



Sri Lanka Accounting and Auditing Standards Monitoring Board

Thematic Inspection on Work of Engagement Quality Control Reviewer

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1. Background and Scope

1.1 Background

Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB) introduced thematic inspections, in addition to the routine audit inspection program, in 2017.

The aim of a thematic inspection is to focus on firms' policies and procedures in respect of a specific area or aspect of the audit, by inspecting selected audit engagements of such firm. This enables comparisons among firms with a view of identifying both good practices and areas of common weaknesses in relation to the selected theme or specific area.

The thematic inspections are narrow in scope by nature, and are chosen to focus on an aspect of the audit of a firm's procedures in greater depth than is generally possible in the normal inspections of audits.

This report sets out the principal findings of the first thematic inspection carried out by the SLAASMB in 2017. This thematic inspection focuses on the work performed by the engagement quality control reviewer ('EQCR') in the audit of financial statements at the engagement level.

Maintaining of audit quality is a key factor in a good audit. In order to meet this requirement engagement teams are entrusted with the responsibility of implementing quality control procedures that are applicable to each audit engagement.

Considering the contribution of an EQCR towards enhancing the quality of an audit of financial statements and considering the overall quality issues encountered from the past audit inspections, SLAASMB selected

the aforesaid theme for the first thematic inspection.

At present, *Sri Lanka Standard on Quality Control (SLSQC) 1 - Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements* and *Sri Lanka Auditing Standard (SLAuS) 220, Quality Control for an Audit of Financial Statements* are the main regulatory requirements prevailing in Sri Lanka in relation to quality control of audit firms and audit engagements respectively.

Maintaining and ensuring quality in audit engagements at audit firm level has been separately addressed in SLSQC 1 and engagement specific requirements have been set out in SLAuS 220.

Engagement Quality Control Review is;

A process designed to provide an objective evaluation, on or before the date of the auditor's report, of the significant judgments the engagement team made and the conclusions it reached in formulating the auditor's report. (SLAuS 220, 7b)

This report intends to promote a better understanding of the role of the EQCR in an audit engagement, on how he/she can contribute to enhance audit quality.

For the purpose of evaluating the application of requirements of engagement quality control review procedures in Sri Lanka, SLAASMB inspected a sample of fifteen (15) audit engagements carried out by six (6) firms that perform majority of audits of economically significant listed entities as depicted in Table 1.1 below:

Firm	No. of Engagements
A	3
B	3
C	3
D	3
E	2
F	1
Total	15

Table 1.1

The principal findings arising from the inspection are set out in Section 2 and the detailed suggestions on quality improvement are set out in Section 3 of the report.

1.2 Overview

All firms have established Engagement Quality Control (EQC) review procedures for financial statement audits of identified entities by appointing EQCRs and by establishing procedures and related documentation as per individual firms' policies.

Existence of effective EQC review procedures, in majority of the audit engagements selected is a healthy sign in the audit quality environment. However, when the issues and concerns of the audit engagement have not been addressed as intended, the contribution from the EQCR cannot be identified as a proper value adding activity.

Areas where firms can make improvements to their procedures and the application of these procedures in practice have been identified in this report, based on the observations made during the thematic inspection.

In order to maximize the contribution from an EQCR towards enhancing the quality of audit, the firms can select EQCR considering his/her industry experience and hierarchy of authority. Further, it is important to make available detailed documentation to reflect the involvement of EQCR including his/ her contribution at different stages of the audit engagement.

2. Principal Findings

EQC review is considered as a function deployed by audit firms to ensure that the quality of the audit engagements are maintained.

In accordance with the requirements set out in SLAuS 220, all firms inspected had appointed an EQCR for each audit engagement.

EQCR is;

A partner, other person in the firm, suitably qualified external person, or a team made up of such individuals, none of whom is part of the engagement team, with sufficient and appropriate experience and authority to objectively evaluate the significant judgments the engagement team made and the conclusions it reached in formulating the auditor's report. (SLAuS 220, 7c)

The engagement partner is required to ensure that an EQCR has been appointed; discuss significant matters arising during the audit, including those identified by the EQCR, with the EQCR; and not date the auditor's report until the completion of the EQC review.

