

# ASSESSING THE EFFECT ON A FIRM'S SYSTEM OF QUALITY CONTROL DUE TO A SIGNIFICANT INCREASE IN NEW CLIENTS AND/OR EXPERIENCED PERSONNEL

## PRACTICE AID FOR SEC PRACTICE SECTION MEMBER FIRMS

### Notice to Readers and Acknowledgments

This Practice Aid is intended to assist firms that have undergone a significant increase in new clients and/or experienced personnel within a short period of time, and is based on existing professional literature, the experience of the members of the SEC Practice Section Executive Committee and information provided by SEC Practice Section member firms to their own professional staff. This information represents the views of the members of a task force of the SEC Practice Section ("SECPS") Executive Committee and is not an official position of the AICPA. Official positions are determined through certain specific committee procedures, due process and deliberation. The information provided herein should be used only with the understanding that it is to be read in conjunction with the professional literature and that it is only a means of assisting firms and their professionals in meeting their professional responsibilities.

The members of the SECPS Executive Committee would like to acknowledge and thank the task force for their exemplary efforts in researching, writing and producing this timely document. The members of the task force include:

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### Introduction

The addition of new clients and the hiring of experienced staff and "direct admit" partners is nothing new to most firms. Recent events, including an unprecedented number of auditor changes within a short period of time among public companies, may lead to situations in which the volume of new client additions and experienced hires puts stresses on a firm's quality control system. Unusually high activity in these areas may require additional resources be devoted to areas such as those listed below, and may also lead a member firm to conclude that its programs for monitoring compliance with its quality controls should be expanded in line with the increased risks implicit in the new environment.

SEC Practice Section ("SECPS") member firms are required to have policies and procedures within their existing quality control systems for areas such as:

- New client acceptance.
- Hiring appropriately qualified personnel.
- Ensuring that applicable independence requirements are met.
- Providing appropriate training to its professionals.
- Staffing engagements with personnel with the appropriate skill-sets for the client, its industry and its risk profile.
- Complying with professional standards and firm policies for initial quarterly reviews, first-year audits and possible re-audit situations.

Some firms also have merged with other firms and have policies and procedures within their existing quality control systems for integrating merged practices into their firms, which may be of assistance in some circumstances.

This Practice Aid provides guidance related to an SECPS member firm's assessment of the potential effect on its system of quality controls of significantly increased levels of new client additions and/or experienced personnel hires, and the firm's planned response.

### **Assessing the Effect on a Firm's System of Quality Control**

The risks associated with a significant increase in new clients and/or experienced hires and the potential effect on the firm's system of control quality will vary by firm.

At one end of the continuum, a member firm might experience only a slight increase in new clients and/or experienced hires, which would not be expected to place any unusual stresses on its system of quality controls. For such a firm, the potential effect on its system of quality controls may be minimal and may require no specific firm response. On the other hand, the firm may choose to reinforce its existing quality control policies and procedures through appropriate communications within its organization.

At the other end of the continuum, a member firm might experience rapid and significant increases in new clients and experienced hires. Depending on the experience of the firm, the risk that its existing system of quality controls might be stressed may be high, and the firm should consider actions to bolster resources, ensure information systems are not overburdened and enhance its monitoring of applicable quality control policies and procedures to provide reasonable assurance that its response to increased risks is timely and adequate. In such circumstances, the member firm may also implement special or temporary procedures or protocols to address the identified risks. For example, the firm might develop special procedures for evaluating and approving the acceptance of groups of new clients, develop tailored orientation and training programs for experienced hires, and establish temporary procedures for the determination and approval of the assignment of personnel to engagements.

In all cases professional judgment is required in assessing risks, developing a response commensurate with the risks identified, and considering the monitoring actions that might be necessary to provide reasonable assurance that quality control issues are identified on a timely basis and adequately addressed.

