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Comptroller General  
of the United States

United States Government Accountability Office  
Washington, DC 20548

September 29, 2006

Mr. John Fogarty, Chair  
Auditing Standards Board  
American Institute of Certified Public Accountants  
1211 Avenue of the Americas  
New York, NY 10036-8775

Subject: Proposed Statement on Quality Control Standards—*A Firm's System of Quality Control*

This letter provides the U.S. Government Accountability Office's (GAO) comments on the Auditing Standards Board's (ASB) July 28, 2006, exposure draft of a proposed Statement on Quality Control Standards (SQCS) —*A Firm's System of Quality Control*.

GAO commends the Auditing Standards Board's efforts to strengthen the quality control standards and guidance and thereby enhance the quality of auditors' work. We believe that an audit organization's quality assurance function is a fundamental and critical determinant of audit quality. We disagree, however, with the proposed significant departures from international standards, whereby the specific requirement for periodic inspections is omitted and engagement quality reviews performed prior to the audit report issuance are considered as an option for monitoring. Our concerns are discussed in greater detail below.

Our comments on the proposed quality control standard focus on the following areas:

- Periodic inspections and other monitoring procedures
- Competencies of practitioners-in-charge
- Small audit organizations
- Engagement quality control review

#### Periodic inspections and other monitoring procedures

Paragraph 90 of the proposed standard contains a significant departure from International Statement of Quality Control (ISQC) No. 1 in that it omits a specific requirement for periodic inspections of a selection of completed engagements from the procedures required in a system of quality control. The proposed standard then goes on to give audit organizations a choice among different types of monitoring procedures in paragraph 93 by requiring either engagement quality control reviews, post-issuance reviews of specific engagement documents, or inspection procedures. Engagement quality reviews, however, are conducted prior to issuance of the audit

reports and, therefore, are a key part of engagement performance and documentation rather than monitoring. The AICPA’s proposed standard allows for engagement quality review to be done in place of other monitoring procedures. The following compares paragraphs 90 and 93 with related paragraphs in ISQC 1:

AICPA Proposed Standard	International ISQC 1
<p>90. The firm should establish policies and procedures designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively, and complied with in practice. Such policies and procedures should include an ongoing consideration and evaluation of the firm’s system of quality control.</p>	<p>74. The firm should establish policies and procedures designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice. Such policies and procedures should include an ongoing consideration and evaluation of the firm’s system of quality control, <u>including a periodic inspection of a selection of completed engagements</u>. [Underlining added for emphasis]</p>
<p>93. A firm's monitoring procedures should include one or more of the following each year:</p> <ul style="list-style-type: none"> <li>• Engagement quality control review.</li> <li>• Post-issuance review of engagement working papers, reports, and clients’ financial statements for selected engagements.</li> <li>• Inspection procedures.</li> </ul>	<p>[ISQC 1 contains no paragraph similar to proposed AICPA standard, paragraph 93]</p>

We believe that paragraph 90 of the proposed standard should conform with ISQC 1 and require periodic inspections, due to their importance in audit quality control systems. In addition, we believe that engagement quality control reviews are an integral element of engagement performance<sup>1</sup> and should not also be used to satisfy monitoring objectives. We believe it is not possible to design an engagement review that could satisfy the objectives of both engagement performance and monitoring. We believe that engagement quality reviews should be deleted as an option to satisfy the monitoring element. In addition, we recommend that the ASB incorporate into its proposed standard the wording noted above from ISQC 1, paragraph 74. A sentence could be added acknowledging that post issuance review of selected engagements could be considered a type of inspection procedure as long as the inspection requirements in paragraphs 96-101 of the proposed standard are satisfied. Allowing for post-issuance reviews to be used as an inspection procedure would provide an option for small firms to satisfy a requirement for inspections.

Competencies of practitioners-in-charge

The discussion in paragraphs 41-44 on competency requirements for practitioners-in-charge, which is similar to the requirement in the AICPA’s current quality control

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<sup>1</sup> The proposed standard classifies engagement quality control reviews as an engagement performance procedure in paragraphs 77-83. ISQC 1, paragraphs 60-73, also discusses engagement quality control review as an engagement performance procedure.

standard's paragraphs 40.05-40.07, is not included in ISQC 1. We generally agree with the principles discussed in this section; however, we believe that the discussion in Paragraph 41 about practitioners-in-charge supplementing experience with education and consultation is confusing and may be viewed as providing a safe harbor. We recommend deleting paragraph 41 from the proposed standard, since paragraph 42 adequately conveys the concept that an audit organization's quality control policies and procedures should provide reasonable assurance that practitioners-in-charges possess the competencies needed to fulfill their responsibilities.

