



By e-mail <EDComments@ifac.org> and by fax (0062 1 212 286 9570)

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8 October 2003

Technical Director,
International Auditing and Assurance Standards Board,
International Federation of Accountants,
545 Fifth Avenue, 14th Floor,
New York,
New York 10017,
USA.

Dear Sir,

IAASB Quality Control Exposure Draft

The Hong Kong Society of Accountants (HKSA) welcomes the opportunity to provide the IAASB with our comments on the IAASB Quality Control Exposure Draft. We apologize for the delay in submitting our comments.

We set out in the attachment our comments for the consideration of the IAASB.

The HKSA has a policy of converging its Auditing Standards with the IAASB's Standards. The standard setting due process applied in Hong Kong (details of which are available on the HKSA's website) acts to support this policy. The HKSA's Auditing and Assurance Standards Committee (AASC) issued an Invitation to Comment on the IAASB Quality Control Exposure Draft with a comment period concurrent with that set by the IAASB. Accordingly, the accompanying comments may reflect the views not only of members of the AASC but also of constituents in Hong Kong who provided comments to the HKSA.

We trust that the IAASB will find our comments helpful. If you require any clarifications on our comments, please contact our Deputy Director (Ethics & Assurance), Stephen Chan <schan@hksa.org.hk>, in the first instance.

Yours faithfully,

WINNIE C.W. CHEUNG
SENIOR DIRECTOR
PROFESSIONAL & TECHNICAL DEVELOPMENT

WCC/SSLC/jc
Encl.

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HONG KONG SOCIETY OF ACCOUNTANTS' COMMENTS ON THE IAASB QUALITY CONTROL EXPOSURE DRAFT

GENERAL COMMENTS

Overall we are supportive of the Exposure Draft which includes the proposed new ISQC 1 "Quality Control for Audit, Assurance and Related Services Practices" that deals comprehensively with a firm's quality control practices in the areas of audit, assurance and related services and the proposed revised International Standard on Auditing (ISA) 220 "Quality Control for Audit Engagements" that establishes standards and provides guidance on specific quality control procedures for audit engagements.

We believe that the proposed Standards are a major improvement over the extant ISA 220 which only deals with audits of historical financial statements and covers both the firm (but only in an audit of historical financial statements context) and the individual audit engagement. The extant ISA 220 addresses major quality control areas, but not to the extent of detail as in the proposed Standards.

We are in agreement with the IAASB that in undertaking this project, it is moving towards its overall objective of improving engagement quality in the public interest.

The proposed Standards will undoubtedly lead firms to reflect on whether their quality control policies and procedures are robust and comprehensive, and will help to both clarify and reinforce the roles and responsibilities of engagement partners and teams and engagement quality control reviewers in delivering quality audit, assurance and related services. We consider this is important in strengthening the public's trust in the profession. However, the implementation of both ISQC 1 and revised ISA 220 may result in increased work effort by firms and engagement teams. In addition, firms and professional bodies will need to consider the training requirements that may result from the proposed Standards.

SPECIFIC COMMENTS/OBSERVATIONS

Proposed New ISQC 1

1. Scope

We support the plan to produce two separate quality control standards, namely ISQC 1 at firm level and revised ISA 220 at engagement level. The rationale for that decision was to clearly segregate both levels of responsibility, i.e. firm and engagement, and that deficiencies in a firm's system of quality control do not, in and of themselves, indicate that a particular engagement was not performed in accordance with applicable professional standards. Conversely, deficiencies in individual engagements do not necessarily indicate that the firm's system of quality control is insufficient to provide it with assurance that it complies with applicable professional standards. However, we note that ISQC 1 applies to all engagements, but the proposed revised ISA 220 only applies to audits of historical financial statements, with the result that quality controls at engagement level for engagements other than audit have been omitted.

We recommend that the IAASB include a statement in the final ISQC 1 to the effect that “For all engagements, in addition to the requirements in ISQC 1, engagement teams should implement appropriate quality control procedures. For non-audit engagements, reference should be made to ISA 220 to the extent that they are applicable”.

