

January 16, 2008

All Practicing Members of the Institute

Dear Member,

ISQC 1 identifies “Leadership Responsibilities for Quality Within the Firm” as one element of a strong quality control system within a firm. This element is often referred to as “tone at the top.” The Transnational Auditors Committee (TAC) of the International Federation of Accountants (IFAC) has recently released a paper on “**The Tone at the Top and Audit Quality**” for the guidance of all sizes of audit firms.

This paper will be a valuable tool for audit firms of all sizes in developing further processes to establish an appropriate tone at the top and to demonstrate their ongoing commitment to deliver audit quality.

We are pleased to enclose herewith this paper for members’ information.

Thanking you.

Yours truly,

Muhammad Asif Iqbal

Director Professional Standards Compliance & Evaluation

Encl. As above.

Tone at the Top and Audit Quality

FORUM OF FIRMS



International Federation
of Accountants

The mission of the International Federation of Accountants (IFAC) is to serve the public interest, strengthen the accountancy profession worldwide and contribute to the development of strong international economies by establishing and promoting adherence to high-quality professional standards, furthering the international convergence of such standards and speaking out on public interest issues where the profession's expertise is most relevant.

Copies of this paper may be downloaded free-of-charge from the IFAC website at <http://www.ifac.org>.

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TRANSNATIONAL AUDITORS COMMITTEE
TONE AT THE TOP AND AUDIT QUALITY

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Background

Delivery of high quality services is the driver of success for all professional services firms. Quality service is vital to maintaining client satisfaction, delivering value for money and establishing professional reputation. For professional accountancy firms¹ (and audit firms in particular), quality service is at the core of the business strategy, and is absolutely vital to the public interest responsibilities of professional accountants.

As part of its ongoing work program, the Transnational Auditors Committee (TAC) regularly reviews the inspection reports published by external audit oversight boards and regulators. The objective of this review is to identify findings common across jurisdictions and to evaluate whether additional guidance would benefit the members of the Forum of Firms.

One matter highlighted in a recent review of these reports² was a recurring comment that audit firms should do more and better evidence their activities and commitment to the “tone at the top.” The relevant international standard in this area is International Standard on Quality Control (ISQC 1), produced by the International Auditing and Assurance Standards Board (IAASB). ISQC 1 identifies “Leadership Responsibilities for Quality Within the Firm” as one element of a strong quality control system within a firm. This element is often referred to as “tone at the top.”

Because the tone at the top is an important driver of audit quality, the TAC has undertaken to explore current practice among members of the Forum of Firms. This good practice guidance paper has been prepared based on the input of ten TAC members, who represent some of the largest international networks. TAC members granted interviews and supplied background materials which have been summarized in this paper on a non-attributed basis.

The TAC believes this paper will be a valuable tool for members of the Forum of Firms, as well as audit firms of all sizes, in developing further processes to establish an appropriate tone at the top and to demonstrate their ongoing commitment to delivering audit quality.

Forum of Firms

The objective of the Forum of Firms is to promote consistent and high quality standards of financial reporting and auditing practices world-wide.

Members in the Forum have committed to adhere to and promote the consistent application of high quality audit practices worldwide, including the use of International Standards on Auditing, and the maintenance of appropriate quality control standards in accordance with International Standards on Quality Control issued by the International Auditing and Assurance Standards Board. Through their organizations, members also conduct globally coordinated internal quality assurance reviews on a regular basis and have policies and methodologies which conform to the International Federation of Accountants’ Code of Ethics for Professional Accountants.

The Transnational Auditors Committee is the executive committee of the Forum of Firms.

¹ Due to the variety of sources used to compile this paper, a number of different terms are used to describe the relevant organization. There is no intent to be either consistent or prescriptive in the usage of terms such as firms, members, networks, organizations, etc. Such terms should be interpreted in their customary meaning and in the particular context.

² See Appendix.

Executive Summary

Much has been written over the last few years on the subject of “tone at the top” and the critical role it plays in establishing and maintaining ethical and accountable work environments. While the tone at the top is a vital consideration in the development of a sound corporate governance policy, it has been recognized as equally important for accounting firms and other entities.

In its 2000 report, the Panel on Audit Effectiveness³ (the “Panel”) recommended that audit firms take action in four areas. The first set of recommendations concerned professional leadership and the tone at the top. The Panel called on audit firms to “reaffirm, within their organizations and to the outside world, the importance of their audit practices and to stimulate their auditors to proudly hold high the banner of objectivity, independence, professional skepticism and accountability to the public by performing quality audit work.”

In a recent report, the United Kingdom’s (UK) Financial Reporting Council (FRC) emphasizes the importance of the culture within an accounting firm.⁴ The FRC has also noted that the achievement of high quality audits needs to be clearly stated as the overriding objective of the audit practices of all firms and that this be recognized more clearly in the firms’ strategies.⁵

In its January 2007 report, the Canadian Public Accountability Board recommended that “ultimate authority for audit quality and the related decision making processes should be formally assigned and those charged with this task should be held accountable”.⁶

The TAC acknowledges the importance of the tone at the top in contributing to audit quality and that audit quality must be a priority for every audit firm. If audit quality is to remain a real priority, audit firms must create and sustain a culture of positive and constant reinforcement. Importantly, this can be supported by the tone set by firm management through the policies and procedures they put in place, their communications on their expectations with respect to compliance, the system of reward and sanctions they implement and, of course, the example they set through their own behavior.

This paper summarizes current practice in several of the largest international audit firms and examines how setting the right tone can positively influence audit quality.

