ICAEW
REPRESENTATION 3/23

PCAOB CONSULTATION: A FIRM'S SYSTEM OF QUALITY CONTROL AND OTHER PROPOSED AMENDMENTS TO PCAOB STANDARDS, RULES AND FORMS

Issued 1 February 2023

ICAEW welcomes the opportunity to comment on the PCAOB's consultation on a new quality control standard, together with other amendments to PCAOB standards, rules, and forms, published by the PCAOB on 18 November 2022, a copy of which is available from this link.

For questions on this response, please contact our Audit and Assurance Faculty at tdaf@icaew.com quoting REP 3/23.

This response of 1 February 2023 has been prepared by the ICAEW Audit and Assurance Faculty. Recognised internationally as a leading authority and source of expertise on audit and assurance issues, the faculty is responsible for audit and assurance submissions on behalf of ICAEW. The faculty has around 18,000 members drawn from practising firms and organisations of all sizes in the private and public sectors.

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GENERAL

1. We welcome the opportunity to comment on this important proposal for a new quality control (QC) standard and we support the high level of alignment of the proposals with ISQM 1. Alignment with that standard is particularly important because of the need for firms to implement firm level requirements on a global basis.
2. We noted in our response to the 2019 Concept Release that preceded this consultation that differing requirements risk causing confusion and ultimately undermining audit quality. We understand the rationale for additional US requirements in some areas, such as certification and communication of deficiencies, and while some of these requirements will work well within the USA, others will be harder to implement globally on a consistent basis.
3. Specifically, we believe that the following require modification or further guidance to be effectively and consistently operationalised on a global basis:
    - the definitions of different types of deficiency
    - the application of the reasonable assurance requirements of the standard to other participant firms, including the .53 g note relating to the conclusion of the most recent evaluation of the QC system of other participant firms and a brief overview of remedial actions
    - the proposal to eliminate the appendix K requirement and rely exclusively on a risk-based approach
    - the prescribed assessment date
    - the 45-day requirement for non-public reporting to the regulator.

4. We understand the rationale for seeking to apply SOX-style requirements to audit firms and to adopt definitions, particularly of deficiencies, aligned with the relevant ICFR requirements. However, in practice, firms will seek to align definitions of deficiencies across different auditing standards globally and to eliminate the distinctions between them. We are not convinced that the definitions need to be different, and caution against the use of different words simply to 'explain better' what is required. This can and will be misconstrued as needlessly adding an unnecessary and costly layer of complexity without commensurate benefit. The unnecessary use of different words may trip some firms up or discourage them from conducting PCAOB audits. We do not believe that PCAOB intends to do any of these things. We make specific suggestions below to further align the proposed definitions with those of the IAASB. We do not believe that this will alter the meaning of either, but that it will instead enhance the consistent application of the PCAOB's standards globally.
5. Without amendment, we fear that when combined with the new certification requirements, the proposed standard risks driving some smaller firms with good quality management systems, as well as those with systems requiring improvement, out of the market for work performed under PCAOB standards. This may be of little concern at present but a long-term decline in the number of firms willing and able to perform or take part in such audits will ultimately harm US investors, and it will not be easily or quickly reversed.
6. The number of firms registered with the PCAOB reflects the quality of its regulatory activity. This diversity reduces the risk of entrenching the larger, existing market players. However, that risk is ever-present, currently exacerbated by challenges to market capacity globally. These proposals represent an important step forward for a re-invigorated PCAOB and we appreciate the care and effort taken by the PCAOB in its deliberations, particularly concerning the implications of the proposals for firms outside the USA. However, in finalising this standard, the PCAOB should consider the wider impact of the proposals on the attractiveness of the US markets and on market accessibility.
7. Regulatory certainty is a valuable asset and the potential for unintended consequences, including changes to the way international networks of audit firms deliver PCAOB audits, should not be discounted. The length of the consultation document, the number of questions and the timing of the proposals render responses challenging even for the most well-

resourced stakeholders, despite the extended comment period. The impact of the proposals and the potential unintended consequences are not diminished simply because some stakeholders are unable or unwilling to respond to these proposals.

8. Those questions on which we have no comment we omit from our response below. We have answered some groups of questions in aggregate.

SPECIFIC QUESTIONS

PROPOSED QC 1000: BASIC STRUCTURE, TERMINOLOGY, AND SCALABILITY

3. Are the proposed definitions of "firm personnel," "other participants," and "third-party providers" sufficiently clear and comprehensive, or is additional direction necessary? Please explain what additional direction may be necessary.

9. The PCAOB should consider amending the definition of lead auditor in AS2101 to include leased staff (in addition to secondees) for consistency with the definition of firm personnel contained in QC1000.

5. Is it appropriate for the proposed standard to require firms that have not and do not plan to perform engagements pursuant to PCAOB standards to design a QC system in accordance with QC 1000? Why or why not? Would this requirement impose disproportionate costs on small firms? Please provide data or estimates, if available, on such costs.