The addition of a group of personnel and clients, for example the hiring of a large number of people from a single practice office, might present special risks. A member firm should consider the potential impact placed on the firm's quality controls for integrating these personnel and clients, including client acceptance/continuance, training of newly-hired personnel, assignment of those personnel and others to new or existing client engagements, concurring partner reviews, and so on. That consideration may require the addition or reallocation of resources in order to maintain quality. For example, a combination of two practices in one major market may cause the firm to consider

supplementing the resources in that market with others from another location, particularly if the new practice is significantly larger than the existing practice.

In any case, firms should not underestimate the stresses that may occur on a firm's system of quality control by adding significantly increased levels of new clients and/or experienced personnel within a short period of time.

### **Elements of a Firm's Quality Control System That May Be Affected**

All member firms of the SECPS are required to "adhere to quality control standards established by the AICPA" and adhere to membership requirements of the SECPS. In accordance with Statement on Quality Control Standards No. 2 and 5 (SQCS Nos. 2 and 5), *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, "a system of quality control is broadly defined as a process to provide the firm with reasonable assurance that its personnel comply with applicable professional standards and the firm's standards of quality." The following summarizes the elements of a firm's system of quality control that may be affected by adding significantly increased levels of new clients and/or experienced hires. Reference is also made to certain SECPS membership requirements that may also be affected.

#### Independence

In accordance with SQCS Nos. 2 and 5, "Independence encompasses an impartiality that recognizes an obligation for fairness not only to management and owners of a business but also to those who may otherwise use the firm's report. The firm and its personnel must be free from any obligation to or interest in the client, its management, or its owners." In addition to the quality control standards, SECPS member firms are required to have "policies and procedures in place to comply with applicable independence requirements of the AICPA, SEC and Independence Standards Board."<sup>1</sup>

In accordance with SECPS membership requirements, new hires are to undergo independence training near the time of initial employment, as required by the member firm's policies. New hires are to certify that he or she has (1) read the firm's independence policies, (2) understands their applicability to his or her activities and those of his or her spouse and dependents, and (3) has complied with the requirements of the member firm's independence policies.

In the context of a significant increase in the level of clients or personnel, the routine practices to ensure independence quality controls may require additional attention in terms of resources or processes. The following areas are particularly pertinent:

- *New Clients* - The firm should promptly add new clients to its Restricted Entity List and inform partners and employees as to the newly restricted entities. During the client acceptance process, the independence implications should be carefully considered, including: any financial interests of the firm or of covered persons;

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<sup>1</sup> SEC Practice Section Reference Manual §1000.46, Appendix L – Independence Quality Controls, outlines the specific requirements for SECPS member firms. The SEC Practice Section Reference Manual is available on the AICPA's website at <http://www.aicpa.org/members/div/secps/refmanual.htm>

employment relationships that bear on independence; business relationships with the prospective client; and other relationships that could impact independence.

- *New Personnel* - The addition of partners and employees requires the firm to manage the following processes: dissemination of the Restricted Entity List and of the firm's independence policies, including information about those responsible for independence within the firm and the resources available to the new personnel for consultation and resolution of issues; training of new personnel in independence matters; entry of investments into the firm's automated tracking system for those firms that maintain such systems; and obtaining written representations near the time of employment to assist in identifying any relevant independence issues.

In cases where a member firm affiliates with new foreign-associated firms, or in cases where the member firm's existing foreign affiliates acquire another practice, certain independence matters may require special attention. In addition to the matters mentioned in the preceding paragraphs, the newly merged practice may generate additional independence considerations, including: scope of services; contingent fees; business relationships with the firm's existing audit clients, including prime-sub contractor relationships; and financial interests arising from firm pension and similar arrangements, banking and lending relationships.

#### Personnel Management

SQCS Nos. 2 and 5 state that, "Personnel management encompasses hiring, assigning personnel to engagements, professional development, and advancement activities. Accordingly, policies and procedures should be established to provide the firm with reasonable assurance that:

- Those hired possess the appropriate characteristics to enable them to perform competently.
- Work is assigned to personnel having the degree of technical training and proficiency required in the circumstances.
- Personnel participate in general and industry-specific continuing professional education and other professional development activities that enable them to fulfill responsibilities assigned, and satisfy applicable continuing professional education requirements of the AICPA, SECPS and regulatory agencies.
- Personnel selected for advancement have the qualifications necessary for fulfillment of the responsibilities they will be called on to assume."