2. Title of the proposed ISQC 1

We note that with the introduction of the new Assurance Framework there will be assurance engagements and other related services practices. Given this, we consider that the title of the final ISQC 1 should be “Quality Control for Assurance Engagements and Related Services Practices”.

3. Reasonable Assurance of Compliance with Professional Standards

We question the logic used in paragraph 2 that a quality control system should be designed to provide *reasonable assurance* that the firm has complied with professional standards. As set out in the Proposed Preface ISAs are to be applied in an audit. Auditors are expected to apply ISAs in order to have reasonable assurance as to whether financial statements give a true and fair view. Accordingly it is essential that auditors have much more than just *reasonable* assurance that auditing standards have been followed in order to have reasonable assurance that financial statements give a true and fair view. We consider that it would be more appropriate to require that a quality control system should be designed to provide *assurance* that the firm has complied with professional standards.

4. Leadership and Responsibilities within the Firm

We note that paragraph 10 states that the firm communicates quality control policies and procedures to personnel in order to *assist in effective implementation*. We consider that these words are too weak as communications of quality control policies and procedures to personnel is a prerequisite for their effective implementation. It is not just to assist their effective implementation.

5. Ethical Requirements

We consider that the black-lettering text in paragraph 18(a) that states:

“Enable the firm to identify and evaluate circumstances that may create threats to independence, and to take appropriate action to eliminate those threats or reduce to acceptable level by application of safeguard;”

should be amended to introduce the concept set out in paragraph 8.20 of the Code of Ethics that where safeguards are insufficient to reduce threat to independence to an acceptable level, auditors should eliminate the activity or interest creating the threat, or refuse to accept or continue the assurance engagement.

6. Rotation of Engagement Partners – Paragraphs 25-27

- a. We believe that "rotation of audit partners" is only one of the ways, and not the only way to address the risk of familiarity threat as a result of a long audit/client relationship between the auditor and its client. This relationship, however, in many instances, works to the benefit of, rather than to the detriment of, the quality and effectiveness of the audit.

- b. Having said that, in the case of financial statement audit of listed companies, we are supportive of the IFAC Ethics Code's requirement for mandatory audit partner rotation after a specified period, and for the further requirement for firms to have policies and procedures in place to comply with this requirement, as set out under paragraph 25 (a) of the proposed ISQC 1. We agree that this helps to increase the Profession's perception of independence, expected of auditors of listed companies, as expressed by market regulators worldwide in the public interest.
- c. We further feel that the requirement should apply across the board for all listed company financial statement audits regardless of the size of firms who audit them. Accordingly, we suggest that consideration should be given to eliminate the flexibility afforded to 'smaller audit firms' under the IFAC Code (paragraph 8.154).
- d. As for the proposal under paragraphs 25 (b) & (c) of the proposed ISQC 1 to extend the concept of audit partner rotation to financial statement audit of non-listed companies and all other assurance and related engagements, we wish to express a few observations and reservations.
- e. We note that the proposal is not to make rotation compulsory as with the case of listed company audits (and we agree with this), but requires that all audit firms, as a quality control requirement that is subject to practice review, must have policies and procedures to set criteria against which all audit engagements should be evaluated for the purpose of determining whether the engagement partner should be rotated after a specified period. Paragraph 27 then provides guidance on the criteria that firms should consider.
- f. We do not disagree with the proposal in principle that all firms should have policies and procedures in place to review on a regular basis their relationship with long-standing audit clients (to be defined) and to address any familiarity threats that may arise with safeguards, including the consideration of engagement partner rotation, to avoid compromising the firm's independence.
- g. However, the proposal went further by requiring criteria to be set and in paragraph 27 attempts to define the considerations to be given when setting such criteria, these include: 1) number and range of stakeholders/users of the auditors' report; 2) extent of interest of the report to the public; 3) specific risk of the engagement.
- h. This creates an implied expectation that if a client has a larger number of owners from a variety of backgrounds, or the report of the engagement is of interest to the public (this may include audit of charities or public sector body accounts), or it is a higher risk engagement (whatever that may mean), there should be criteria established by the firm for rotating the engagement partner in respect of such engagements and the firm should adhere to such criteria. Having created this expectation, however, the ED is leaving it wide open to the firms to determine whether or not to rotate and after how long in the job. Under this scenario, we could have a wide variation of criteria/standard that may be set by the firms, the result is that we will be creating further expectation gaps in the profession in that different firms will set different criteria under these same headings.
- i. We believe the ED has fallen short of making it clear that the criteria established by the firm for partner rotation may include criteria for not rotating (ie, other safeguards provided).