³ In October 1998 the U.S. Public Oversight Board established the Panel on Audit Effectiveness in response to a request by the Securities and Exchange Commission. The Panel conducted a comprehensive review and evaluation of the way independent audits of financial statements of publicly traded companies are performed and assessed the effects of recent trends in auditing on the quality of audits and on the public interest. The final *Report and Recommendations* was issued on August 31, 2000.

⁴ United Kingdom Financial Reporting Council Discussion Paper, *Promoting Audit Quality*, November 2006.

⁵ United Kingdom Financial Reporting Council 2005/6 Audit Quality Inspections Public Report.

⁶ Canadian Public Accountability Board, “*Fourth Public Report*”, January 2007.

Principal Findings

- **Strategy** – In the design and development of a firm’s strategy, management needs to emphasize the importance of quality performance over commercial considerations. Quality may be recognized in the firm’s strategies in several ways: sufficiently documenting it as a key objective; formally documenting it in the firm’s operations manual; including it in organizational documents; involving experienced and knowledgeable leaders whose primary role is risk management and/or quality control; and having all key quality control and/or risk management individuals independent of local operational management.

Within several global firms, a current common audit methodology is maintained and provided to all member firms. Additionally, all Forum of Firms members are required to conduct globally coordinated internal inspections to monitor compliance with the relevant audit methodology.

The tone set by the firm’s leadership is focused so that quality is understood by all to be a pre-requisite for survival and growth and embedded in the firm’s values statement, global code of conduct, training and internal communications.

- **Communications** – Management’s commitment to quality can be communicated, both internally and externally on a regular basis. Internal communications foster reinforcement while external communications impact the firm’s reputation, both perceived and real. Prominence can be given to audit quality issues in internal communications from the leadership team. These communications address the concepts of integrity, objectivity, independence, professional skepticism, and accountability to the public. Messages are typically positive, constructive, and refreshed frequently.

The form, content and type of internal communications are dependent on the size of the firm but quality messages can generally be communicated through the performance appraisal system, partner updates, email alerts, office meetings, intranet system, conventions, web updates, and newsletters.

- **Job Descriptions** – Clearly articulated and well defined job descriptions that are formally documented create an environment where goals and expectations are more likely to be achieved. Job descriptions emphasize quality, technical competency and continuing professional development.

Sufficient and appropriate experience, together with problem assessment, resolution capability and authority, are necessary for individuals to function effectively in a leadership role in the firm.

- **Performance Appraisal** – Management needs to ensure that a clearly identifiable link exists between performance and compensation. Additionally, performance appraisals are formally documented and reflect that quality is a key driver of performance assessment.

There should be sufficient visibility of quality indicators in the documented goals and objectives against which performance is assessed. These objectives should be clear, and should be communicated to ensure the priority of quality work.

- **Monitoring** – The quality control system is tested regularly and provides for feedback from all levels within the organization. The system is documented in the policy and procedure

manual and the results of the monitoring process are routinely communicated to all managers and professional staff.

Where grading of individual audits is performed, the grading assigned to each audit is designed to be meaningful and accurately reflect the issues identified and/or the quality of the individual audits reviewed. Serious deficiencies that are identified should be reported immediately so that timely action can be taken by the firm.

Finally, the monitoring process is designed to provide incentives for individual partners and staff to improve their performance.

Introduction

Defining Tone at the Top

What is tone at the top? It can be considered as the following: the standard set by the organization's leadership whereby performance is measured; the culture within which the members of the organization operate; the tone set by senior management; irrespective of management's documented strategy and policies, it is the force that drives individual professionals; the "unseen hand" that directs activities regardless of management's proximity to the action; and a commitment to the quality of care clients receive. Although a commitment to quality may be described in an organization's strategy, communications, job descriptions, performance appraisal process, etc., unless the message becomes a way of life within the organization, where managers actually lead by example, the likelihood of achieving organizational objectives could be substantially diminished.

Importance of Tone at the Top

Why is tone at the top important? Every organization needs a sense of direction. The organization's direction is determined by the leadership. As noted in the November 2004 issue of CFO magazine, "Setting the right tone requires a clear vision of the basic values under which you operate...One of the big reasons companies with difficulties have failed is that they lacked that basic discipline of understanding where they are going, how they are going to get there, and how much it is going to cost...Well-run companies do that day in and day out." Tone at the top is the ultimate responsibility of the organization's leadership – lead from the top by giving consistent messages on the importance of quality. This responsibility is shared by every level of management within the organization as individuals look to their immediate supervisors for guidance.

Relevance to Audit Firms

In public accounting, tone at the top is as important, if not more so, than in other commercial enterprises, because of the many stakeholders who rely on or are affected by the work of audit firms, the significant impact the profession makes on capital markets worldwide, and the public interest responsibilities of the accounting profession.

In a recent paper, the UK FRC notes the importance of the culture within an accounting firm. The paper points out that auditors must be cognizant of the public interest nature of an audit, review audit evidence skeptically and exercise judgment objectively and robustly. The environment in which the audit team works can materially affect the mindset of the audit team and the way it discharges its responsibilities. The paper emphasizes that the culture within a firm is a key driver of audit quality because it has the ability to create an environment where achieving high quality in every aspect of the audit process is valued, invested in, and rewarded.

According to the FRC paper, some of the principal indicators of whether a firm has an appropriate culture from the perspective of enhancing audit quality are:

- Whether the firm's leadership promotes effectively the importance of the firm properly discharging its professional responsibility as an auditor.