New partners and personnel who are CPAs should have the appropriate professional credentials. It is typical for the hiring firm, as part of its policies for new personnel, to determine whether individuals have a license in good standing and, where required, membership in the AICPA. Further, firm policies usually require the firm to ascertain that these individuals do not have any restrictions imposed on them by federal or state regulatory bodies or by the AICPA.

SCQS Nos. 2 and 5 also state, “all of the firm’s personnel are responsible for complying with the firm’s quality control policies and procedures.” Therefore, firms should ensure that any new employees are sufficiently trained in the firm’s policies and procedures.

In addition to the quality control standards, SECPS member firms are required to adhere to membership requirements governing audit partner rotation and concurring partner review, as follows:

- A new audit partner is to be assigned to be in charge of each SEC engagement<sup>2</sup> that has had another audit partner-in-charge for a period of seven consecutive years, and such incumbent partner may not return to in-charge status on the engagement for a minimum of two years, with few exceptions. This rotation requirement is applicable to the individual partner and respective client. Accordingly, when an individual joins a member firm and is assigned as partner-in-charge of an audit, any consecutive years of service as partner-in-charge on that client immediately preceding the date that person joins the new firm carryover to the new firm.
- A concurring review partner is to be assigned for each SEC engagement<sup>3</sup>. The concurring review serves as an objective review of significant auditing, accounting, and financial reporting matters that come to the attention of the concurring partner reviewer and the resolution of such matters prior to the issuance of the firm’s audit report with respect to financial statements of SEC engagements, and prior to the completion of a quarterly review about any matters identified in the review that involve a significant risk of material misstatement in the financial statements. Concurring partner reviews are to include a timely review of audit planning for initial audits of SEC engagements and high-risk SEC engagements. A prior audit partner-in-charge should not serve as the concurring review partner for at least two annual audits following his or her last year as the partner-in-charge.

With respect to the staffing of engagements, if new clients are accepted and the predecessor<sup>4</sup> firm’s entire engagement team are now part of the successor<sup>5</sup> firm’s organization, the quality control aspects of assignment to the engagement should be carefully considered. Assuming that the successor firm’s audit approach will now be employed to complete the engagement, the firm should strive to strike the appropriate balance between continuity on the audit and the ability to competently apply the new audit approach. For example, if the engagement staff continues from the prior year, assignment of a successor firm engagement partner might be appropriate. Alternatively, if the predecessor firm engagement partner continues, then a successor firm concurring reviewer would be a good practice. In the same vein, partner continuance might result in the firm assigning a successor firm manager or senior accountant.

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<sup>2</sup> See SEC Practice Section Reference Manual §1000.38, Appendix D – Definition of an SEC Engagement, for purposes of determining compliance with this membership requirement.

<sup>3</sup> Ibid.

<sup>4</sup> The term “predecessor” is defined in this context in AU §315, *Communications Between Predecessor and Successor Auditors*.

<sup>5</sup> The term “successor” is defined in this context in AU §315, *Communications Between Predecessor and Successor Auditors*.

### Acceptance and Continuance of Clients and Engagements

In accordance with SQCS Nos. 2 and 5, “policies and procedures should be established for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for that client. Such policies and procedures should provide the firm with reasonable assurance that the likelihood of association with a client whose management lacks integrity is minimized...Such policies and procedures should also provide reasonable assurance that the firm:

- Undertakes only those engagements that the firm can reasonably expect to be completed with professional competence.
- Appropriately considers the risks associated with providing professional services in the particular circumstances.”

With the addition of new clients, firms should also consider the following:

- Provisions of AU §315, *Communications Between Predecessor and Successor Auditors*, relative to communications between the predecessor and the successor auditor.
- Availability of firm resources to staff new engagements, including plans to obtain such resources.
- Resource constraints of foreign-associated firms when considering multinational engagements.

