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Düsseldorf, August 27, 2003
494/523/541/538

Dear Jim

**Re: Exposure Draft Proposed International Standard on Quality Control 1
“Quality Control for Audit, Assurance and Related Service Practices” and
Exposure Draft Proposed Revised ISA 220 “Quality Control for Audit En-
gagements”**

We would like to thank you for the opportunity to provide the International Auditing and Assurance Standards Board (IAASB) with our comments on the Exposure Drafts *Proposed International Standard on Quality Control “Quality Control for Audit, Assurance and Related Service Practices”* and *Proposed Revised ISA 220 “Quality Control for Audit Engagements”*.

In addition to comments on specific paragraphs in the documents, this comment letter includes general comments on the exposure drafts and the IAASB’s handling of its intention to split the current ISA 220 into two new standards.

This comment letter addresses the general comments first and then each item in turn.

General Comments

1. Definition of Types of Engagements

We would like to point out that current IFAC pronouncements contain an inconsistency in terminology. The recently approved Preface includes a chart that classifies audit and review as falling within the scope of Assurance Engagements. Assurance Engagements are depicted as separate from Related Services. The definitions within the IFAC Code of Ethics for Professional Accountants (and in the proposed new Code) specifically include audits and reviews within the term Assurance Engagements.

The Glossary of Terms at December 2002 in the current edition of the IFAC Handbook of International Auditing, Assurance, and Ethics Pronouncements, in contrast, defines Related Services as comprising reviews, agreed-upon procedures and compilations. The latter definition should therefore be amended.

The use of the word “Practice” in the title is ambiguous, particularly in translation and is not defined in the Standard. Hence, it should be replaced with the term “Firm”, which is defined in the Standard.

In our view, based on the use of the word “Firm” rather than “Practice”, and by applying the chart included with the recently approved Preface, in which assurance engagements encompass audits, the title “Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, Other Assurance Engagements and Related Services” for ISQC 1 would be more appropriate.

2. Organization and Content of the Quality Control Standards

We agree that ISA 220 be reorganized into two standards: a standard dealing with policies and procedures to be applied at firm level (ISQC 1) and a new standard specifically for individual audit engagements (ISA 220). This reorganization does not appear to have been appropriately implemented. The revised ISA 220 repeats the requirements of ISQC 1 in several instances: Paragraphs 27, 28 and 29 closely mirror paragraphs 45, 46 and 47 of ISQC 1, and paragraphs 39, 40 and 41 closely mirror paragraphs 60, 61 and 62 of that document. On the other hand, paragraph 42 of ISA 220 refers directly to paragraphs 57-72 of ISQC 1. The treatment of matters covered by ISQC 1 in ISA 220 does not appear to be consistent. In any case, it would appear unnecessary to reproduce extracts of ISQC 1 in ISA 220 as is currently proposed.

Instead, it would be more helpful if ISA 220 were to focus on the specific policies and procedures that apply at the audit engagement level. Were the various thereby re-

dundant paragraphs to be removed from ISA 220, the standard would be considerably shortened. Some of the redundancies could be replaced by references to ISQC 1.

Furthermore the content of the remaining paragraphs is closely related to aspects of the logistical planning of an engagement. A new exposure draft revising the planning standard has recently been issued by the IAASB. A review of the proposed exposure draft of the planning standard shows that considerable overlap with the audit risk standards and the quality control standards exists. We do not see the need for repetition in a planning standard of matters that have been addressed in other standards. Furthermore, those issues in the exposure draft of the planning standard that do not overlap with other standards relate primarily to issues of logistics and other matters that ultimately relate to quality control. Consequently, we suggest that the redundancies in the planning standard be eliminated and that those matters in the proposed standard that apply to the overall planning and management of resources of the firm be placed into ISQC 1 and those matters in the proposed planning standard that apply only to individual audit engagements be placed into ISA 220 and the proposed audit risk standards, as appropriate.

We support the application of a principles-based approach in ISQC 1. However, the appendix of the current ISA 220 does contain a lot of helpful guidance that has not been included in either of the draft quality control standards. In particular, guidance with respect to human resources currently included in the appendix to ISA 220 is considered useful by many firms. While this guidance need not be incorporated in the standard, we believe that such guidance could be placed into an IAPS. However, if no IAPS in relation to this guidance is contemplated by the IAASB, it should be updated and incorporated into the text of ISQC 1 because it includes useful guidance for evaluating skills and competence of potential employees, professional development and advancement.

3. Special Quality Control Requirements for Listed Entities

Paragraph 25 of ISQC 1 states that firms should establish policies and procedures requiring the rotation of the engagement partner after a specified period of time for all audits of financial statements of listed entities. Furthermore, paragraph 57 of ISQC 1 states that firms should establish policies and procedures that require the performance of an engagement quality control review for all audits of financial statements of listed entities.