- Whether in complying with ethical and professional conduct standards, the firm adheres to the fundamental principles of those standards and acts in a way that respects those principles. No ethical standards can cater to every situation – particularly as business relationships become increasingly complex. Consequently, the approach that a firm takes to situations that might compromise that firm’s objectivity or independence in ways that are not specifically contemplated in ethical or professional conduct standards constitute important indicators of whether the culture of a firm is appropriate.
- Whether the firm’s training, counseling, appraisal, promotion and remuneration structures promote the personal characteristics – such as integrity, objectivity, rigor, skepticism, perseverance and robustness – that are essential to quality auditing.⁷

In order to achieve the objective of a quality focused culture, audit firms need structures and processes to establish, maintain and provide evidence of their commitment to quality. This requires that the global organization and the respective member firms develop and implement relevant policies and procedures as well as a system of rewards and sanctions in areas relevant to the performance of audit engagements and the overarching system of quality control.

This paper has been prepared to assist audit firms in achieving this important objective.

Approach

Using the input from the firms represented on the TAC, descriptions and examples of good practice in establishing, communicating and reinforcing the tone at the top have been organized into five major areas where firms typically demonstrate and document their commitment to audit quality:

- Strategy
- Communications
- Job Descriptions
- Performance Evaluations
- Monitoring

⁷ United Kingdom Financial Reporting Council Discussion Paper, *Promoting Audit Quality*, November 2006.

Strategy

ISQC 1 paragraph 11⁸

Of particular importance is the need for the firm's leadership to recognize 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.

As indicated in ISQC 1, the recognition of quality in the firm's strategy is essential to communicate the firm's commitment to audit quality to partners, employees, clients and other external stakeholders.

How is quality recognized in a firm's strategies?

Firms note that quality is viewed as a requirement in everything that they do. Notably, quality is identified as being an essential component of a firm's reputation and a prerequisite for a firm's survival and growth.

A firm's strategy might include a statement on the firm's values related to quality (e.g., ethics, integrity, commitment to continuing professional development). Specific goals are also typically included in the strategy document focusing on areas such as service excellence, development of individuals, and development of systems that provide value to clients.

The manner in which quality is recognized in firm strategies is generally a function of the size of the firm. For small firms with a less formal structure, the commitment to quality may not be as explicitly documented but an emphasis on quality is typically evident in the strategies actually deployed. For example, some small firms can show a quality imperative in their client acceptance procedures by employing a strict selection process and only taking on those clients whose risks the firm is willing to assume.

Larger firms, on the other hand, tend to be more explicit in their commitment to quality, expressing it in strategic and other documents. For example, one Big Four firm states in its philosophy document: "We must safeguard our reputation and the public perception of our integrity and objectivity. Accordingly, we are selective in accepting clients and will follow processes established by the firm for assessing background and reputation of prospective clients." The document goes on to say that in performing engagements of any nature, integrity, objectivity and due care are to be exercised by all personnel.

Leadership and values

Another way in which firms specifically address quality is by requiring that the membership agreement signed by each member firm includes a clear commitment to provide quality service for all clients, regardless of where they are located in the world. This may be supported by a set of shared values, a code of conduct, and common policies, procedures and controls.

⁸ All references to International Standard on Quality Control 1 (ISQC 1) refer to the standard issued and effective as of June 15, 2006.

Quality is also evidenced in firm strategies by assigning experienced partners in leadership positions whose principal responsibility is risk management and/or quality control and whose roles do not include managing business activities and objectives.

In recognizing quality as the cornerstone of their global strategies, sitting at the core of their values and client service mindset, firms embed quality in their values statement, global code of conduct, and training and internal communications. In one firm, for example, "...integrity... courage [and] ...doing the right thing" are key concepts in the values statement. In its global code of conduct, "Delivery of Quality in Everything We Do" resonates throughout. A Balanced Scorecard is used to help ensure alignment of strategic objectives and consistent measures of performance.

It is also important to note that in applying the policies and procedures set forth in a firm's strategy, manual, work programs, checklists and other relevant materials, firms require employees to give attention to the spirit as well as the letter of such policies.

To commit the right level of thought and effort to each aspect of quality, firms have dedicated significantly more people to their quality initiatives. One firm, for example, started at the top of the organization by naming a global managing partner for quality and risk management (Q&RM) (these functions are sometime separated within some firms), who reports directly to the Chairman and CEO and who is a member of the Global Executive Committee. This individual leads a global team of area and country practice Q&RM leaders who are independent of local operational management, and work in conjunction with the Q&RM leaders of the three global service lines (Audit, Tax, and Other Advisory Services). The partners throughout the global organization who are responsible for quality and/or risk management participate in reviewing and strengthening the policies and procedures, and have primary accountability for implementation of quality standards, policies and training to meet the firm's objectives.

While the audit engagement leader takes primary responsibility for the delivery of a firm's audit opinion, deficiencies in audit quality can also occur because of circumstances not necessarily under the engagement leader's control. These can include staffing and resource shortages, inadequate audit tools and training, and the lack of an appropriate emphasis on quality at higher levels. Ultimate responsibility for audit quality in any member firm rests with the leadership of that firm, and accountability needs to extend beyond the engagement leader to other leaders and management in the firm.

Global and regional leadership need to take responsibility for policies, tools and oversight that impact audit quality and ensure that appropriate action is taken with respect to member firms that fail to satisfy audit quality standards.

Client Acceptance and Continuance

Firms expect the same commitment to quality and integrity on the part of their clients as they do of themselves. As a result, many firms have developed and implemented enhanced processes for reviewing and approving new clients as well as reviewing relationships with existing clients. Several firms state that they will and have resigned from a client when the client does not meet the firm's high standards, or when the firm cannot commit sufficient resources to deliver quality services to the client.