6. Is the proposed distinction between the obligation to design a QC system and the obligation to implement and operate a QC system appropriate? Is the proposed threshold for full applicability of QC 1000—having obligations under applicable professional and legal requirements with respect to a firm engagement—appropriate?

10. The proposed design requirements seem likely to result in at least some registered firms outside the USA deregistering. The incremental requirements of QC 1000 above and beyond those of ISQM 1 will be perceived by some as substantial, and the effort required simply to design a compliant system, considerable. A few deregistrations may be no bad thing but the PCAOB should consider the longer-term implications of the potential for a significant number of deregistrations. Consideration should be given to the provision of guidance on design to ensure that firms do not deregister out of an excess of caution.

THE FIRM'S QC SYSTEM

10. Is the reasonable assurance objective described in the proposed standard appropriate? If not, why not? Are there additional objectives that a QC system should achieve? If so, what are they?

11. Are the proposed requirements regarding design of the QC system appropriate? Are there other aspects of QC 1000 that should be required as part of the design of the QC system? If so, what are they?

11. The consultation notes that under proposed QC 1000, the reasonable assurance objective of the firm's QC system covers 'other participants' whereas the reasonable assurance requirements of other standards do not. Reasonable assurance is a high bar and the risk that this requirement will result in unintended, negative changes to the structure of the audit market globally is not negligible. Unprecedented challenges to capacity in the audit market should not be discounted.

12. Overlapping definitions across standard-setters, and the inclusion of the material in different standards, may lead to misinterpretation and inconsistency. We encourage the PCAOB to reconsider this area and in particular the extent to which further alignment with ISQM 1 might be possible. Our response to the 2019 Concept Release suggested that the material would be better placed in standards relating to the use of other auditors and specialists.

ROLES AND RESPONSIBILITIES

12. Are the proposed requirements related to roles and responsibilities described in the standard clear and appropriate? If not, how should they be clarified or modified?

13. Would firms have difficulty filling the specified roles in light of the proposed requirements?

13. The certification requirement applied to a specific individual within the firm represents one of the most significant differences between proposed QC 1000 and ISQM 1. We understand the rationale for this requirement, but the PCAOB should be aware that it may represent a significant barrier to registration for firms operating in environments in which there are no SOX-style reporting requirements. It will also have a disproportionate impact on smaller firms who have fewer resources.

THE FIRM'S RISK ASSESSMENT PROCESS

16. Should the proposed definition of "quality risks" explicitly address risks of intentional misconduct by firm personnel and other participants? If not, please explain why. Should the definition explicitly address other risks? If so, what are the other risks?

17. In the proposed definition of "quality risks" should the threshold of "reasonable possibility of occurring" also apply to all risks, including risks of intentional misconduct by firm personnel and other participants? If so, why?

14. Proposed QC 1000 treats the risk of intentional acts by firm personnel and other participants to deceive or to violate applicable requirements differently to other quality risks. .A12 refers to quality risks generally, that have a reasonable possibility of occurring; or risks of intentional acts by firm personnel and other participants to deceive or to violate applicable requirements. The construction of this paragraph can be read as implying that the latter risks are not required to have a reasonable possibility of occurring, and include all such risks, regardless of likelihood.

15. The PCAOB should consider clarifying how firms should deal with remote risks of deception or violations i.e., those that have less than a reasonable possibility of occurring. We understand the rationale for treating these risks differently, although we are not convinced that these risks really are different to other quality risks, all of which have a significant human element. Without clarification, we fear that a disproportionate level of resource may be allocated to this area, to the detriment of other quality risk areas assessed as having more than a remote likelihood of occurring. The bar here appears to be set higher than it is for issuers and goes beyond the reasonable assurance objective.

GOVERNANCE AND LEADERSHIP

22. For the proposed specified quality response related to the firm's governance structure, is the threshold (firms that issued audit reports with respect to more than 100 issuers during the prior calendar year) appropriate? If not, what is an appropriate threshold?

23. Is the proposed specified quality response to incorporate an oversight function for the audit practice for firms that issue auditor reports with respect to more than 100 issuers appropriate? If not, why not?

24. Is the proposed specified quality response related to the firm's policies and procedures on receiving and investigating complaints and allegations appropriate? Are there any other specified quality responses in this area that we should consider, and if so, what are they?

25. Are there any other specified quality responses for the governance and leadership component that we should consider? If so, what are they?

16. The firms covered by these responses are likely to be restricted to large firms in the USA and possibly Canada. Our outreach suggests that consideration might be given to lowering this bar given the number of repeated independence issues highlighted by the PCAOB among all

firms, including those currently likely to have less than 100 issuers. Some consideration might also be given to the size of the issuer in this context.

ETHICS AND INDEPENDENCE

Key differences from other QC standards

26. Are the proposed quality objectives for ethics and independence requirements appropriate? Are changes to the quality objectives necessary for this component? If so, what changes?

27. Are the proposed specified quality responses for ethics and independence requirements appropriate? If not, what changes to the specified quality responses are necessary for this component?

