partner in charge of the quality assurance team of WeiserMazars LLP, described quality as a big circle—if you keep quality people, your clients will be happy, adding: "I go back to a song I learned somewhere along the way, 'Simply the Best.' That's what we're aiming for and what we want to translate to our people and clients. At the end of the day, that should elevate your client list."

Risk Management

Several survey firms cited better risk management as a key benefit of an effective QC system. This is especially important in troubled times, when more businesses fail and more lawsuits are filed. Tom Childers, assurance quality control director of Elliott Davis LLC, noted that having a solid QC system in place can reduce engagement risk to its lowest level possible. "All of these procedures help to protect the firm and produce a better product, which helps you with your reputation in the community." To mitigate their increased risk, survey firms have (among other things) assigned more unassociated reviewers to engagements, required more consultations, improved documentation, and flagged financially troubled clients.

All participants noted the importance of having risk-based QCs over client acceptance and continuance. Anita Ford, CPA, CFE, partner, chief practice officer of Clifton Gunderson LLP, stated: "Client acceptance and continuance policies and procedures are absolutely critical. Having bad clients is as bad as—or worse than—doing bad work." Survey firms have strengthened their processes for evaluating new clients and engagements, reassessed existing clients, and placed laser-like focus over high-risk engagements. While some may see the additional scrutiny and possible rejection of certain clients as anti-growth, said one participant, "That's not where we want to grow." At least one survey firm does background checks on every new attest client the firm considers.

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Firms have also beefed up their required consultations to address additional risks caused by a weaker economy. But consulting alone is not always enough. As Ford described, at the end of the consultation process, the QC professional and the engagement team generally come to the same conclusion, but the initial documentation is often not sufficient to make the case. By the end of the consultation process, she said, the documentation has been improved: "From a risk management standpoint, this was huge. There's a lot of risk to the firm if a client goes down ... there may have been good evidence at the time, but we don't want it in the partner's head. We want it documented in the work papers."

Informed Decision Making

By evaluating their monitoring results, firms can make informed decisions about enhancing their QC systems. Eddie Dutton,

CONSEQUENCES OF QC DEFICIENCIES

Firms that fail or receive low grades on outside reviews of their QC systems face certain unpleasant consequences, including the following:

AICPA Peer Reviews. Some of the consequences of a peer review that will result in a "pass with deficiencies" or "fail" are:

- All of the deficiencies may be identified in the report as well as the sectors in which those deficiencies arose (e.g., audits performed under government or Department of Labor standards). This would not bode well for a firm whose practice derives a large proportion of its revenues from one of these sectors.
- Entities requiring audits under Circular A-133 and other government (and some non-government) organizations require firms to attach a copy of their most recent peer review to the proposal or engagement letter.
- Some state accountancy boards require firms to disclose their peer review findings to the state, which can result in the state opening an investigation against the firm or individuals involved.
- The firm must provide a comprehensive, feasible, genuine response to the deficiencies noted in the report with a plan for remediating them. If this response is not provided, the firm may be terminated from the peer review program for non-cooperation.
- The firm will likely be required to complete some type of remedial or corrective action as a condition of acceptance of the peer review. If the action is not completed, the firm may be terminated from the peer review program for non-cooperation.
- If a firm is terminated from the program, members of the firm will lose their membership in the AICPA and possibly the state CPA society. The names of terminated firms are posted to the AICPA's website.
- A peer reviewer should recommend how the firm could correct any deficiencies in specific engagements; some regulators (e.g., the Government Accountability Office) may insist that the relevant reports be withdrawn and reissued after the engagements are repeated.
- The costs associated with obtaining independent, outside reviews of internally inspected engagements, pre- and post-issuance reviews of certain engagements, and additional CPE may be steep.

More than any other consequence, firms suffer embarrassment when such failures occur. Morale sinks and sometimes firms will split up or terminate the partners who caused the deficiencies.