External dialogue

Several firm strategies underscore the firm's commitment to quality by encouraging professionals to participate in external activities where they can help to define quality and shape public policy. These professionals play leadership roles on the boards and committees of professional accountancy organizations, oversight and regulatory bodies (where permitted), and business associations. Among the issues that are addressed are improvement of the public's understanding and expectations of the role of audits and auditors, enhancing the quality of financial reporting, and achieving greater consistency and quality in regulation.

Audit methodology and internal inspection

In recognition of the need for consistent quality across the globe, major firms develop a common audit methodology compliant with the International Standards on Auditing (ISAs) as set by the International Auditing & Assurance Standards Board (IAASB). This methodology is kept current for changes and additions to the standards and it is regularly promulgated to all member firms.

For networks that do not maintain a common audit methodology, the member firms are typically responsible to ensure that the methodology used is, at a minimum, compliant with the ISAs.

In both cases, there is a program for globally coordinated internal inspections. During these inspections, opportunities for improvement are identified and addressed. Firms note that if the same deficiencies keep appearing on multiple inspections of a member firm then that firm may lose the right to use the global name – only quality firms are accepted by the global organization and they are expected to maintain an appropriate standard of quality. Inspection results are forwarded to the global office and to key management individuals at both the national and global levels where action plans are monitored.

How is quality recognized in the firm's strategies?

- Sufficiently documented as a key objective of the strategy
- Formally documented in firm's operations manual
- Reflected in the procedures employed
- Understood by all to be a pre-requisite for survival and growth
- Membership agreement includes a clear commitment to quality for all clients
- Involvement of experienced and knowledgeable leaders whose primary role is risk management and/or quality control. Such individual(s) report directly to the head of the global organization. All key individuals involved in quality control and/or risk management are independent of local operational management
- Embedded in network firms' values statement, global code of conduct, firm strategy, and all training and internal communications
- Network firms have dedicated people to lead quality initiatives throughout the world
- Leaderships' commitment to quality operates both at the level of their own firm and that of the profession as a whole
- Networks maintain a common audit methodology which is kept current and provided to all member firms
- Networks conduct globally coordinated internal inspections

Communication

ISQC 1 (paragraph 10)

The firm's leadership and the examples it sets significantly influence the internal culture of the firm. 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 emphasizing the firm's quality control policies and procedures, and the requirement to:

- (a) Perform work that complies with professional standards and regulatory and legal requirements; and
- (b) Issue reports that are appropriate in the circumstances.

Such actions and messages encourage a culture that recognizes and rewards high quality work. They may be communicated by training seminars, meetings, formal or informal dialogue, mission statements, newsletters, or briefing memoranda. They are incorporated in the firm's internal documentation and training materials, and in partner and staff appraisal procedures such that they will support and reinforce the firm's view on the importance of quality and how, practically, it is to be achieved.

Effective and ongoing communication is necessary for a firm to deliver its messages about quality to the widest possible audience and to firmly establish a clearly understood tone at the top. It is important for firms to look for opportunities to reinforce its quality messages among all levels of staff and to create a work culture that embraces quality.

The Panel on Audit Effectiveness also made some recommendations that audit firms "emphasize to all audit personnel the importance of performing high-quality professional work. Such messages might be delivered frequently by the CEO, COO, by leaders at the firm's regional and national offices, and by the head of the assurance practice, as well as by the firm's top technical partners. It should stand out above all other messages. The Panel further recommended that the firm leadership convey a positive, constructive message that is refreshed frequently so that it commands attention, rather than becoming a tired slogan that is ignored."⁹

How is the firm's strategy communicated?

Firms communicate their core strategy both internally and externally. Internal communications, distributed to employees, are often publications that explain the firm's strategies. Member firms of each network or association are responsible for promoting a clear understanding of the global organization's strategy and its commitment to quality among its employees. This is important work for the member firm when the global strategy is adopted on the local level and local initiatives are implemented. Both the global leadership and the local audit leadership communicate regularly on different topics to demonstrate the firm leadership's commitment to quality. With respect to external communication, the global leadership issues publications with a

⁹ The Panel on Audit Effectiveness, *Report and Recommendations*, August 2000.

global perspective on topics such as integrity and quality that publicly state the global organization's position on these matters, while local audit leadership discusses the commitment to quality in periodicals, publications and in focused messages that address specific aspects of the system of quality control.

How are routine quality messages communicated by firm leadership?

Generally, quality messages are communicated by firm leadership on a regular basis. The form and formality of communications depend on the size of the firm. These communications may take a variety of forms: newsletters – weekly/monthly; partner updates – daily/quarterly (depending on the size of the member firm); web updates; email alerts – daily; office meetings; ethics and independence instruction and testing; conventions – annually (lasting as many as four days); and presentations. Additionally, several firms continually use intranet systems to deliver inspiring messages on quality.

One firm recently designed a series of posters for staff. Each poster starts with the message "Quality is..." and then the rest of the poster describes key quality drivers with related quality messages. These individual messages deal with matters such as integrity, consultation, etc. The posters are used in training rooms, at training seminars hosted externally, and are placed at various strategic positions around the office.

Communications

- Prominence should be given to audit quality issues in internal communications from the leadership team
- Communications should be delivered frequently and messages about quality should stand out above all other messages
- Messages should be positive, constructive, and refreshed frequently
- They should address the importance of the role and responsibility of audit professionals
- They should address the concepts of integrity, objectivity, independence, professional skepticism, and accountability to the public

Many of the day-to-day communication activities are managed by the member firms in each network or association.

