



BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Chairman

Via Email: EDComments@ifac.org

Mr Jim Sylph
Technical Director
International Auditing and Assurance
Standards Board
545 Fifth Avenue, 14th Floor
New York, NY 10017 USA

11 September 2003

Exposure Drafts on Quality Control

Dear Mr Sylph,

The Basel Committee on Banking Supervision welcomes the opportunity to comment on your recent exposure drafts:

- Proposed ISQC 1 *"Quality Control for Audit, Assurance and Related Services Practices"*; and
- *Proposed Revised ISA 220 "Quality Control for Audit Engagements"*.

The Committee has a strong interest in promoting high quality international standards for audits, and believes that the exposure drafts include many useful proposals.

Please find our detailed comments in the attached note. The Committee's Accounting Task Force, chaired by Prof Arnold Schilder, Executive Director of De Nederlandsche Bank, has prepared the note. This note has been approved by the Basel Committee. The Basel Committee trusts that you will find its comments useful and constructive.

If you have any questions regarding our comments, please feel free to contact Prof Schilder (+ 31 20 524 3360), or Bengt A Mettinger at the Basel Committee Secretariat (+ 41 61 280 9278).

Yours sincerely,

Jaime Caruana

Appendix

Basel Committee Comments on IAASB Exposure Drafts Proposed ISQC 1 “Quality Control for Audit, Assurance and Related Services Practices” and Proposed Revised ISA 220 “Quality Control for Audit Engagements”

Overall comments

The Basel Committee on Banking Supervision¹ has a strong interest in high quality and independent audits of banks and has therefore carefully analysed the proposals.

The Committee is pleased to note the IAASB's efforts to ensure adequate quality control arrangements in all audit firms. Clearly, in the modern audit environment, quality needs to be ensured through measures both at the firm level and at the engagement level, and we support the IAASB's efforts to address quality control at both levels.

The exposure drafts include many useful proposals. As you will see in the following comments, we believe that both exposure drafts can be further enhanced before they are issued as final standards. Also, on a general level, we have, for different reasons, found the standards somewhat difficult to read. One reason is that a number of topics are dealt with both in ISQC 1 and in ISA 220 and within the same standard in different places. Another reason is that quality control is not defined. Instead, the exposure drafts introduce a system concept that includes a number of factors that impact quality, but do not necessarily control whether quality is actually achieved. Examples of these factors are ethical requirements, acceptance of clients, human resources and engagement performance. The exposure drafts do not make clear what system elements (as they are called) are parts of quality control (in our understanding, notably engagement quality control review and monitoring) and what system elements are subjected to quality control (which seems ultimately to be engagement performance). You may wish to consider ways to further clarify the structure of the guidance in these two important standards.

Our main comments include the following recommendations:

- The governing body (board of directors or corresponding body) of a firm should ultimately be responsible for the firm's quality control;

¹ The Basel Committee on Banking Supervision is a committee of banking supervisory authorities, which was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basel, where its permanent Secretariat is located.

- Quality deficiencies need to be adequately reported in the firm;
- IAASB or another appropriate IFAC Committee should consider developing guidance for corporate governance in audit firms and networks;
- IAASB or another appropriate IFAC Committee should develop disclosure requirements for audit firms and networks;
- Quality control requirements should also be defined for networks of audit firms; and
- The objective of engagement quality control review should be stated to be to provide reasonable assurance that the engagement has been performed in accordance with professional standards and applicable regulatory and legal requirements.

Proposed ISQC 1 “Quality Control for Audit, Assurance and Related Services Practices”

The audit firm’s corporate governance of quality control

The firm’s governing body should be ultimately responsible for the firm’s quality control

The draft ISQC 1 allocates the firm’s responsibility for quality control to the CEO. To us, the appropriate level for important policy decisions should be the firm’s governing body (Board of Directors or corresponding body), which should also carry the ultimate responsibility for the effectiveness of the firm’s quality control. We also believe that the governing body in larger firms needs to be assisted by a Quality Control Committee. A Quality Control Committee should:

- Review and comment to the governing body on the CEO’s proposals for quality control policies; and
- Review and comment to the governing body on the CEO’s reports over the firm’s quality and quality control work.