We question whether special quality control policies and procedures are always necessary for the audit of listed entities in all jurisdictions, because in some jurisdictions audits of listed entities are not subject to additional audit risk merely due to their being listed.

In other words, by singling out listed entities the Standard is not taking a principles- or risk-based approach in determining when special quality control policies and procedures would be necessary. However, we recognize that in many jurisdictions and many situations, listed entities are subject to additional audit risks or requirements. For example, in Germany, for the audits of financial statements of listed entities, firms must rotate audit partners as specified in the law. Consequently, we believe that the IAASB, in taking a risk-criteria approach, should address whether or not an entity is listed as being an important criterion for determining whether additional audit risks exist requiring special quality control policies and procedures. Given the additional risks associated with audits of listed entities in some jurisdictions we would be prepared to accept a criterion with a presumption that audits of listed entities may require special quality control policies and procedures in certain jurisdictions.

Consequently, we suggest that paragraph 25 (a) of ISQC 1 be deleted and the word “other” in front of audit in paragraph 25 (b) also be deleted, and that paragraph 27 address the criterion “listed entity” in a separate bullet point. Similarly, paragraphs 57-59 could be changed in the same manner.

4. Consideration of Special Circumstances and Alternative Safeguards for Small Audit Firms and Sole Practitioners

We support the general rule in paragraph 4 of ISQC 1, that even though the standard applies to all firms, individual firms are free to develop differing policies and procedures suited to their particular circumstances, provided they meet the requirements of this ISQC. The nature, timing and extent of those policies and procedures will depend on many factors, including the size and operating characteristics of the firm.

Nevertheless we feel that further clarification of this matter would be useful, because there are aspects, such as operating characteristics, other than size, that need to be addressed explicitly. For example, in establishing its quality control policies and procedures an individual firm should consider its particular **risk situation**.

The nature and complexity of the professional and regulatory requirements and their concomitant risks drive the nature and complexity of the quality control system that needs to be established. Some firms are subject to more complex professional and regulatory requirements than others due to the types of engagements that they perform.

There may be situations, where, due to the size or other operating characteristics of the firm, certain quality control measures are either impracticable or may not constitute an appropriate safeguard, for example, internal rotation in the case of a sole practitioner. In such situations, the firm should be required to establish other safe-

guards that address the risks. For example, the external consultant that performs monitoring functions or the engagement quality control reviewer could focus on the effectiveness of safeguards for risks arising from a lack of internal rotation. In this respect, an additional paragraph could be added subsequent to paragraph 27 that describes the use of other safeguards to address risks for which a safeguard set forth in ISQC 1 is not practicable. This would be in line with paragraphs 52, 68 and 78, which suggest alternatives to solutions that are solely internal to the firm.

5. *The Use of the Term “Significant”*

The term “significant” appears in both standards without being defined. Its usage is not consistent because the current definition in the Glossary of Terms relates the definition of significant to materiality, which is, we believe, not the intention in its use in the proposed standards. Consequently, we think the current definition in the Glossary of Terms needs revision.

6. *Accountability of those Responsible for Quality Control*

Paragraph 12 addresses the responsibility within the firm for the quality control system. As noted, in some larger firms this responsibility is delegated to one or more individuals. However, in our view, the standard does not appear to address the accountability relationships between staff that perform quality control functions and those that are responsible for the quality control system. We believe that the standard should explain that, to the extent that members of staff perform quality control functions, such staff should be accountable to and hence report to those to whom the CEO or equivalent has delegated responsibility for quality control, and not to other parties. Ultimately, the individual to whom the CEO or equivalent has delegated responsibility for quality control should also be accountable to the CEO or equivalent for quality control and not to other parties. Additional guidance in this respect could be added in a grey-lettered paragraph following paragraph 13.

Comments on Specific Paragraphs of ISQC 1:

Para 5(c) Definition of “Firm”

The definition of “Firm” is not precise enough to take into account all circumstances in which professional accountants may use the name of an entity in the issuance of an assurance or related services report. For example, given the desire of the IAASB to incorporate considerations with respect to government auditors (INTOSAI), we believe the

definition should be more generic to cover all of the circumstances that might be encountered in practice. Furthermore, in Germany there are associations of auditors in whose name audit reports are issued that are not sole practitioners, partnerships or corporations of professional accountants.

We suggest the following definition of firm: “any entity in whose name an assurance or related services report is issued”. We recognize that this would make the ISQC 1 definition inconsistent with the one used in the IFAC Code of Ethics, but we consider the definition of “firm” in the IFAC Code of Ethics to be seriously deficient in this respect.