Day-to-day communications by one US member firm of an international network include:

- **“Management Live”** – Web based sessions with partner and managers to discuss various matters which often focus on quality issues
- **Accounting Alerts** and **Practice Alerts** – These are sent to professionals based on new/updated issuances/interpretations of accounting standards and instructions on addressing these items in practice
- **“Audit Weekly”** - U.S. Audit leader distributes emails to all audit professionals. These cover the following subject matters: Leadership Corner; People; Quality; Growth; and Operational Excellence. Some of the topics covered relate to new accounting and auditing standards, learning requirements/opportunities, ethics, independence, practice management matters, technology, and client wins.
- **Partner/Director Monthly** – Issued by U.S. audit leader a few times in 2006. Topics included focus on people's careers, regulatory update, Client Relationship Management system, Center for Corporate Governance, and strategy refresh (the process the network went through with all functions to refresh where it was focusing – including the marketplace, what it should pursue, its people, quality, and operational excellence).
- **Various Voicemails** - Sent to partners and professionals from leaders such as the U.S. audit leader, with focus on quality.
- **CEO Communications – Communications from the CEO** to partners and staff are in forms of voicemails, management lives, etc., and often have a component focused on quality.

Annual external inspection reports, which are generally publicly available, also communicate the firm's quality strategy.

Larger firms often use vehicles such as values statements and their global code of conduct as key components of internal communications on quality. These are frequently referenced by firm leadership. Other firm-wide communications around quality include the annual performance review, mentioned above, and various communications from the Chairman/CEO and/or global managing partner of quality and/or risk management. Quality control policies and procedures may also be communicated to audit and other assurance personnel through a global practice manual, global audit and assurance policy and practice statements, global audit and assurance information releases, the firms' global audit methodology, or the firms' global independence website. These are available to all personnel worldwide through the firms' global information systems.

In smaller firms communications tend to be less formal. A parallel can be found in ISA 315¹⁰ paragraph 71 which states “Audit evidence for elements of the control environment does not have to be available in documentary form, in particular for smaller entities where communication between management and other personnel may be informal, yet effective. For example, management’s commitment to ethical values and competence is often implemented through the behavior and attitude they demonstrate in managing the business instead of in a written code of conduct. Consequently, management’s attitudes, awareness and actions are of particular importance in the design of a smaller entity’s control environment.”

Form, content, type and frequency of quality messages communicated by firm leadership

- Dependent on the size of the firm
- Should be communicated on a regular basis
- Newsletters
- Partner updates
- Web updates
- Email alerts
- Office meetings
- Ethics and independence instruction and testing
- Conventions
- Other presentations
- Performance appraisal process
- Intranet system
- Integral part of the internal and external quality assurance review process

How are the results from internal and external quality assurance reviews communicated to professional personnel?

As would be expected, internal review comments on specific engagements are usually reviewed with the relevant partner, senior staff and other members of the engagement team. Findings that are common to several engagements are typically the subject of an annual presentation for partners and staff, noting key areas where improvements in adherence to policies or methodology are required and reminding them of the relevant requirements. External review results are communicated to all professionals.

¹⁰ International Standard on Auditing (ISA 315) Understanding the Entity and its Environment and Assessing the Risk of Material Misstatement.

One firm noted that in addition to communicating the results of internal and external reviews to the relevant professionals, periodic memoranda are distributed to the entire audit staff by the risk management department summarizing significant findings noted during the review process. These communications are designed to alert the auditors to sensitive, complex or new issues and methods of dealing with them. Findings are also communicated at partner and senior manager meetings as well as during training programs. In this firm, the risk management department periodically provides the executive committee with a summary of engagement evaluations, highlighting significant findings. These findings are also fed into the partner evaluation system which allows the executive committee access to them as part of the performance appraisal process.

Job Descriptions

In establishing the right tone, it is useful to have quality elements included in the formally documented job descriptions for audit personnel. At least one external inspection report noted the need for expanded job descriptions for senior management personnel in relation to the firm's systems of quality control, including ultimate responsibility and day-to-day operational responsibility for effective operation of the various facets of the quality systems.¹¹

In many larger firms, this is usually the case. However, job descriptions for firm leadership/management positions in smaller firms are not always formally documented, but may be embedded in the organizational structure. The absence of formal job descriptions does not preclude firm leadership/management from being evaluated against quality considerations that are identified during internal/external quality reviews. For some firms, the job descriptions for firm leadership and other senior individuals are tied directly to the firm's strategy, including the quality component.

What quality elements are included in the job descriptions of firm leadership and management?

Firms stress the importance of filling all positions of responsibility with highly qualified individuals. They believe that their reputation is directly affected by the actions of individual partners and senior staff both internally and externally. Accordingly, the partnership agreement and employment contracts generally emphasize, among other things:

- The need for competent execution of responsibilities;
- Commitment to the strategy of the firm;
- Setting an example as a professional, by performing high quality work and expecting the same from subordinates; and
- The importance of continuing professional development.

Several firms employ a framework approach in articulating the job descriptions for firm leadership/management. One Big Four network, for example, uses a framework which includes three major dimensions: clients; people; and the firm. The framework is adapted at a national level to accommodate jurisdictional differences.

¹¹ Canadian Public Accountability Board, *Public Report on Initial Quality Inspections for the Four Largest Accounting Firms*, (October 2004).

What quality elements are included in the job descriptions of personnel responsible for the firm's system of quality control?