Thus, the CEO certainly needs to assume important quality control responsibilities, but the work should be strengthened by the allocation of the ultimate responsibilities to the governing body. It is important that the entire leadership team within firms set the right tone and serve as an example to others in terms of the importance they attach to assuring audit quality and ensuring that the firm’s policies are followed. They should specifically ensure that the structures in place within the firm do not allow commercial pressures to compromise audit quality.

Quality deficiencies need to be adequately reported in the firm

In a systematic approach for quality control, there is a need for a formalised feedback process to ensure that the governing body, the Quality Control Committee, the CEO and others in the firm with defined roles and responsibilities concerning quality control receive the necessary information to a) undertake such immediately required corrective actions that may be necessary and b) evaluate the quality of the firm’s work and the functioning of the firm’s quality control system. A

formalised feedback requirement would be a powerful component in the firm's quality control systems. We recommend that the final standard should include a requirement for the establishment of reporting routines for all noted quality deficiencies.

IAASB or another appropriate IFAC Committee should consider developing guidance for corporate governance in audit firms and networks

We note that firms do not have a unified model for corporate governance, in part because they are incorporated in different countries with differences in legislation, or because they use different types of legal forms. As you are well aware, the importance of good corporate governance is obtaining increased recognition. Considering the importance of quality control measures at the firm level, we similarly believe that IAASB or another appropriate IFAC Committee should consider developing guidance for good corporate governance for audit firms and networks of audit firms.

In such guidance, it would also be beneficial for the key roles and functions within the audit firm's governance structure and audit engagement teams to be defined. That there appears to be a need for this can be illustrated by the suggested paragraph 64, which deals with the situation when the **engagement team** does not accept recommendations from the quality control reviewer. We believe that the engagement partner - and not the "team" – should be the relevant decision maker on key decisions relating to the engagement.

IAASB or another appropriate IFAC Committee should develop disclosure requirements for audit firms and networks

We share the view expressed in a recent IFAC report² that increased transparency on the part of accounting firms could help significantly in raising their credibility and that firms should disclose details of their quality control processes and of their procedures for ensuring that those processes are effective. Improved disclosure for audit firms and networks should also explain their legal and operation structure and their business in various regards. Such information can for example be made available to the public on Internet. We recommend that IAASB develop disclosure requirements for audit firms and networks.

Networks of audit firms

The development of audit firm networks is one of the key features in the audit industry. Audit networks seems to naturally strive for being perceived as one, often international, firm that delivers a consistent product and consistent quality. The proposals provide only limited requirements for networks of firms. We believe that this is an important shortcoming and recommend that quality control requirements also should be defined for networks of audit firms. See also our comment below on the definition of networks.

² "Rebuilding Public Confidence in Financial Reporting", pp 37–38.

The engagement quality control review

When analysing your proposal, we were struck by four aspects of the engagement quality control review as outlined in the draft standards. The first aspect is the lack of a stated objective for the review. Instead, paragraph 60 explains that the review should include an objective evaluation of:

- Significant judgements made by “the engagement team”;
- Conclusions reached in formulating the report; and
- Other significant matters that have come to the attention of the engagement quality control reviewer.

We believe that the standard should explicitly and positively state, in black lettering, the objective of the engagement quality control review and that the objective should be to provide reasonable assurance that the engagement has been performed in accordance with professional standards and applicable regulatory and legal requirements. We think that such a statement would strengthen the standard and recommend that it should be inserted.

If this recommended approach is used, you will also be able to delete paragraph 61 and thereby avoid the lack of meaningful guidance in that paragraph. As drafted, this grey letter paragraph explains that the reviewer’s 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. Corresponding changes also should be made to paragraph 40 of ISA 220.

The second aspect is that the standard only requires engagement quality control review for audits of financial statements of listed entities. The draft, in paragraph 57(b), leaves it to the firm to decide the other types of engagements for which it wishes to undertake engagement quality control review. Thus, the standard would not require engagement quality control reviews for audits of financial statements of any unlisted bank. We believe that for audits of banks, the opposite approach should be taken; the standard should require engagement quality control reviews not only for listed entities but also for banks if they are significant or identified as high audit risk. Each firm should be requested to set out criteria for how to define significant and high audit risk for this purpose. This could of course be further simplified by national standard setting. The standard should additionally require engagement quality control reviews to be performed for other entities where mandated by national pronouncements. Corresponding changes also should be made to paragraph 37 of ISA 220.