- j. In the case of engagements other than audit of listed company financial statements where clear rotation rules have now been set, we suggest that the ED should go back to general principle and stipulate the need for firms to have policies and procedures in place to assess risk and introduce safeguards, and giving guidance to the types of appropriate safeguards that should be considered, including but not limited to engagement partner rotation.

7. Rotation of Senior Engagement Personnel

We note that paragraph 25 only mentions the rotation of the engagement partner. However, the IOSCO principles for auditor independence (paragraph 14) < <http://www.iosco.org/pubdocs/pdf/IOSCOPD133.pdf> > require that standards of auditors' independence should address specifically the need to ensure appropriate rotation of the audit engagement team such that *senior members* of a team do not remain in *key decision-making positions* for extended periods. However, before the IOSCO requirements may be introduced, the definitions of *senior members* and *key decision-making positions* must be clearly laid down first. This may be illustrated by an example where an audit engagement partner has been on the audit engagement as an engagement partner for say only one year but as a senior manager or manager for say ten years preceding becoming a partner. Without laying down the definitions mentioned above clearly, different conclusions could be reached on the rotation requirement as different audit firms may allow senior managers and managers to have different key decision-making roles.

8. Acceptance and Continuance of Client Relationships and Specific Engagements

a. Paragraph 28

We recommend to include one more factor for the firm to consider as point (d), being “Has considered that there are no scope limitations imposed by management”, pursuant to paragraph 41 of ISA 700 “The Auditor’s Report on Financial Statements”, which states that when the limitation in the terms of a proposed engagement is such that the auditor believes the need to express a disclaimer of opinion exists, the auditor would ordinarily not accept such a limited engagement as an audit engagement, unless required by statute.

b. Paragraph 29

We agree with the examples provided but recommend including “internal enquiry” as an additional example of the source of information regarding the integrity of the prospective client. The purpose of an internal enquiry is to establish whether any other partner in the firm has any additional knowledge about the prospective client which might affect the decision whether or not to accept the appointment or whether there are threats to independence.

c. Paragraphs 28 to 34

We consider that there is insufficient reference in these paragraphs to the obligations as set out in the IFAC Code of Ethics paragraphs 13.15 to 13.26 which deals with the responsibilities for an incoming auditor to communicate with the outgoing auditor, in particular:

- i. the expectation that the incoming auditor will not accept an appointment unless it has received the satisfactory reply from the outgoing auditor; and

- ii. where the outgoing auditor is prohibited by a client from providing information to the incoming auditor, the incoming auditor will decline the appointment.

We recommend that the above obligations as set out in the IFAC Code of Ethics be reflected in these paragraphs.

9. Engagement Performance

We consider that the basic principles and essential procedures in paragraph 43 on the requirement that engagements are performed in accordance with professional standards and applicable regulatory and legal requirements should be expanded to cover the concepts (i) of *supervision*, where guidance thereon is provided in paragraph 46; and (ii) that work performed by members of the engagement team is reviewed by more experienced engagement team members or the engagement partner as more fully described in paragraph 47.