ISQC 1 paragraph 12

Any person or persons assigned operational responsibility for the firm's quality control system by the firm's chief executive officer or managing board of partners should have sufficient and appropriate experience and ability, and the necessary authority, to assume that responsibility.

As explained in ISQC 1, individuals responsible for the firm's system of quality control should have the necessary experience and ability along with the authority to perform successfully. Such individuals should also be independent of the design and operational functions under review.

In most firms, to provide an appropriate degree of independence, such individuals report directly to the executive committee, not the partner in charge of audit or to operational management at the office or other levels. Some firms report that the risk management department staff's job description includes responsibility for quality control reviews and the quality control system. In other firms, the quality control system is separated from risk management.

What quality elements are included in the job descriptions of personnel responsible for individual audit partners and other professional staff?

Firms expect engagement partners to have excellent technical knowledge and the ability to recognize problems and reach appropriate conclusions. Other professional staff have requirements commensurate with their level.

In one firm, for example, performance management is based upon a "global excellence model" The model defines core competencies related to the roles and responsibility for each level, with an emphasis on technical skills and complying with the firm's policies and professional standards. For audit, the model is:

- a. Technical competencies
 - Utilizing business knowledge
 - Understanding and using technology
 - Complying with and applying the network's methodology
 - Applying professional standards
 - Managing risk
- b. Generic competencies
 - Service excellence
 - Marketing, sales and communication
 - Management effectiveness
 - Leadership effectiveness

In this firm, an important objective of what the firm calls “learning and awareness programs” is to ensure that partners, managers and other levels of professional staff understand their responsibilities under the firm’s policies. To support this, the global office has developed and made available learning units that can be tailored by each member firm to address topics such as the professional practice manual, leading a quality audit, risk management, etc.

In some firms, the senior partner in smaller member firms is responsible for assessing the performance of all partners and is also personally involved in appraisals of other senior staff. In other firms, the national executive committee, or a sub-committee thereof, plays this role. The assessment is facilitated in part by periodic engagement evaluations transmitted by the risk management or review department as well as input from hierarchical superiors.

Quality elements of job descriptions for firm leaders

- Formally documented job descriptions
- Strong emphasis on quality
- Technical competency
- Continuing professional development
- Sufficient and appropriate experience
- Necessary authority
- Ability to recognize problems and reach appropriate conclusions

Performance Appraisal

ISQC 1 paragraph 40

The firm's performance evaluation, compensation and promotion procedures give due recognition and reward to the development and maintenance of competence and commitment to ethical principles. In particular, the firm...helps personnel understand that advancement to positions of greater responsibility depends, among other things, upon performance quality and adherence to ethical principles, and that failure to comply with the firm's policies and procedures may result in disciplinary action.

A positive tone is set, as indicated in ISQC 1, when the firm's performance appraisal system provides a clear and direct link between quality performance and rewards. In its 2000 report, the Panel on Audit Effectiveness recommended that audit firms "review performance measures for all experience levels, and ensure that performing high-quality audits is appropriately recognized as the highest in performance evaluations and in compensation, promotion and retention decisions for all personnel. The measures, according to the Panel, should focus on such matters as (1) the depth and substance of understanding of the client's business and risks, (2) responsiveness to unexpected or unplanned conditions encountered in audits, (3) development of innovative audit approaches, (4) professional skepticism and persistence, and (5) knowledge of accounting principles and practices."¹²

In line with these recommendations, several firms have implemented a formally documented performance appraisal system.

In some firms, a formal performance appraisal system does not exist, and external inspections have noted the need for improvement in this area. Firms have been encouraged to ensure that quality indicators are an integral and visible part of their human resources system, with documented goals and objectives being set for partners and senior staff as a basis on which their performance can then be assessed. While these goals and objectives may include matters of a commercial nature, it should be clear that quality considerations and measures are a prominent component of performance assessment. This is critical in establishing the right "tone at the top." A process should be in place both to identify performance indicators and ensure that partners are explicitly assessed against them. The link between the quality ratings achieved by the firms' partners and their overall performance assessment should be clear. A clearly identifiable link should also exist between partner remuneration and the results of formal partner appraisal.

Professional development is vital to support quality performance. At the time of its report in 2000, the Panel noted "that partners and other supervisory personnel, and sometimes the firms themselves, did not always view professional development as a high priority."¹³ Some in the profession attributed this to professional and regulatory continuing education requirements which specify a number of required hours per year rather than being focused on the specific skills and competencies required by individual auditors to remain current. The Panel stated "that outcome

¹² The Panel on Audit Effectiveness, *Report and Recommendations*, August 2000.

¹³ The Panel on Audit Effectiveness, *Report and Recommendations*, August 2000.

measures, such as assessments of performance against agreed-upon knowledge and competency criteria, would be effective in developing auditors' skills and improving audit quality."¹⁴

Where quality considerations are embedded in the Balanced Scorecard or equivalent systems, firms stress this as a core competency in their learning and development programs and is reinforced by the emphasis placed on quality and risk management in performance evaluations and rewards. Individual performance goals for partners around the world include measurable quality and risk management objectives, and the results are factored into the standard partner remuneration system. Parallel goals and measures are incorporated into the staff performance evaluation process as well.

How can goals and objectives for partners be visibly focused on quality indicators?

Some firms have developed specific programs to provide assurance that goals and objectives for partners and professional staff are visibly focused on quality indicators. In addition to ensuring that the firm has sufficient personnel with appropriate capabilities, competence and commitment to ethical principles some firms are establishing competency and accountability frameworks. The objective of these efforts is to:

- Have a global core competency framework that supports development of partners and professional staff globally.