The third aspect is that the standard does not require firms to establish policies and procedures to undertake and report on their engagement quality control reviews within the firm in a standardised and systematic manner. It seems to be necessary for such a requirement to be included.

The fourth aspect relates to what seems to be a lack of clarity on the meaning of the word “report” in the case of audits. The report in question probably is the audit report. We see this as an unsatisfactory limitation. The audit report of course is still the most important summarisation of the audit work. Nevertheless, other reports are increasingly important. A public example is the report on management’s assessment of the effectiveness of internal controls over financial reporting that now is required in some countries. In addition, the auditor’s communication with

those charged with governance is of significant interest and should be included in the engagement quality control review.

Reasonable assurance

Throughout the ED the expression *reasonable assurance* is used. It would be useful to define the meaning of the term '*reasonable assurance*' in the context of an ISQC. The term is defined in the glossary of terms in relation to an audit engagement as providing a high, but not absolute, level of assurance that the information subject to audit is free of material misstatement. However, this audit engagement definition would need to be modified to make it applicable to quality control.

Quality Control Reviewer Recommendations

The important paragraph 64 deals with the situation when the engagement team does not accept the engagement quality control reviewer's recommendations. In such a case the report should not be issued until the matter is resolved. We recommend that this paragraph should be upgraded to a basic principle and essential procedure by appearing in black letters. As already noted above, we believe that the engagement partner and not the "team" is the relevant decision maker on key decisions relating to the engagement.

Other important comments

Paragraph 4 System considerations

Paragraphs 3 and 4 describe the "system of quality control". According to paragraph 4, individual firms are free to develop differing policies and procedures suited to their particular circumstances. The use of the phrase "differing policies and procedures" may be subject to misinterpretation. Alternative language could say that individual firms develop policies and procedures that meet the requirements of the standard and are suited to the firm's particular circumstances.

It would also be helpful if the last sentence were expanded to include additional factors that affect the nature, extent and formality of a firm's quality control policies and procedures. Examples could be number of offices, degree of authority allowed its personnel and offices, the nature and complexity of the firm's practice, and the knowledge and experience of its personnel.

Paragraph 5 Definitions

The standard defines "Network firm" as "an entity under common control, ownership or management with the firm or any entity that a reasonable and informed third party having knowledge of all relevant information would reasonably conclude as being part of the firm nationally or internationally." Normally, the audit report adds credibility to financial information issued for consumption in capital markets. If an audit firm gives the impression that it is a member or part of an international audit network or organisation, it in effect implies that its product, the audit work and report, provides the level of reliability that the network stands for. Thus, the definition of network firm as drafted is not sufficient because it disregards the importance of how firms present themselves.

Paragraphs 14 and 18 Ethical requirements

Compliance with relevant ethical requirements necessitates an ongoing assessment of client and personnel relationship. You may therefore wish to consider amending paragraph 14 as follows:

“The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply **on an ongoing basis** with relevant ethical standards.”

A similar change could also be made to paragraph 18.

Paragraphs 20 and 22 Notification

Paragraph 20(b) and paragraph 22 fail to require that the relevant engagement quality control reviewer should be notified of identified breaches of independence requirements and actions taken to resolve them. The quality control process would be more effective if the standard were to explicitly require that the quality control reviewer and other designated persons/functions within the firm are also notified of such breaches and the actions taken.

Paragraphs 25 and 27 Engagement partner rotation

Paragraph 25(a) requires policies and procedures for the rotation of the engagement partner after a specified period of time for all auditors for financial statements of **listed entities**, in compliance with the IFAC Code and **national pronouncements** where they are more restrictive. The exposure draft, in paragraph 25(b), leaves it to the firm itself to decide the other types of engagements for which it wishes to introduce engagement partner rotation. Thus, the standard would not require engagement partner rotation for audits of unlisted banks. We believe that for audit engagements of such institutions, the approach described earlier with respect to engagement quality control reviews should be taken; the standard should require engagement partner rotation for unlisted banks that are significant or identified as high audit risk, and require each firm to set out criteria for how to define significant and high audit risk. This also could be further simplified by national standard setting.

Paragraph 27 discusses engagement partner rotation for engagements other than audits of financial statements of listed companies. However, it seems that the words “over a prolonged period” are missing after the words “listed entities” in the first sentence of the paragraph.