Para 5 (d) Definition of “Listed entity”

We believe that the definition of a “listed entity” does not encompass those situations where special accounting or other legal requirements may exist with respect to the public offering or trading of securities. Consequently, we suggest the following definition: “any entity that has issued, or has specific intentions to issue, financial instruments that are or are intended to be quoted, listed or traded on a recognized stock exchange, offered or traded under the regulation of a recognized stock exchange or other equivalent body, or are subject to securities regulation over their public offering or trading”. We recognize that our proposed definition is inconsistent with the one used in the IFAC Code of Ethics, but the definition in the Code of Ethics is deficient because it does not cover derivative securities or the public offering or trading of securities where such offering or trading is subject to securities regulation but not an exchange or equivalent body.

Para 25 Partner Rotation

Should paragraph 25(a) not be deleted, we suggest the following: Paragraph 25(a) includes requirements, which are “in compliance with the IFAC Code and national pronouncements where these are more restrictive”. As the wording in this paragraph was changed from “or” to “and”, the last part of the sentence “where these are more restrictive” can be deleted. If both IFAC Code and national pronouncements have to be applied, logically, the more restrictive requirements are necessarily included.

Paragraph 25(a) requires the rotation of the engagement partner for all audits of financial statements of listed entities in compliance with the IFAC Code. In addition, paragraphs 25(b) and (c) oblige firms to set out criteria against which all other audit, assurance and related ser-

vices engagements should be evaluated for the purpose of determining whether the engagement partner should be rotated after a specified period and, where applicable, require the rotation of the engagement partner for those engagements. The wording “all other audits, assurance and related services engagements” is inconsistent with the recently approved diagram attached to the Preface and should, therefore, be changed to **all other audits and reviews of historical financial information, other assurance engagements and related services.**

The IFAC Code of Ethics, Section 8.150 is less restrictive than ISQC 1, as it suggests further options which would be equally applicable; in particular, it allows for situations where the lead partner is not rotated after such a predefined period when equivalent safeguards are applied to reduce any threats to an acceptable level (8.153 and 8.154), the latter providing guidance for small firms and sole practitioners.

Our concern is that, as quality control standards are designed to establish guidelines for the implementation of quality control systems that assure compliance with relevant professional standards, by setting stricter requirements for rotation in ISQC 1, the IAASB effectively goes beyond the requirements of the IFAC Code of Ethics.

Internal rotation is aimed at preserving the objectivity of the practitioner with respect to any subject matter of an assurance engagement, which includes the provision of an opinion or conclusion of the practitioner to users. No such opinion or conclusion requiring objectivity is issued for related services engagements. When related services are being performed, such as compilations of financial statements or other financial information, the practitioner performs the services that are outsourced to him or her that could otherwise have been performed within the entity. In these circumstances it is questionable whether objectivity, and hence independence, is an issue because, if these services had been performed by management or their staff, these would have not needed to be independent. On this basis, the current proposal to set criteria for the determination of whether internal rotation is necessary for services other than assurance engagements appears to be superfluous.

If criteria for the determination of whether internal rotation is necessary are retained for related services engagements, then we believe it should be limited to agreed-upon-procedures engagements. Moreover, if such criteria are to be set for agreed-upon-procedures engagements, they should be based on a risks and safeguards approach as used in

the Code of Ethics.

Para 29 (d) second bullet point We suggest that the term “references” be changed to “information”, because references can only generally be obtained from the clients’ bankers or legal counsel and they are unlikely to provide such references due to confidentiality obligations, whereas information would likely be available from bankers or legal counsel that do not provide services to the potential client in question.

Para 60 Scope of the Engagement Quality Control Review

This paragraph states that an engagement quality control review should include an objective evaluation of

- a. The significant judgments made by the engagement team;
- b. The conclusions reached in formulating report; and
- c. Other significant matters that have come to the attention of the engagement quality control reviewer.

As this does not represent a complete list of what should be objectively evaluated, the introductory sentence should be amended to read as follows:

”An engagement quality control review should comprise an objective review of whether quality control policies and procedures of the firm are complied with in the performance of an engagement, including:”

We are concerned that there may be room for misunderstanding, especially in translation, due to the use of the terms “review” and “evaluation”. The exact duties of the engagement quality control reviewer should be clearly stated. Is merely a review required? If not, what depth should an evaluation have? The term evaluation appears only in the introductory sentence in paragraph 60 – it may be clearer if this term were replaced with “review”, which would be consistent with the title of the procedure “engagement quality control review”.

Furthermore, it would be helpful to add examples, e.g. the engagement quality control reviewer should review the list of unadjusted differences to see if these differences have been dealt with properly.

Para 71 Replacement of the Engagement Quality Control Reviewer

We agree that firm policies should provide for the replacement of the engagement quality control reviewer where the ability to perform an objective review may be impaired.