The competencies (including competencies around quality) are integrated with the global partner performance management system, thereby guiding partners in their development plans. These are also integrated with the global performance management and development process (the performance management system for non-partners). There are clear alignments between the competencies and both the global and service line Balanced Scorecards.

- Design the core competency framework so that it defines the specific technical and quality competencies that are needed by audit and assurance professionals for the successful execution of their jobs and advancement of their careers.
- Ensure the framework reinforces the firm's global strategy by aligning each partner's personal goals with the firm's goals, values and strategic direction.

All partners worldwide are evaluated according to a similar process. Partners develop a personal Balanced Scorecard that is linked to the business unit and other relevant scorecards, all of which are linked to the global scorecard. The personal scorecard each partner develops must include quality goals, against which his/her performance is annually evaluated and measured. When individuals are being considered for promotion to partner, their commitment to and ability to deliver quality is specifically assessed. The promotion forms address quality service in key areas such as: technical competency, client activities, high quality service to clients and risk management.

- Develop the performance management and development process for non-partners so that it establishes the building blocks for a global organizational system to manage performance and rewards of employees.

¹⁴ Ibid.

The aim is to establish consistent standards on the elements of good performance and to help ensure that everyone's performance directly supports the overall strategic direction of the firm. As for partners, each employee annually sets quality goals and the individual's performance is evaluated and measured against these goals.

In addition to a competency framework, firms may wish to consider the use of an "accountability framework" to address deficiencies in audit quality identified by internal and external reviews. Individuals need to be held accountable for deficiencies in meeting professional standards or complying with the firm's policies relevant to audit quality.

An accountability framework will only operate effectively if it is based on robust data, consistent processes, and acceptable criteria. The criteria against which performance can most reasonably be assessed for application of an accountability framework are the objectives agreed between the partner concerned and his/her primary reporting partner.

How is the achievement of quality indicators measured?

As mentioned earlier, quality indicators are initially measured at the individual level during the performance appraisal process. However, performance may also be measured at the member firm level.

For example, one mid-tier firm reports that at the global level, member firms are evaluated by other member firms regarding their experience of working with each other. Areas addressed in this type of evaluation include: quality of work; timeliness of work and response to queries; client satisfaction with member firm; areas for development; and business development. The data obtained by the global organization from respondents are used to rate the member on a scale – excellent; satisfactory; needs improvement, etc.

How important are quality considerations when candidates are being considered for promotion to audit partner or other key engagement positions?

All firms believe that quality considerations are extremely important for promotion to audit partner or other key engagement positions. One firm noted that unless the individual has attained a rating of "excellent" for his/her technical skills then the promotion is withheld. For this firm, promotion and hiring are always discussed within a technical committee. This firm's approach to assigning personnel, including partners, involves the planning of overall firm needs and the measures employed to achieve a balance of engagement manpower requirements, personal competencies skills, individual development, and utilization.

Although leadership skills and the ability to generate new business are important, quality considerations should feature prominently in the promotion process and quality indicators should be embedded in the human resources system as a whole. For example, the assessment of partner candidates' track record in relation to audit quality and their level of achievement in relation to relevant technical and personal competencies should be given visible focus in the partner promotion process. Also, firms should establish and review regularly appropriate development plans for new partners and ensure that the identified development needs of successful candidates are addressed.

Performance appraisal quality messages

- Performance appraisals should be formally documented.
- There should be sufficient visibility of quality indicators in the documented goals and objectives set as the basis on which performance is assessed.
- The documentation should indicate that quality, not commercial, considerations and measures, are the drivers of performance assessment.
- The objectives against which partners are assessed should be very clear.
- Discipline should be instilled in the appraisal procedures established for partners and senior members of the firm (the focus on the importance of audit quality, established by the firm, will not be effective if the procedures are not followed).
- Outcome measures, such as assessments of performance against agreed-upon knowledge and competency criteria should be used.
- Performing high-quality audits is appropriately recognized as a priority in performance evaluations and in compensation, promotion and retention decisions.
- Performance measures need to be clearly and carefully communicated to ensure that all understand that quality work is a priority.
- Performance should not be measured primarily on meeting time deadlines and budget estimates. This should be effectively managed.
 - Provide guidance and training on actions that engagement partners and other supervisory personnel should consider in managing time pressures.
- Management and employees should view professional development as a high priority.
- Other areas to focus on include the following:
 - The depth and substance of understanding of the client's business and risks;
 - Responsiveness to unexpected or unplanned conditions encountered in audits;
 - Development of innovative audit approaches;
 - Professional skepticism and persistence; and
 - Knowledge of accounting principles and practices.

Monitoring

ISQC 1 paragraph 74

The firm should establish policies and procedures designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice.

To ensure that the tone set by the firm's leadership is operating effectively, regular monitoring is required. This includes testing the quality control system and providing for opportunities for feedback from all individuals within the organization. Additionally, the system should be documented in the policies and procedures manual, and the results of the monitoring process should be communicated to all managers and professional staff.

The grading assigned to each inspection or audit is designed to be meaningful and accurately reflect the issues identified and/or the quality of the individual audits reviewed. Serious deficiencies that are identified should be reported immediately so that timely action can be taken by the firm.

Finally, the monitoring process is designed to provide incentives for individual partners and staff to improve their performance.

What are member firms doing to ensure that they are meeting the tone at the top requirements of ISQC 1?

To monitor whether individual firms within the global organization are meeting the tone at the top requirements of ISQC 1, most networks have incorporated coverage of these in their internal inspection programs to provide reasonable assurance that the policies and procedures established for each of the elements of quality control are suitably designed and are being effectively applied.