SECPS member firms are encouraged to review Professional Issues Task Force (“PITF”) Practice Alert 94-3, *Acceptance and Continuance of Audit Clients*, which outlines various risk factors that the auditor should consider as part of his or her decision to accept or continue a client (available on the AICPA’s website at <http://www.aicpa.org/members/div/secps/lit/practice/943.htm>). Firms also are encouraged to review §8900 of the AICPA’s Technical Practice Aids relative to guidance regarding communications with a predecessor auditor.

### Engagement Performance

SQCS Nos. 2 and 5 state that, “Engagement performance encompasses all phases of the design and execution of the engagement.” The AICPA’s quality control standards require that these policies and procedures “cover planning, performing, supervising, reviewing, documenting, and communicating the results of each engagement.” The firm should have policies and procedures “to provide reasonable assurance that personnel refer to authoritative literature or other sources and consult, on a timely basis, with individuals within or outside the firm, when appropriate (for example, when dealing with complex, unusual, or unfamiliar issues). Individuals consulted should have appropriate levels of knowledge, competence, judgment and authority.”

The following engagement performance matters are particularly relevant during a period of significant change:

- *Completing Audits in Progress* – In some cases, firms may be engaged to complete an audit that was begun, but not completed, by the predecessor auditor. The professional

literature does not directly address this situation. AU §315 indicates that a predecessor auditor is not a specialist as defined in AU §336, *Using the Work of a Specialist*, or an internal auditor as defined in AU §322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*. Nevertheless, the successor auditor may use as audit evidence the results of inquiry of the predecessor auditor, and the results of the successor auditor's review of the predecessor auditor's working papers. This evidence may affect the nature, timing and extent of the successor auditor's procedures. However, the nature, timing and extent of the audit work performed and the conclusions reached in completing the audit are solely the responsibility of the successor auditor.

On March 18, 2002, the SEC issued *Temporary Final Rule and Final Rule: Requirements for Arthur Andersen LLP Auditing Clients* (available on the SEC's website at <http://www.sec.gov/rules/final/33-8070.htm>). The Rule provides special relief for registrants who were Andersen clients on or after March 14, 2002 but who are unable to, or choose not to, engage Andersen to complete the audit. The Rule generally relates to fiscal years ending between and including November 30, 2001 and April 15, 2002; if Andersen had issued a manually signed report on or before March 14, 2002, the relief is not available. The Rule also contains special relief for registrants who were Andersen clients with regard to timely quarterly reviews. The Rule generally relates to fiscal quarters ending between and including January 26, 2002 and June 15, 2002. Firms and their professionals should refer to the Rule for precise requirements. In addition, on April 1, 2002, the SEC issued *Application of Requirements for Arthur Andersen Auditing Clients – Frequently Asked Questions* (available on the SEC's website at <http://www.sec.gov/divisions/corpfin/guidance/andersenfaq.htm>).

- *Re-audits* – If an auditor is asked to audit and report on financial statements that have been previously audited and reported on (referred to as a re-audit), the auditor accepting such engagement is considered the successor auditor, and the auditor who previously reported is the predecessor auditor. In accordance with AU §315.14-.20, the successor auditor should not assume responsibility for the predecessor auditor's work or issue a report that reflects divided responsibility. The successor auditor should plan and perform the re-audit in accordance with generally accepted auditing standards.

For example, in a re-audit, the successor auditor generally will be unable to observe inventory or make physical counts at the re-audit date or dates. In this case, the successor auditor may consider the knowledge obtained from his or her review of the predecessor auditor's working papers and inquiries of the predecessor auditor to determine the nature, timing, and extent of procedures to be applied in the circumstances. The successor auditor performing the re-audit should, if material, observe or perform some physical counts of inventory at a date subsequent to the period of the re-audit, in connection with a current audit or otherwise, and apply appropriate tests of intervening transactions.

