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# DID YOU KNOW THAT **INDEPENDENT AUDITORS** ARE ALSO **AUDITED?**

Learn how quality management, inspections, and oversight function in Independent Audit



No. 09

# DID YOU KNOW THAT INDEPENDENT AUDITORS ARE ALSO AUDITED?

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**THROUGHOUT THE MIND THE GAP SERIES**, we have reinforced the importance of the role played by Independent Audit to increase the reliability of corporate reports and reduce information asymmetry in the capital market. Auditors must be able to analyze, perform tests and express an opinion on the information subject to audit, following regulatory requirements, auditing standards and the fundamental ethics principles of the accounting profession. All of this is guided by skepticism and independence, which are crucial for the adequate performance of their activities.

Faced with so much responsibility and requirements for a highly technical profession and relevant to the capital market, the supervision and the monitoring of professionals and audit firms are equally strict and technical. Considering that the activity is permeated by countless laws, professional standards and regulations, there is nothing more natural than the profession also being subject to internal and external controls to monitor the performance of the professionals who practice it.

The high quality of the audit is an indispensable condition for generating confidence in their work. After all, for the independent opinion contained in the Independent Auditor's Report to be accurate and credible, it is necessary to guarantee the quality of the services provided at all stages of the audit. And it is never too much to remember that the profession's Code of Ethics is categorical in emphasizing that the professional's responsibility is not exclusively to satisfy the client's needs, but to act in the public interest<sup>1</sup>.

<sup>1</sup> NBC PG 100 (R1), item 100.1A1.



To perform their work with the quality expected by society as a whole, audit firms are responsible for implementing an effective quality control system. The standards related to the quality management system issued by the International Auditing and Assurance Standards Board (IAASB), after extensive discussion, were recently revised and published in 2020<sup>2</sup>. The revision covered international standards on quality management (ISQM 1 and 2) for Independent Audit firms and the quality management for an audit of financial statements (ISA 220).

The international standard ISQM 1, implemented in Brazil by the Federal Accounting Council (CFC) with the edition of NBC PA 01, requires all audit firms to develop, implement and operate a quality management system for audits, reviews of financial statements and other assurance engagements.

Quality management must cover all aspects, from the governance of the audit firm, which includes its values and institutional culture, reaching

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the processes of risk assessment, engagement acceptance and decision on its continuance, the stages of execution of services, and the continuous monitoring of implemented controls<sup>3</sup>.

The quality review must exist for each of the engagements performed and is regulated by NBC PA 02, equivalent to ISQM 2 of the international standards issued by the IAASB. The standards establish a series of technical requirements for quality reviews, including requirements for appointing the reviewer – a person who must be independent of the team assigned to conduct the engagements. It is important to understand the scope of the quality review, which is: to maintain an objective assessment of the “significant judgments” of the engagement team and their conclusions<sup>4</sup>. Regarding the choice of the person responsible for the review, fundamental ethics aspects must be present, such as objectivity and professional competence. The reviewer cannot be a member of the engagement team and must have the appropriate competence, skill and authority to properly perform the function.

<sup>2</sup> <https://www.ifac.org/knowledge-gateway/supporting-international-standards/discussion/quality-management>.

<sup>3</sup> The items that the firm's quality system must cover are described in NBC PA 01, item 6.

<sup>4</sup> NBC PA 02, item 8.

The role of the quality reviewer does not replace or reduce the responsibility of the engagement partner and of the audit team. His role is to objectively evaluate the significant judgments and the conclusions reached by the team. To this end, he must discuss the significant matters and judgments made when planning and performing the engagement, as well as when preparing the corresponding report. He is also responsible for checking the audit documentation supporting the conclusions reached, observe the use of professional skepticism and independence requirements, whether consultations were made on difficult or controversial matters, in addition to reviewing the financial statements and the draft audit report prepared by the team. All this engagement must be completed before the final issuance of the report. If concerns are not satisfactorily resolved in the view of the engagement quality reviewer, he should notify the appropriate persons within the firm that the engagement quality review cannot be completed.