### Small audit organizations

Paragraphs 100 and 101 of the proposed standard, which are similar to the requirement in the AICPA's current quality control standard's paragraphs 30.10-30.11, discuss the challenges faced by small audit organizations in developing monitoring procedures. While we acknowledge the importance of allowing flexibility for small audit organizations with limited resources, we believe it is important to emphasize that individual auditors are not able to monitor their own work. We recommend revising the proposed standards as follows:

100. In small firms with a limited number of persons with sufficient and appropriate experience and authority in the firm, monitoring procedures may need to be performed by some of the same individuals who are responsible for compliance with the firm's quality control policies and procedures. **However, engagement inspections should be performed by individuals who had no significant role in the engagement planning, fieldwork, or reporting.** ~~This includes post-issuance review of engagement working papers, reports, and clients' financial statements by the person with final responsibility for the engagement. To effectively monitor one's own compliance with the firm's policies and procedures, an individual must be able to critically review his or her own performance, assess his or her own strengths and weaknesses, and maintain an attitude of continual improvement. Changes in conditions and in the environment within the firm (such as obtaining clients in an industry not previously serviced or significantly changing the size of the firm) may indicate the need to have quality control policies and procedures monitored by another qualified individual.~~

~~101. Having an individual inspect his or her own compliance with a quality control system may be inherently less effective than having such compliance inspected by another qualified individual. When one individual inspects his or her own compliance, the firm may have a higher risk that noncompliance with policies and procedures will not be detected. Accordingly, a firm with a limited number of persons with sufficient and appropriate experience and authority in the firm may find it beneficial to engage a qualified individual from outside the firm to perform inspection procedures.~~

**Small firms and sole practitioners may wish to use a suitably qualified external person or another firm to carry out engagement inspections and other monitoring procedures. Alternatively, they may wish to establish arrangements to share resources with other appropriate organizations to facilitate monitoring activities.** [from ISQC 1, paragraph 80]

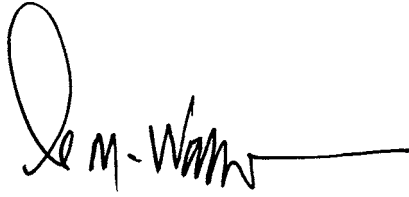
## Engagement quality control review

Paragraph 81 of the proposed standard would allow quality control review procedures to be limited to a report review and discussions with the partner in charge. Whether to review key documentation would be left to the judgment of the reviewer. We believe the standard should require the review of critical documentation, which could include (1) documentation of the resolution of significant auditing, accounting and reporting issues, including consultation with specialists; (2) the summary of unadjusted misstatements; and (3) the audit summary memorandum. Review of critical documentation is needed for reviewers to determine if decisions to omit any important matters from the engagement report were appropriate, if an engagement complies with professional standards, and if significant judgments made and conclusions reached by the engagement team have been properly documented. This view was supported by the SEC Practice Section's previous requirement for review of critical documentation, including key decisions and the summary of unadjusted misstatements. We propose revising paragraph 81 as follows:

81. The engagement quality control review procedures should include reading the financial statements or other subject matter information and the report, and, in particular, consideration of whether the report is appropriate. An engagement quality control review also should include ~~either~~ (a) a discussion with the practitioner-in-charge, **and** (b) a review of selected ~~documentation~~~~working papers~~ relating to the significant judgments the engagement team made and the conclusions they reached, ~~or (c) both discussion and review~~. The **documentation selected for review** ~~decision to review selected working papers in addition to, or instead of, discussion with the practitioner-in-charge~~ depends on the complexity of the engagement and the risk that the report might not be appropriate in the circumstances. **For instance, the reviewer may review (1) documentation of the resolution of significant auditing, accounting and reporting issues, including consultation with specialists; (2) the summary of unadjusted misstatements, and (3) the audit summary memorandum.** The engagement quality control review does not reduce the responsibilities of the practitioner-in-charge.

We thank you for considering our comments on this important proposed standard as we work together on issues of mutual interest to the accountability profession.

Sincerely yours,

A handwritten signature in black ink, appearing to read "D M Walker", with a long horizontal line extending to the right.

David M. Walker  
Comptroller General  
of the United States

Enclosure

cc:

The Honorable Christopher Cox, Chairman  
Securities and Exchange Commission

The Honorable Mark W. Olson, Chairman  
Public Company Accounting Oversight Board

Mr. James M. Sylph, Technical Director  
International Auditing and Assurance Standards Board