PCAOB Inspections. If, after inspection of a firm's QC system, the PCAOB finds certain defects in the system, the firm is given one year to remediate the defects. During this time, the PCAOB must not publicize the deficiency. If after one year, the defects are not resolved to the PCAOB's satisfaction, however, the board publishes that information on its website. For example, a review of the PCAOB's website on June 1, 2010, indicated that of the 67 firms that failed to sufficiently address the PCAOB's QC criticisms, approximately 60% of the firms had one or more deficiencies related to independence compliance (e.g., QCs failed to provide reasonable assurance that the firm meets independence requirements, assure that the firm communicates with the client's audit committee about independence, or verify the completeness and accuracy of independence representations).

director of risk management and quality of Cherry, Bekaert & Holland LLP said: "Monitoring helps us focus on opportunities to improve our system (for example, we consider what might be unnecessary, or missing, or where we need to communicate better). We slice and dice the results a variety of ways (by office, industry, and partner) to answer the question: What is the root of any problem?" For example, firms typically consider whether a gap is isolated or occurring in multiple offices. One participant noted that even if a matter was isolated to one office in the firm, it would determine whether there are any learning opportunities to share via training with all assurance staff. Once gaps are analyzed, they can be addressed, often through additional training and communications, or by changing policies, procedures, or practice tools.

Examples of how some survey firms addressed gaps in their systems follow:

- One firm learned that professionals were not providing certain information in response to independence questionnaires, which they attributed to the wording of one of the questions, a relatively simple fix.
- Another firm changed certain practices related to the use of specialists on audits (such as business valuation or information technology professionals) as a result of QC monitoring.
- Some participants discovered they needed to change the way they trained certain professionals on independence rules. They concluded that non-CPAs generally need more training on the fundamentals of independence than audit and tax professionals who have spent their careers in public accounting and developed a certain mindset on the subject. Whereas periodic updates and reminders may suffice for audit and tax professionals, non-CPAs may need more thorough explanation and more frequent reminders of the requirements. Firms can foster goodwill between professionals by considering both the practical reality of consultants (who were brought into the firm to provide consulting services to clients) along with the importance of compliance with professional standards. (Also see the *Sidebar*, "Improving Compliance with Interpretation 101-3," which illustrates how adopting certain policies to help compliance can foster better relationships within firms.)

Monitoring also provides valuable information about professionals whose work is deficient, allowing QC personnel to perform pre-issuance reviews to ensure the quality of the firm's attest reports, and protect the public and the firm. If a professional's work does not improve, additional action would be taken.

Some participants said that better, more effective technology—and the use of technology where manual processes were once used—greatly enhanced their ability to analyze the results of QC monitoring (for example, in the client acceptance process, accounting for restricted entities, and independence surveys). Said Eddie Dutton of Cherry Bekaert: "Automation makes monitoring easier and less time-consuming, and the data is more trustworthy." Technology enables firms to sort, compare, and combine data in multiple ways, which is more efficient and cost-effective than manual systems and enables more timely and informed decision making.

SQCS 7 requires firms to obtain written statements of compliance with independence requirements from all professionals—a useful exercise that allows firms to gather, analyze, and monitor information about financial, business, or other relationships between professionals and clients to ensure compliance with independence requirements. Generally, firms gather this information using a questionnaire, which requires professionals to answer the questions and provide information about relationships or interests that may raise independence issues. The following are two fictional examples of matters that could be reported in an independence survey and typical questions a QC department would ask to address these matters:

■ *Reported matter 1:* A tax partner serves on the board of Pet-Savers, a nonprofit organization for which the firm provides only tax services.

■ *Reported matter 2:* An audit partner was named as the co-executor of the estate of John Davis, 80% owner of Trend Automotives, the partner's audit client.

Questions:

■ Has the firm targeted Pet-Savers as a potential attest client? Note that the partner's board service would impair the firm's independence with respect to the period of the engagement and any periods covered by the audit opinion. Thus, the relationship could preclude the firm from acquiring Pet-Savers as an attest client for a certain period.