In addition to the work of the quality reviewer, the management system also provides for a monitoring and correction process. Monitoring

is a relevant stage, in which the firm must establish policies and procedures to randomly select and review at least one completed engagement for each partner, periodically, in cycles, for example, of three years. And independence, once again, is a mandatory requirement: monitoring must be carried out by people who have the necessary skills and abilities and who have not been part of the relevant engagement team nor have been quality reviewers of the engagement in question.

With the results of the various reviews, as well as the issues identified by the quality management, the firm must assess the severity of possible deficiencies and the risk of their dissemination, investigating their causes. It must also plan and implement the necessary corrective measures, continually seeking excellence in the quality of its services.

In addition to the reviews provided for in the quality control system, several regulators, even international ones, regularly inspect or monitor the quality of the audits.

For example, the Regional Accounting Councils (CRC) conduct periodic inspections, covering aspects of licenses and registrations, as well as the audit process itself in selected cases.

As detailed below, the Brazilian Securities and Exchange Commission (CVM), in turn, in addition to inspections, requires the implementation of the quality management system and external quality review controls. The implementation of internal controls is governed by the quality standards issued by the CFC, already addressed. External control is carried out through annual quality inspections carried out by peers, under the management of the Management Committee of the External Quality Review Program (CRE), composed of four members appointed by the CFC and four by Ibracon.

Auditors registered with the CVM and those registered with the CNAI PJ (National Register of Independent Auditors – Legal Entities) must undergo peer review at least once every four-year cycle<sup>6</sup>. To this end, the CRE makes a random selection annually, in such a way that the revised firm cannot anticipate

<sup>5</sup> CVM Resolution No. 23, of February 25, 2021.

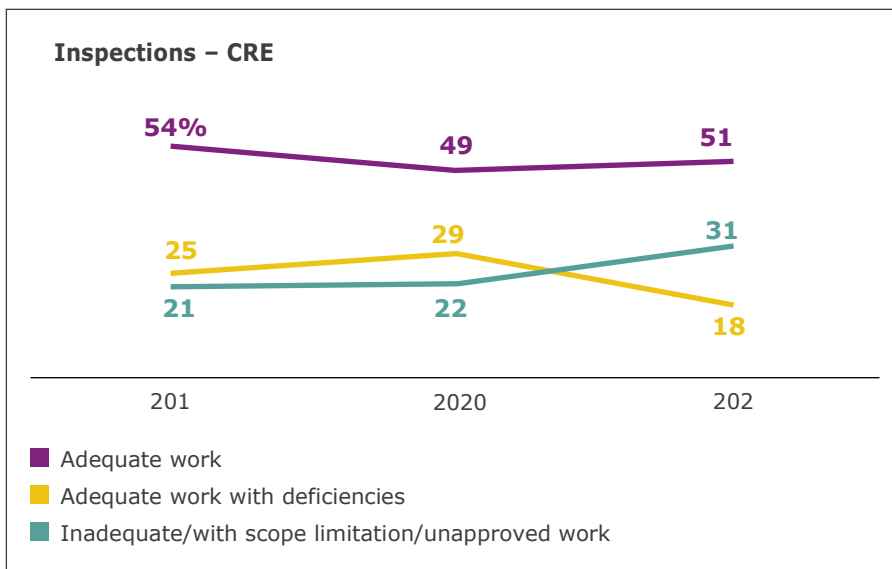
<sup>6</sup> The NBC PA 11 standard governs the procedures and sets out the CRE's competencies.

in which year the evaluation will be carried out. This process is known as Peer Review. In this process, the reviewing auditor issues an assurance report expressing an opinion on whether the reviewed quality control system was adequately designed, implemented and is operated effectively with the objective of:

- (i) the firm and its personnel comply with the applicable technical standards and legal and regulatory requirements; and
- (ii) reports on financial statements and other reports are issued in a manner appropriate in the circumstances.