Based on the requirements and guidance provided in SLSQC 1 to establish policies and procedures for EQC process, the detailed principal findings have been set out under following areas:

2.1 EQCR eligibility

2.2 EQCR objectivity

2.3 Evidence of the EQC review

2.4 Effectiveness of the EQCR

2.1 EQCR Eligibility

The firm shall establish policies and procedures to address the appointment of engagement quality control reviewers and establish their eligibility through:

(a) The technical qualifications required to perform the role, including the necessary experience and authority; and (Ref: Para. A47)

(b) The degree to which an engagement quality control reviewer can be consulted on the engagement without compromising the reviewer's objectivity. (Ref: Para. A48) (SLSQC 1, 39)

Majority of the firms have appointed a partner as their EQCR while in certain other instances individuals in other capacities had been appointed by some firms. Partners who have been appointed possessed more than five years of total experience as a partner in their respective firms.

Firms A, B, C and D, have appointed partners as EQCR in their audit engagements. In each of those reviews, except for an omission of one significant issue, in an audit engagement of Firm C (refer 2.4 for more details of the issue), such EQCRs have raised important industry specific questions and provided qualitative insights to the work performed by the engagement teams.

Firm E has appointed a quality control manager as the EQCR for one of its engagements, quoting that such EQCR possesses the industry specific experience in addition to the academic and professional qualifications.

The involvement of such reviewer has been evident by the continuous evaluation of the working paper file by such reviewer throughout the audit.

Firm F has appointed an individual in the capacity of a director, with more than twenty years of experience, who overlooks the quality assurance of the said firm, as its EQCR.

In both the above instances, it appears that the respective firms have not identified the EQC review process separately, from overall quality assurance of the audits of the firm.

2.2 EQCR Objectivity

The firm is required to establish policies and procedures designed to maintain objectivity of the engagement quality control reviewer. Accordingly, such policies and procedures provide that the engagement quality control reviewer:

- Where practicable, is not selected by the engagement partner;
- Does not otherwise participate in the engagement during the period of review;
- Does not make decisions for the engagement team; and
- Is not subject to other considerations that would threaten the reviewer's objectivity. (SLSQC I, A49)

Audit firms' policies and procedures are required to include clear guidance detailing circumstances that might threaten the objectivity of the EQCR, how this might be safeguarded and requiring EQCRs to evaluate whether their objectivity has been maintained throughout each of the audits.

In the engagements where the firms have appointed EQCR in the capacity of partners, existence of any specific threats to the objectivity of EQCR was not observed.

However, individuals who served as EQCR being in different designatory capacities within the firms, other than a partner of the firm, has resulted in creating a doubt as to whether the objectivity of an EQCR has been met by the said firms.

In two audit engagements referred to above in Firms E and F, individuals other than partners had served as the EQCR. Accordingly, the ability and authority of such EQCRs to challenge the decisions of the audit partner is doubtful. Similarly, in such situations whether the engagement partner, in his capacity as the engagement partner, has been free to consult the EQCR in areas where judgements were involved also caused doubt.

2.3 Evidence of the EQC Review

Where the appointment of an EQCR has been determined at the inception of an audit, the audit working paper file is required to comprise of documentary evidence on the involvement of an EQCR.

The engagement quality control reviewer shall document, for the audit engagement reviewed that:

- (a) The procedures required by the firm's policies on engagement quality control review have been performed;
- (b) The engagement quality control review has been completed on or before the date of the auditor's report; and
- (c) The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions it reached were not appropriate. (SLAuS 220, 25)

11 audit engagements of Firms A, B, C and D provided evidence on the participation of the EQCR at the meetings held at both planning and concluding stages of such audit engagements. In one audit engagement of Firm D, EQCR has not participated for the planning meeting and an 'audit highlight concluding memo' had been circulated among the engagement team including EQCR instead of conducting a conclusion meeting.