■ What is the nature of the executor arrangement between the partner and the John Davis estate? Should the audit partner have assumed this role? Which other options could be weighed in light of the appearance of independence? Has the partner discussed this matter with Davis?

With this information at their fingertips, in both matters, QC personnel will not only be able to evaluate independence—they may also ask whether the relationship between the professional and the client makes sense from a business standpoint, that is, does it expose the partner and/or the firm to excessive liabilities? In this case, independence monitoring provides the opportunity to address some very important risk management questions.

A firm that evaluates these questions will make wise decisions in protecting its independence. Other benefits, such as minimizing risk to the firm and its owners, maintaining good relationships with clients, and promoting the firm's business strategies, should not be overlooked.

Firm Culture and Internal Communications

Survey firms emphasized the importance of firm culture and internal communications on the firm's QC system. "It's about how we conduct ourselves," said Marshall Lehman, partner of Lurie, Besikof, Lapidus & Company LLP. "You can have all the systems and processes in place, but you've got to walk the talk." Other survey firms made similar comments about having a culture of "doing the right thing" and getting issues out on the table early.

Figuring prominently in the interviews, all survey firms discussed internal communication and QC policies for required consultations. Early action was seen as critical, because the sooner an issue is identified, the easier it is to resolve the problem. Howard L. Wilensky, partner, director of accounting and auditing of Lurie, Besikof, Lapidus, said: "The overall message is that anything we can do to identify a potential matter earlier in the engagement process as opposed to near the end of the process has proven very beneficial to us." LarsonAllen LLP provides only two items in its list of required consultations but employs a "sensitive client issue" policy that guides staff on when to consult, forcing them to continuously contemplate possible risk scenarios (e.g., if a situation is risky to the firm or if there is a client service or fee issue). Said Chas McElroy, executive principal: "Rather than look at a list, we say, 'If you have an uncomfortable feeling in your head or your gut, you should consult. You should con-

IMPROVING COMPLIANCE WITH INTERPRETATION 101-3

Interpretation 101-3, *Performance of Nonattest Services*, which interprets rule 101, Independence, of the AICPA Code of Conduct, poses certain challenges because it requires evaluation of the nonattest services before an engagement with an attest client is accepted. Adopting the following few simple procedures can improve compliance with the standard and provide additional benefits:

■ Client acceptance and continuance procedures prompt nonattest services partners to communicate with audit partners early in the client acceptance or continuance process so that the requirements are satisfied timely.

■ Because the communication generally starts with the nonattest services partner, increasing their awareness is essential, as these partners might not share an auditor's mindset toward independence. Training geared toward non-auditors and periodic reminders can promote awareness.

■ Additional benefits include:

- ■ Knowledge sharing, such as what nonattest services may we provide an attest client? What are the professional and regulatory requirements?
- ■ Working towards a common goal, and
- ■ Better working relationships across disciplines.

sult early—don't try to fix an issue yourself.' Dealing with clients early and making them a part of the solution has pulled us through many situations in very good shape."

Moss Adams LLP has a rigid consultation process with respect to possible conflicts of interest, which, according to Jeff Brown, a partner in the professional practice group, "has worked very effectively in terms of avoiding those situations that we should not be getting into." The process, he continued, involves evaluating the facts and circumstances, determining whether the work can be performed, and obtaining waivers of conflicts when necessary.

Regarding other internal communications, Ford of Clifton Gunderson considers interaction with assurance services leaders throughout the firm—staying in tune with what's going on in the practice offices—to be invaluable. Chris Piché, principal, assurance and accounting, at LarsonAllen LLP, commented that having a healthcare specialist from one office inspect a healthcare engagement in another office helps keep the lines of communications open and improves consistency throughout the firm in terms of how audits in specialized industries are approached.

There are obvious benefits that accrue to firms that continuously enhance their internal culture and communications; not only are they integral to a firm's QC framework but also to every other benefit discussed here.