- *Quarterly Reviews* – The SEC requires that a company’s independent auditor review the company’s interim financial information prior to the company filing its quarterly report on Form 10-Q or Form 10-QSB<sup>6</sup>. In accordance with SAS No. 71, *Interim Financial Information*, “To perform a review of interim financial information, the accountant needs to have sufficient knowledge of a client’s internal control as it relates to the preparation of both annual and interim information...When the accountant has not audited the most recent annual financial statements, and thus has not acquired sufficient knowledge of the entity’s internal control, the accountant should perform procedures to obtain that knowledge.” Therefore, for an initial interim review, the firm should determine that the engagement team has sufficient knowledge about the client’s accounting and reporting practices for the purposes contemplated in the review by obtaining an understanding of internal control, including practices used for preparation of both annual and interim financial information. This understanding may be aided by reviewing the predecessor auditor’s working papers to the extent considered necessary and by making inquiries of the predecessor auditor as to matters they believe could affect the review.

The SEC staff has indicated that a change in auditor, even if close to the filing date of a Form 10-Q or Form 10-QSB, does not alleviate the requirement for the registrant to have a timely quarterly review prior to the filing of the Form 10-Q or Form 10-QSB (unless the predecessor auditor was Andersen, in which case the registrant should review the SEC’s Temporary and Final Rule, if the applicable quarter is covered by such SEC Rule; see discussion above in “Completing Audits in Progress”).

SECPS member firms are also encouraged to review PITF Practice Alert 00-4, *Quarterly Review Procedures for Public Companies*, which provides information that may help auditors improve the efficiency and effectiveness of their quarterly reviews (available on the AICPA’s website at <http://www.aicpa.org/pubs/cpaltr/oct2000/supps/paltr1.htm>).

- *First-Year Audits and Review of Opening Balances* – The responsibility for analyzing the impact of the opening balances on the current year financial statements and consistency of accounting principles rests with the successor auditor. The successor auditor must obtain sufficient competent evidential matter to afford a reasonable basis for expressing an opinion on the financial statements under audit. SECPS member firms are encouraged to review PITF Practice Alert 97-3, *Changes in Auditors and Related Topics*, which provides types of audit evidence the auditor may obtain with respect to opening balances (available on the AICPA’s website at <http://www.aicpa.org/pubs/cpaltr/nov97/suppl/pub.htm>), and AU §315, paragraphs .12 and .13.
- *Request to Issue Comfort Letters* – Firms may be requested to issue comfort letters for newly engaged clients under a number of scenarios, such as a request to issue an agreed-upon procedures report prior to completion of an interim review or audit, a

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<sup>6</sup> For further information pertaining to this requirement, see the SEC release entitled “Audit Committee Disclosure” at the SEC’s web site at <http://www.sec.gov/rules/final/34-42266.htm>

request to issue a comfort letter upon completion of one or more interim reviews but prior to the completion of an audit, or a request to provide comfort on amounts outside the financial statements relative to periods prior to those encompassed by the firm's engagement. AU §634, *Letters for Underwriters and Certain Other Requesting Parties*, provides guidance to accountants for performing and reporting on the results of such engagements.

- *Discovery of Possible Misstatements in Financial Statements Reported on by a Predecessor Auditor* – If during the audit or re-audit, the successor auditor becomes aware of information that leads him or her to believe that financial statements reported on by the predecessor auditor may require revision, the successor auditor should request that the client inform the predecessor auditor of the situation and arrange for the three parties to discuss this information and attempt to resolve the matter. The successor auditor should communicate to the predecessor auditor any information that the predecessor auditor may need to consider in accordance with AU §561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, which sets out the procedures that an auditor should follow when the auditor subsequently discovers facts that may have affected the audited financial statements previously reported on, and AU §315, paragraphs .21 and .22 in re-audit situations. In addition, auditors are encouraged to review §8900.06 of the AICPA's Technical Practice Aids for additional guidance.
- *Compliance with Appendix K* – SECPS member firms that are members of, correspondents with, or similarly associated with international firms or international associations of firms are to report annually to the SECPS (or more frequently, if desired) the name and country of the foreign associated firms, if any, for which the SECPS member firm has been advised by written representation from its international organization or individual foreign associated firms that policies and procedures are consistent with the objectives in Appendix K - SECPS Member Firms With Foreign Associated Firms That Audit SEC Registrants, SECPS Reference Manual §1000.45.
- *Part of Audit Performed by Other Independent Auditors in Overseas Locations* – AU §543, *Part of Audit Performed by Other Independent Auditors*, provides guidance on a) the professional judgments the independent auditor makes in deciding whether he or she may serve as the principal auditor and use the work and reports of other independent auditors who have audited the financial statements of one or more subsidiaries, divisions, branches, components or investments included in the financial statements presented and b) the form and content of the principal auditor's report in these circumstances. Ordinarily, the principal auditor is not required to make reference to the other auditor if that auditor or firm is an associated or correspondent firm and whose work is acceptable to the principal auditor based on his or her knowledge of the professional standards and competence of that firm. There may be situations in which a firm, other than an associated or correspondent firm, is used for a portion of the audit. Auditors are encouraged to review AU §543 for guidance in this area. In addition, firms should be mindful of the SECPS Appendix K responsibilities, referred to above.