10. Engagement Quality Control Review

a. Paragraph 58

In addition to the three criteria already provided, we recommend to include one more criteria such that in the event that a modified report would be issued, which would usually involve judgement, it would be useful for an objective review by independent partners by having an engagement quality control review in order to ensure that the reports issued are appropriate in the circumstances.

b. Paragraphs 60 - 62

We are concerned that the description of the responsibilities of the engagement quality control reviewer in paragraphs 60 and 61 may suggest a more detailed compliance review than we consider is appropriate. We concur with paragraph 60 which refers to an objective evaluation of the significant judgement, conclusions and other significant matters but paragraph 61 says that the work is designed to provide a basis to *conclude* whether any matters have come to the reviewer's attention that would cause the reviewer to believe that the engagement was not performed in accordance with professional standards and applicable regulatory and legal requirements or that the report was not appropriate in the circumstances. We suggest that the wording of paragraphs 60 and 61 be revised so that it is clear that the engagement quality control review is not expected to have performed sufficient work to be able to *conclude* on compliance with professional standards, but rather that the engagement quality control reviewer's role is to provide an independent perspective on significant matters requiring the exercise of judgement. The engagement quality control reviewer should not be expected to form a second, independent audit opinion.

We question the last bullet point in paragraph 62 which include whether the documentation reviewed reflects the work performed and supports conclusions drawn as a result of that work as part of the scope of an engagement quality control review. This might imply that the engagement quality control reviewer is expected to review all documentation. We believe that level of review would be excessive and unnecessary.

We recommend that the wording of the guidance in the paragraphs 60 - 62 be reconsidered to avoid the risk of misinterpretation regarding the engagement quality control reviewer's role and responsibilities. In addition, we recommend that the following points can be included in the scope of an engagement quality control review:

- i. To consider the engagement team's acceptance and retention decision. This is a control mechanism intended to protect the firm from accepting overly risky clients. Generally, the quality control review partner is more objective than the engagement partner in this process.
- ii. To review the appropriateness of opinion given in any report issued during the course of the engagement.

c. Paragraph 65

We note that paragraph 65 assumes that the quality control reviewer is a person. Clearly this is right so far as there is one person who takes overall responsibility for the review. However, there is no discussion of the role of a quality control review team and there is a strong implication that this is a one man exercise. We consider the proposed ISQC 1 should deal with the concept of a quality control review team particularly for large complicated cross border assurance engagements.

d. Paragraph 66

We consider that the basic principles and essential procedures in paragraph 66 on the criteria for the eligibility of engagement quality control reviewers should be expanded to incorporate the principles where guidance is provided in paragraph 69 on objectivity and independence of the reviewer, paragraph 70 on consultation by engagement partner and paragraph 71 on the replacement of reviewer if objectivity of review may be impaired.

Proposed Revised ISA 220

11. Ethical Requirements

Paragraph 15(c) requires the engagement partner to take appropriate steps to eliminate threats to independence or reduce them to an acceptable level by the application of safeguards, or if it is not possible, to withdraw from the engagement. We consider that this paragraph should be amended to include the idea of elimination of the activity or interest that gives rise to the threat as an alternative to withdrawing from the engagement.

12. Engagement Performance

Paragraph 30 includes guidance that the engagement partner documents the extent and timing of the review of the working papers and matters arising from the review are resolved to the satisfaction of the engagement partner. We note that there is inconsistency in how the various ISAs deal with guidance on documentation of audit work. Some ISAs such as paragraph 49 of ISA 240 treat the guidance on documentation as an essential procedure that is identified in bold type. Some ISAs provide no guidance on documentation and rely on the general guidance in ISA 230 "Documentation". Other ISAs such as the draft of proposed revised ISA 220 provide guidance but this is not identified as an essential procedure. We consider that documentation of audit procedures that is specifically identified in the various ISAs other than ISA 230 is essential, and do not see that documentation of audit work discussed in one ISA can be considered an essential procedure whilst documentation of work discussed in another is not an essential procedure. We recommend that except for ISA 230 all guidance on documentation of audit procedures in ISAs is afforded the same status.

Other matter

13. Retention of audit working papers

We note that neither the proposed new ISQC 1 nor the proposed revised ISA 220 provided guidance on the retention (and form of retention) of audit working papers. We consider that guidance should be provided in the subject statements given that there are increasing demands and expectation for standard and guidance in this area.