Completed EQC review checklists were available in each of the 13 audit engagements of 5 audit firms except in 2 audit engagements of Firm E.

As per the explanations given by the engagement teams during the inspections, firms using electronic audit files have cleared the comments raised by the EQCR prior to archiving of such audit files. Some firms have explained that their system has been designed to delete such comments once the issue has been cleared by the engagement team and reviewed by the EQCR. This completely

eliminates trails on effective involvement of the EQCR with the engagement teams unless his/her involvement is evident in the minutes.

In contrast, comments and concerns raised by the EQCR in the manual working paper file of the audit engagement of Firm F were evident.

In one of the audit engagements of Firm E, where a partner had been involved as the EQCR, there was no evidence available in the audit working paper file of such EQCR's involvement throughout the audit.

2.4 Effectiveness of the EQCR

The engagement quality control reviewer shall perform an objective evaluation of the significant judgments made by the engagement team, and the conclusions reached in formulating the auditor's report. (SLAuS 220, 20)

Audit teams and EQCRs should ensure that the EQCR's review is performed on a timely manner at appropriate stages of the audit engagement and be diligent in addressing matters raised by the EQCR. EQCRs should ensure that their review is effective to safeguard auditor's independence and the quality of the audit work performed.

As stated in 2.3 above, SLAuS 220 requires EQCR to document that he is not aware of any unresolved matters which would cause him to believe that the significant judgments made and the conclusions reached by the engagement team were not appropriate for the audit engagement reviewed.

However, a significant judgement made by the engagement partner of Firm C that had been subsequently found as inappropriate by SLAASMB had not been addressed by the

EQCR during the EQC review. In this instance, assumptions made in estimating the allowance for impairment for customers - in - default in the said financial statements were found to be not appropriate by SLAASMB. This had also been communicated to the relevant company.

In addition, the following issues had been identified by SLAASMB in the financial statements of the audit engagement of Firm F and one audit engagement of Firm E respectively. However, there was no evidence of EQCR raising any concerns on these aspects during the audit:

- Deficiencies in the mechanism of calculating the impairment losses.
- Assessment of recoverability of carrying value of investment in subsidiary.

Further, the ongoing quality review had been considered as the EQC review process in the other audit engagement of Firm E. Therefore, this does not facilitate the overall assessment of the quality of the final decisions made by the audit partner, when formulating the auditor's report, since the ongoing quality reviewer's scope can differ as such ongoing review pays more attention to proper compilation of audit documents.

SLAuS 220 requires the EQC review process to be completed by the EQCR on or before the date of the auditor's report. However, based on the evidence available in the EQC review notes in the audit engagement of Firm F, the EQC review has been concluded after sixty (60) days from the date of the auditor's report. This incident has undermined the role of the EQCR.

3. Way Forward

All audit firms are required to consider whether they have made appropriate arrangements to assess the EQCR's contribution to improve the audit quality.

Existence of following can be considered as evidence for effective EQC review in an audit engagement:

- Appointment of a suitably qualified person as the EQCR with sufficient and appropriate experience and authority to independently and objectively evaluate, the significant judgments the engagement team has made and the conclusions they have reached in formulating the auditor's report.
 - Availability of checklists confirming completion of procedures required by relevant standards.
 - Availability of documentary evidence of the significant matters the EQCR had discussed with the audit team or the Engagement Partner had discussed with the EQCR and how they have been resolved.
 - Evidence consisting of copies of draft financial statements and reports to the Audit Committee that have been annotated by the EQCR during the EQC review.
 - Availability of EQCR's review notes showing the areas in which the EQCR had challenged and/or had concerns on the work performed by the engagement team.
- Sign-offs on key audit working papers indicating that the EQCR has reviewed them on or before the date of the auditor's report.
 - Availability of appropriate documentation of the timing and extent of the review performed by the EQCR on the audit.
 - Clear segregation of the duties of EQCR from quality review process of the firm.