## Monitoring

In accordance with SQCS Nos. 2 and 5, “policies and procedures should be established to provide the firm with reasonable assurance that the policies and procedures established by the firm for each of the other elements of quality control are suitably designed and are being effectively applied. Monitoring involves an ongoing consideration and evaluation of:

- Relevance and adequacy of the firm’s quality control policies and procedures.
- Appropriateness of the firm’s guidance materials and any practice aids.
- Effectiveness of professional development activities.
- Compliance with the firm’s policies and procedures. When monitoring, the effects of the firm’s management philosophy and the environment in which the firm practices and its clients operate should be considered.”

In accordance with SQCS No. 3, *Monitoring a CPA Firm’s Accounting and Auditing Practice*, a firm’s monitoring procedures may include:

- Inspection procedures.
- Pre-issuance or post-issuance review of selected engagements.
- Analysis and assessment of –
  - New professional pronouncements.
  - Results of independence confirmations.
  - Continuing professional education and other professional development activities undertaken by firm personnel.
  - Decisions related to acceptance and continuance of client relationships and engagements.
  - Interviews of firm personnel.
- Determination of any corrective actions to be taken and improvements to be made in the quality control system. Communication to appropriate firm personnel of any weaknesses identified in the quality control system or in the level of understanding or compliance therewith.
- Follow-up by appropriate firm personnel to ensure that any necessary modifications are made to the quality control policies and procedures on a timely basis.

As previously stated, a firm might experience only a slight increase in clients and/or experienced personnel. For such a firm, the potential effect on its system of quality controls might be minimal. Conversely, a firm might experience significant increases in new clients and experienced personnel. For such a firm, there is a likelihood that the impact on its existing system of quality controls would be greater and special or temporary procedures or protocols to address the identified risks may be necessary.

Such monitoring procedures could include timely testing at the engagement level and the office or national functional area level, as appropriate in the firm's circumstances. For example, the firm's annual internal inspection process may include coverage of the population of new clients and new hires depending on the assessment of increased risk.

A member firm might also consider whether the internal inspection should be accelerated, if warranted in the firm's particular circumstances, to provide reasonable assurance that quality control issues are identified on a timely basis and adequately addressed. For example, a member firm might design special monitoring procedures to be completed after new clients have been added, risks have been assessed, personnel have been assigned and the preliminary planning has been completed, but before interim or year-end field work for those clients.

In all cases, a firm's planned response should be commensurate with the risks it has identified and should include consideration of what monitoring procedures might be necessary to provide reasonable assurance that quality control issues are identified on a timely basis and adequately addressed.

### **Conclusion**

The guidance contained in this Practice Aid was designed to assist SECPS member firms in assessing the potential effect on its system of quality controls of increased levels of new client additions and/or hiring of experienced personnel. The guidance contained herein refers to existing professional standards. Firms are encouraged to review those standards in their full text form as this Practice Aid only highlights excerpts from those standards.

While the addition of new clients and the hiring of experienced staff is nothing new to most firms, the level of such activity may be unprecedented, thereby requiring an extra level of care to ensure the maintenance of quality during the period of significant change. Firms are encouraged to take appropriate action by utilizing the guidance available in the existing standards to ensure that its personnel comply with applicable professional standards and the firm's standards of quality.