Accountability and Inclusiveness

Participants noted the importance of keeping all professionals in the firm fully informed of their obligations under the QC standards. For example, Lurie Besikof Lapidus invites all client service staff to periodic breakfast meetings with the firm's partners where QC discussions are held, and all accounting and auditing staff attend the firm's peer review exit conference. The firm emphasizes an open door policy, providing access to all of the firm's partners, even if solely to act as a sounding board. Consultations are frequent and often informal. Staff is encouraged to take a chance and be vulnerable: "Whether you're right or wrong, the question is: Can we as a team get to the right answer?" said Wilensky. At Clifton Gunderson, Ford recently discussed risk management with new entry-level recruits, stating: "While I'm in charge of risk management for the whole firm, they're my eyes and ears on the ground. Risk management is everyone's job," adding, "Everyone is held accountable for QC—people in the field and people in the national office."

Each year, Crowe Horwath LLP requires all firm professionals to take a course on ethics and independence and pass an examination. Wes Williams, partner in charge of the assurance professional practice group, considers this control indispensible because it ensures that everyone has been exposed to the information, which raises accountability and knowledge. "It is not easy; it's tougher than the average ethics test," said Williams, "We designed it that way." Childers of Elliott Davis stated, "We hit independence very hard … make it very clear that it's difficult to fix an independence issue after the fact. To be proactive and help ensure the staff will know the independence requirements in commonly encountered situations, we tell the staff: 'If a client has not approached you about employment yet, it will happen, and you must report it and come off the engagement while you consider the offer.'"

Participants reported factoring the quality of a partner's or shareholder's services (e.g., determined via inspections or file reviews), and his or her record of compliance with ethics standards into their firms' evaluation, compensation, and promotion decisions. According to Shelly Van Dyne, national director of independence & regulatory compliance for McGladrey & Pullen LLP, the firm builds these factors into its new partner process; that is, it considers the candidate's record of compliance with independence requirements when determining whether to admit staff into the partnership. Clearly, policies that link the quality of professionals' work and their ethics compliance to compensation and promotion decisions send a powerful message about accountability.

Firms that make everyone responsible for upholding professional standards and that instill a sense of inclusiveness among staff foster the qualities that help assure high-quality work.

Adaptability and Preparedness

Firms that continuously focus on enhancing the quality of their work can more easily adapt in changing times and are better prepared when events such as mergers, acquisitions, or the issuance of new regulatory requirements occur. For example, when people and processes are functioning effectively, new regulatory requirements can be implemented into a CPA firm's existing framework with relative ease, said Crowe Horwath's Williams. Several participants whose firms acquired other firms in recent years credited their strong monitoring controls and culture for

ANNUAL QC MONITORING REPORT

The evaluation. In the annual reporting process, which generally follows the performance of a firm's internal inspection process, QC professionals formally evaluate the QC system and determine needed follow-up. For example, if the staff does not appear to sufficiently understand the firm's policy on documenting independence consultations, QC staff will arrange additional training on the subject.

The report. QC professionals prepare the annual monitoring report, typically a high-level strategic document, which highlights the results of the monitoring procedures performed over the past year and proposes a plan for resolving any deficiencies. Firm management reviews and approves the report. More detailed information is disseminated to the field via accounting and auditing training, webcasts, technical updates, and other means. Dutton of Cherry Bekaert & Holland noted three broad goals connected to the annual reporting process: communication, education, and where warranted, compliments. "The whole purpose is to improve the system," he said, "Informing professionals of what they need to do and how is key. It's also important to recognize success; if someone has done a good job, they deserve a pat on the back."

facilitating the process. McGladrey's Van Dyne observed that smaller firms acquired by larger ones generally need a period of time to adjust to more formal policies and procedures and the acquirer's ways of doing things. Often, firms provided integration training to get new professionals up to speed, especially when the acquirer's policies (accounting, audit, or independence) were more stringent than those of the acquired firm. During the transition period, survey firms typically sent their personnel to work closely with the new firm's personnel.