However, we disagree that such impairment takes place when the engagement quality control reviewer has undertaken the engagement quality control review of a client for several years, because quality control reviewers, by definition, are expected to retain a certain distance from operating decisions made by the engagement partner, and generally have minimal direct contact with the client. Consequently, impairment of engagement quality control reviewer objectivity ought to be rare. Hence, the part in the sentence providing an example of an impairment of the objectivity of a quality control reviewer due to having undertaken such reviews for a particular client for several years can be removed.

Para 73

In our opinion, this paragraph does not match the requirements in paragraph 2. We suggest that paragraph 73 be reworded as follows: “The firm should establish policies and procedures to obtain reasonable assurance that:

1. the system of quality control is designed to obtain reasonable assurance that the firm and its personnel comply with professional standards and applicable regulatory and legal requirements, and that reports issued by the firm or engagement partners are appropriate in the circumstances, and
2. policies and procedures of the quality control system of the firm are operating effectively”.

Para 74

Monitoring

The current wording of this paragraph gives the impression that the elements of a system of quality control are monitored as a separate exercise from a periodic inspection of a selection of completed engagements. To avoid misunderstanding, we suggest that the second sentence be amended to read:

“A firm’s monitoring is designed to monitor both the design and operating effectiveness of the firm’s system of quality control. Monitoring the adequacy of the firm’s quality control system can be achieved by an

ongoing consideration and evaluation of the elements of the system of quality control as set out in paragraph 6 below. The prerequisite for operating effectiveness is that the system has been both appropriately designed and implemented. A procedure necessary to establish whether the firm's quality control system is operating effectively is the periodic inspection of a selection of completed engagements."

Para 87 Monitoring on a network basis

It would be useful if an example of the purpose of monitoring on a network basis were given in this paragraph. For instance, firms using a monitoring system on a network basis may then be in a position to rely on the work of a network firm (e.g. when they are the auditors of subsidiary or related company) without having to perform the extent of procedures that might have otherwise been necessary under ISA 600 "Using the Work of Another Auditor".

Para 88 - 90 Complaints and allegations

The topic of complaints and allegations is, in our opinion, a part of the firm's overall quality control responsibilities to the extent that such complaints and allegations do not arise from the operation of the monitoring system. As such, the information in paragraph 88 would be better placed in paragraph 7(e), and paragraphs 89 and 90 could be placed subsequently to 7(e). Furthermore, policies and procedures for complaints and allegations arising from the operation of the monitoring system should be treated separately in the current section on complaints and allegations from those policies and procedures for complaints and allegations not arising from the operation of the monitoring system. However, the standard should note that there is an exchange of information between the two sets of policies and procedures for complaints and allegations.

Paragraphs 88 to 90 dealing with complaints and allegations, which were added later, seem unsystematic and do not provide adequate guidance. The information given here should be extended to provide a link with the quality control system and include a description of examples of procedures to be performed.

Comments on Specific Paragraphs of ISA 220:

Para 5(c) Definition

As for the definition of “firm” we refer to our comments for ISQC 1, paragraph 5(c).

Para 6, 7 Leadership and Responsibilities

In our view, the engagement partner is not responsible for the promotion of a quality-oriented internal firm culture on each audit engagement to which that engagement partner is assigned, but rather is responsible on behalf of the firm for conveying the *firm's* quality control culture. Furthermore, the engagement partner is not responsible for the firm's quality control responsibilities, which are defined in ISQC 1, but rather is responsible for engagement quality control. Hence, we would revise this paragraph to read as follows: On each audit engagement to which an engagement partner is assigned, that engagement partner should be responsible on behalf of the firm for conveying the firm's quality-oriented culture, and is responsible for engagement quality control on that audit engagement.

Para 15(a) Independence

This paragraph states in (a) that the engagement partner should obtain sufficient information regarding the engagement, including the scope of services provided to the client by the firm or, where applicable, other network firms, in order to evaluate whether there are potential threats to independence. In our view, particularly in larger firms or networks, the engagement partner necessarily relies upon the firm's or network's quality control system to appropriately collect the information so that the partner can make use of it for his or her evaluation of potential threats to independence. The way this paragraph is written now it appears that the engagement partner is saddled with the responsibility for collecting information over the whole network about potential threats to independence for the an engagement. This is unreasonable.

Rather, ISQC 1 should include a requirement for the firms to collect information in this respect so that partners can make use of it. The requirement here in paragraph 15(a) of ISA 220 should be limited to hav-

ing the engagement partner obtain the information made available by the firm or network.

Furthermore, consideration should be given to the data protection and confidentiality laws in some jurisdictions that may hinder the collection of such information.

If you have any further questions about our views on these matters, we would be pleased to be of further assistance.

Yours truly,

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Dr. Gross