Paragraphs 48 and 53 Consultation

The proposed standard requires the conclusions resulting from consultations to be documented but it requires the documentation of the consultation itself to be sufficiently complete and detailed only in the case of “significant consultations”. We believe that there should be a formal requirement to document in writing the issue on which consultation was sought and the resulting decisions when consultation has been undertaken on difficult or contentious matters. Thus, the documentation standard in paragraph 53 should apply to all consultations involving difficult or contentious matters. Without such documentation it is not possible to assess the conclusions arrived at, particularly from the quality control standpoint. Corresponding changes should also be made to paragraph 33 of ISA 220.

Paragraph 62 Nature and Extent of Engagement Quality Control Review

We suggested above that the standard should state the objective of the engagement quality control review and that the objective should be to provide reasonable assurance that the engagement has been performed in accordance with professional standards and applicable regulatory and legal requirements. The adoption of this approach in the standard will have some consequences for the content of paragraph 62. In particular, we believe it is necessary to modify the statement that the reviewer review selected working papers **to the extent the reviewer considers it necessary**. It should always be necessary for the engagement quality control review to include a review of selected working papers. Corresponding changes should also be made to paragraph 41 of ISA 220.

Paragraph 65 Eligibility of Engagement Quality Control Reviewer

We believe that the engagement quality control reviewer should not be a member of the engagement team. We have the impression that this is also the spirit of the standard, but this is not made explicitly clear. Our recommendation is that the standard include a clear statement to this effect.

Paragraph 67 Qualifications of Engagement Quality Control Reviewer

Paragraph 67 states “ ... the engagement quality control reviewer is an individual with sufficient and appropriate experience and authority to act as an audit engagement partner on audits of financial statements **of listed entities**.”

The quality control reviewer should have the relevant skills and industry experience specific to the engagement and not merely the experience of listed entities. Thus, an audit partner who does not have the knowledge, experience or competencies to audit a bank should not be assigned as the quality control reviewer for a bank audit merely on the basis that he could act as an audit engagement partner of a listed entity. We recommend the qualification requirement for the quality control reviewer be modified in this manner.

Paragraph 71 Rotation of the engagement quality control reviewer

Paragraph 71 refers to the replacement of the engagement quality control reviewer after a period of “several years”. This should be more rigorous and the time period for the rotation of the quality control reviewer should be at least the same as the number of years required for engagement partner rotation and preferably the rotations would not be at the same time (i.e., the rotations should be staggered).

Paragraph 72 Documentation

The standard is silent on the need to archive the documentation of the engagement quality control review. We assume that this documentation should be part of the engagement documentation and should be subject to the same archiving requirements as the engagement documentation. This should be made clear in the standard.

Paragraph 76 Monitoring cycle

Paragraph 76 states, *inter alia*, that the monitoring cycle should be designed so that an engagement for each engagement partner should be inspected at least once every three years. Specifying at least one inspection for each engagement partner in every inspection cycle (every third year) does not appear sufficient for

partners with bank audit engagements and we suggest that those should be monitored with a higher frequency.

Paragraph 94 Effective date

Paragraph 94 – The effective date should be clarified by stating that the ISQC is effective **for new engagements and continuing engagements beginning on or after** January 1, 2005. Corresponding changes should also be made to paragraph 45 of ISA 220.

Proposed ISA 220 “Quality Control for Audit Engagements”

Paragraph 8 Compliance with ethical requirement

The Standard states that the engagement partner should obtain an understanding about potential threats to compliance with ethical requirements and the safeguards put in place. It would be preferable to require that this understanding be gained from a review by the partner of information obtained through inquiries and discussion.

Paragraph 23 Competent engagement teams

The Standard does not offer guidance to the engagement partner concerning what to do when the partner is not satisfied that the engagement team has the necessary competencies to perform the audit engagement in accordance with applicable standards. We recommend that explanatory language be added that makes it clear that in such situations the team must be strengthened with additional resources from within the firm or from external sources.

Paragraph 33 Consultation

As drafted, the standard states that the engagement partner should encourage and facilitate consultation on difficult or contentious matters. However, in our view, the partner should actually be required to undertake appropriate consultation on all difficult or contentious matters in accordance with the firm's policies and procedures governing consultation.