Among other functions of the CRE, it is its responsibility to supervise the work performed by the reviewing auditor, request any necessary measures, present an annual report on his activities and communicate with regulatory bodies, such as CVM, Central Bank and SUSEP, about the results of the review work.

Notes made by the CRE on Peer Review reports presented with deficiencies, inadequacies or that have not been approved by the Committee are not rare cases. In the last work cycle, approved reports indicated that quality systems operating effectively represented 51% of the firms submitted to the program.



Graph – results of inspections conducted by the CRE in 2019 to 2021. Source: Final CRE reports for 2019, 2020 and 2021 available on the CFC website

Annual reports are public and available on the Federal Accounting Council (CFC) website<sup>7</sup>, with the transparency that is expected from Independent Audit. The graph above shows the evolution of the CRE assessments between 2019 and 2021.

In addition to peer review, auditors who audit listed companies (with securities traded on the stock exchange) are subject to inspections by regulators. In Brazil, audit firms of listed companies undergo inspections carried out directly by the CVM – on average, every three years. In the case of audits of companies listed in other countries, there are additional inspections carried out by the foreign regulator, from the cor-

responding country. This is the case, for example, of the firms responsible for auditing companies registered at the U.S. Securities and Exchange Commission (SEC), as well as those listed on the Toronto Stock Exchange (TSX), Canada's main stock exchange. In this context, Brazilian audit firms are subject to quality inspections conducted regularly by the Public Company Accounting Oversight Board (PCAOB) and by the Canadian Public Accountability Board (CPAB), in general, every three-year cycle. CVM does not issue inspection reports, but initiates sanctioning administrative proceedings against auditors if any deviations are identified.

<sup>7</sup> Information about the CRE, as well as the standards and final reports, are available at: <https://cfc.org.br/tecnica/areas-de-interesse/cre/>.



Regarding the PCAOB, all inspections are subject of reports, which are made available to the public on the agency's website<sup>8</sup>. CPAB also publishes an annual report on its website with the results of inspections carried out<sup>9</sup>.

Inspections are particularly relevant for a constructive dialogue between regulators and firms, to promote actions aimed at improving quality systems. Inspections, taken as a whole, provide regulators with important elements for evaluation, in the public hearings they promote the revision or updating of standards, in the form of what was explored in the article "Evolution Gap", in this Mind the Gap series<sup>10</sup> (which deals with how audit improves to better

meet society's desires).

In addition to possible sanctions imposed by regulatory bodies, firms are exposed to notorious risks to their reputation and image. In this context, the standards related to the quality management system (NBC PA 01 and 02) are not just sources of obligations for auditors. They can and should be used to one's advantage, to establish a culture that demonstrates commitment to quality, the importance of professional ethics, values and attitudes, recognizing and reinforcing the firm's role in serving the public interest, through the performance of high quality engagement, in a consistent manner.

*With great power comes great responsibility.* This proverb, popularized in the universe of comic books, reflects well the condition of the audit, as well as the reason why its conduct is closely monitored by so many bodies and regulators, under great interest from investors and society as a whole. The importance of audit and its responsibility permeates the internal quality reviews of each firm, through Peer Review, controls and inspections carried out by national and international regulatory bodies. Nevertheless, the profession views all these controls positively and with optimism. After all, reputation is the most valuable asset for Independent Audit.

<sup>8</sup> <https://pcaobus.org/oversight/inspections/firm-inspection-reports>.

<sup>9</sup> <https://cpab-ccrc.ca/>

<sup>10</sup> <https://www.ibracon.com.br/portal-do-conhecimento/pesquisas-e-publicacoes/mind-the-gap-4-voce-sabe-o-que-e-o-gap-de-evolucao-na-auditoria-independente/>

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