Several participants underscored how ongoing (as opposed to periodic) inspections, audits, and reviews enhanced the flexibility of their systems; for example:

- At the time, McGladrey was considering replacing annual personal independence audits with ongoing audits and other arrangements to facilitate the audit process.
- Lurie Besikof Lapidus implemented post-issuance reviews for selected engagements, which has made its internal inspection process more efficient.

Said one participant about his firm's year-round inspection process: "The old once-a-year approach really wasn't beneficial because, by the time you identified the problem, it was too late to do anything about it … . Under the new approach, we can respond much more quickly."

In terms of preparedness, firms with strongly monitored QC systems tend to proactively address issues affecting their practices. One participant said her firm recently evaluated the use of social media sites (e.g., LinkedIn) by staff because they thought it could raise certain ethical issues—for example, would comments made by staff about a client be viewed as promoting the client?

Firms use the results of their monitoring procedures to identify and resolve weaknesses in their controls, which serves as a test run for outside reviews, such as peer reviews or regulatory inspections by the Public Company Accounting Oversight Board (PCAOB). (See the *Sidebar*, "Annual QC Monitoring Report," for a description.) Effective monitoring provides a level of comfort that the QC system will be found free of major defects. As Van Dyne of McGladrey put it: "It would not be possible to get a clean opinion on a peer review without having a good QC monitoring system in place." When firms monitor their QC systems properly, there should be no surprises because an effective "self-audit" has already been performed.

Firms that can act quickly due to their finely tuned QC systems enjoy a competitive advantage over firms that cannot respond as quickly.

Recruiting, Retention, and Morale

Improved staff recruiting, retention, and morale are invaluable byproducts of a high-quality audit practice. Professionals who perform quality work and set high ethical standards for themselves will be drawn to firms that hold the same values, while others will not seek opportunities with the firm, or will be more prone to leave. Said Dutton: "We should remember how much Internet searching our employment candidates do; they and our clients and prospective clients can look up AICPA peer review and PCAOB reports online—there's a lot more of that going on than people realize."

Moss Adams' Jeff Brown commented: "Firms' long-term existence is so dependent upon strong ethical standards, and no one wants to be part of a firm that has a tarnished reputation." WeiserMazars' Stevens noted, "We put the best people on the best jobs … the cream rises to the top."

Bright, content, and competent professionals are the most valuable commodity an audit firm has; thus, the importance of effective recruitment and retention of personnel cannot be overstated.

Profitability

A firm must be profitable to survive, especially when economic conditions are not ideal; thus profitability—enhancing revenues and minimizing expenses—will always be a prime concern. Staff in firms that have defective QCs can become frustrated and demoralized because the QCs don't ensure the quality of the firm's services. Clients are lost (or never acquired), reputations suffer, fees plunge, lawsuit and insurance costs rise, and professionals seek other places to work. Said one participant: "If you have quality and you deliver timely and accurately, you will make money. It's the times that you don't get it right the first time that profitability plummets." Crowe Horwath's Williams noted: "The issue is the cost of failure is way too high. Many of the benefits of QC monitoring relate to avoiding large, unanticipated costs." Brown of Moss Adams noted: "To some degree, a benefit of QC monitoring (and QCs in general) is that you avoid problems you would have otherwise. Having the problem brings more problems." Problems are profit-killers because dealing with lawsuits and regulatory investigations is extremely costly and disheartening.

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Quality: the Bottom Line

Firms with effective QC systems not only continuously improve the quality of their services and comply with professional standards; significant additional benefits abound. These firms are more competitive in the marketplace, both for employees and clients; they also are supple, and have a culture of accountability and inclusiveness that values great work and ethical conduct. They communicate and manage risks proactively. Because they are competitive and avoid problems, they generate excellent profits. Reputations are priceless and these firms maintain high marks with clients, prospective clients, peers, lenders, investors, students, prospective employees, regulators, and other members of the business community. Said one participant: "It all starts with quality; your reputation is built on quality, integrity and protection of the public interest." ❑

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