In one network, member firms follow a "practice manual" which contains the policies that support the areas identified in ISQC 1. These policies play an important part in establishing an effective control environment where employees understand their responsibilities, authority and the commitment to act ethically. As part of the monitoring activities the review team interview staff members on topics such as:

- Leadership communications on audit quality, integrity and objectivity;
- Understanding of member firm risk management and consultation processes; and
- Understanding of independence requirements.

The results of the review are communicated annually to all audit partners. To set expectations from the top, the global CEO always comments on the results and the important issues to address in a personal message attached to the inspection report. Global audit leadership then follows up this communication with additional messages on certain focus areas.

At another firm, the global organization's compliance with ISQC 1 was specifically documented when ISQC 1 was issued. As new professional standards are issued and/or as new internal

policies and procedures are updated, the documentation is updated. This documentation is maintained within the global professional practice department. The documentation is also provided through the professional practice organization to area and country practices to use in supplementing the documentation of global compliance with additional area and/or country practice policies and procedures. Monitoring is the responsibility of the area and/or country professional practice. The annual independence confirmations from all professional personnel, the country practice independence confirmations, the global code of conduct confirmations, performance assessment documentation and the audit quality review questionnaires are other evidence of compliance.

External inspections have identified the need, in some cases, for more rigor in the system used by some firms to inspect and monitor their quality control system and the work of engagement partners.¹⁵ During internal inspections, firms can emphasize that the grading of individual audits is reasonable, and that there is integrity in the manner in which certain gradings are viewed. Firms may wish to distinguish between the qualities of individual audits reviewed and provide feedback within the audit practice. In doing so, firms may wish to consider the following:

- Rigorous application of the grading system so that audits for which significant deficiencies are identified are downgraded accordingly;
- Introduction of a mechanism for identifying audits which are genuinely of high quality (as opposed to having a relatively low threshold for the highest grade to be achieved);
- Better use of data and analysis arising from the review process, relating to performance in individual audit areas, in providing constructive feedback to partners and staff;
- Better utilization of output from the review for individual partner and staff performance appraisals; and
- Where significant deficiencies are identified in relation to a particular audit, the firms should determine whether further action is required to confirm the appropriateness or otherwise of the audit opinion issued.

While identifying common deficiencies in particular audit areas which may require action at a firm wide level is a valuable output of the review process, assessing the overall quality of individual audits in a manner that provides incentives for individual partners and staff to improve their performance is equally important. Firms may therefore wish to consider assessing the quality of individual audits in a manner that enables them to take appropriate action in relation to both the audits concerned and the individuals responsible for them, including appropriately recognizing and rewarding those who are performing to a high standard.

While the identification of deficiencies is a central objective of engagement reviews, firms may also wish to emphasize that these efforts are also central to creating an environment of continuous improvement and learning.

¹⁵ Canadian Public Accountability Board, “*Fourth Public Report*”, January 2007.

Quality elements of monitoring

- The quality control system should be tested regularly
- The system should provide for feedback from all levels within the organization
- The system should be documented in the policy and procedure manual
- The results of the monitoring process should be communicated to all employees
- Rigor should be established in the system used to inspect and monitor the quality control system.
- The grading assigned to each inspection or audit should be meaningful and accurate by reflecting the issues identified and/or the quality of individual audits reviewed.
- Serious deficiencies that are identified during the review process should be reported immediately so that timely action can be taken by the firm
- The monitoring process should provide incentives for individual partners and staff to improve their performance

Conclusion

In setting the right tone at the top, management is establishing a foundation for the achievement of an organization's objectives. For professional services firms, and audit firms in particular, a clear, consistent and overriding commitment to quality by management is essential in creating an environment that enables professionals to perform to the best of their abilities. This commitment to quality is also fundamental to establishing and maintaining the reputation of the profession. The five areas addressed in this paper - firm strategy, communication, job descriptions, performance appraisals and monitoring - represent only a portion of the activities and processes undertaken by firms to implement their commitment to quality. This commitment to quality is also demonstrated each day by the hundreds of thousands of audit professionals in their daily actions. Many firms have devoted significant additional resources in recent years to implement the requirements of ISQC 1, including those requirements related to the tone at the top. Undoubtedly, the leadership of the firms will continue to strengthen the delivery of high quality audit services through the development of new approaches, investing in the training of their people, enhancing their monitoring processes and creating innovative communications for their personnel.

Appendix – External inspection reports reviewed

Country	Name of Body	Name of Report
Australia	Australian Securities & Investments Commission (ASIC) http://www.asic.gov.au	Report on the auditor inspection program, September 2005 Audit inspection program, Second report to FRC, August 2006
Canada	Canadian Public Accountability Board www.cpab-ccrc.ca	Fourth Public Report in Inspections of Quality of Audits Conducted by Public Accounting Firms, January 2007
Hong Kong	Hong Kong Institute of Certified Public Accountants http://www.hkicpa.org.hk/	Enhancing Quality Through Practice Review – Practice Review Committee Operations Report, 2005
Japan	Certified Public Accountants Firms and Auditing Oversight Board http://www.fsa.go.jp	Quality Control of Audits of the Four Largest Japanese Audit Firms, June 30, 2006
South Africa	Independent Regulatory Board for Auditors www.paab.co.za	South Africa: Second Cycle Findings
United Kingdom	Professional Oversight Board for Accountancy www.frc.org.uk/poba	2005/6 Audit Quality Inspections Public Report, July 2006
United States	Public Company Accounting Oversight Board www.pcaobus.org	All Public Inspection Reports – published through January 25 th , 2006



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