28. Is the proposed specified quality response to have an automated process for identifying direct or material indirect financial interests appropriate? If not, why not? Is the proposed threshold (firms that issued audit reports with respect to more than 100 issuers during the prior calendar year) appropriate? If not, why not?

29. Is the proposed specified quality response related to communication of changes to the list of restricted entities at least monthly (and more frequently, if appropriate) to firm personnel and others performing work on behalf of the firm who are subject to independence requirements appropriate? Could communication to a more limited group accomplish the goal of alerting all individuals whose actions and relationships are relevant to independence? If so, to whom should changes be communicated?

30. In addition to the annual written independence certification, should the proposed standard require an annual written certification regarding familiarity and compliance with ethics requirements and the firm's ethics policies and procedures? Why or why not? Should firms be required or encouraged to adopt firm-wide codes of ethics or similar protocols? Why or why not? Are there other specific policies that QC 1000 should require or encourage to promote ethical behavior?

17. The PCAOB notes that proposed QC 1000 includes two quality objectives related to violations of ethics and independence requirements, and communication. These are not included in other standards, which address violations of ethics and independence requirements as part of their specified responses.

18. Guidance or further clarification on the nature, extent and scope of the automated process referred to in Q28 would be helpful, to establish whether the PCAOB generally expects more of firms, above and beyond what than they are doing now. The PCAOB should be clear about the nature and extent of change it is seeking. We also note that the effectiveness of the processes referred to are always limited by the human element and that there is always a downstream effect of such structured monitoring. The evaluation of output, rather than the design of systems, may be more appropriate.

ACCEPTANCE AND CONTINUANCE OF CLIENT RELATIONSHIPS AND SPECIFIC ENGAGEMENTS

35. We are proposing to eliminate the current Appendix K requirement and rely exclusively on a risk-based approach. Should the standard include specified quality responses explicitly directed to non-U.S. firms that audit issuers? If so, what are they?

19. Appendix K is clearly out of date. However, we fear that without additional guidance or clarification, simply removing the requirement and replacing it with a risk-based approach risks:
    - a negative impact on risk assessments in this area
    - inconsistent quality responses.

20. Individuals with the knowledge and experience to conduct Appendix K reviews outside the USA have historically been a scarce resource. The few who have that expertise may not be willing or able to be part of engagement teams in other jurisdictions. The independent role of the Appendix K filing reviewer avoided this potential issue.
21. In practice, firms will continue to ensure that they have the right skills sets engaged, and those with the relevant expertise will either be part of the EQCR, the engagement team or both. However, additional guidance and clarification would be helpful for firms and inspectors alike.

INFORMATION AND COMMUNICATION

Key differences from other QC standards

43. Are there legal or regulatory concerns regarding other participant firms sharing the most recent evaluation of their QC system and a brief overview of remedial actions taken and to be taken? If so, please specify.

22. We have concerns about the practicality of other participant firms, many of which are not part of networks, sharing the most recent evaluation of their QC system and a brief overview of remedial actions taken. Furthermore, the proposals may be counterproductive to the extent that a firm level QC inspection finding might result in the best person for the job being bypassed.
23. Guidance on the options available to the firm where the evaluation and/or the overview of remedial actions is not forthcoming is needed.

MONITORING AND REMEDIATION PROCESS

55. Should firm personnel be allowed to inspect engagements or QC activities in which they are involved? If so, please explain why and provide examples of mechanisms that could reduce to an appropriate level the risk that noncompliance with PCAOB standards or the firm's policies and procedures would not be detected.

24. Firm personnel should not be allowed to inspect engagements or QC activities in which they are involved.

EVALUATING AND REPORTING ON THE QC SYSTEM

57. Is November 30 an appropriate evaluation date for firms to conclude on the effectiveness of the QC system? Is there another specific date that would be more appropriate and if so, what date? Should firms be permitted to choose their own evaluation date?

25. It is neither desirable nor necessary for all firms to conclude on the same date. Firms should either be permitted to choose their own evaluation date, or a window from say, November to March, should be offered.

58. Is the proposed definition of "major QC deficiency" clear and appropriate? If not, what changes should be made and why?

26. The PCAOB notes that there is no term in either ISQM 1 or SQMS 1 that is analogous to 'major QC deficiency'. It also states that one or more major QC deficiencies under QC 1000 would be analogous to a firm concluding under ISQM 1 that its system of quality management does not provide the firm with reasonable assurance that it has met its quality management objectives. But it also states that a firm might conclude under QC 1000 that its QC system was ineffective, but still view its QC system as providing reasonable assurance

for purposes of ISQM 1. We believe that this is unhelpful, unless a good example can be given. Furthermore, we are not convinced that this term is capable of consistent application globally, even with additional guidance.

27. A192 of ISQM 1 refers to identified deficiencies having a 'pervasive' effect. Even if the deficiency relates to a specific component, business unit or geographical location, it may be 'fundamental' to the QC system, the firm overall or a substantial proportion of certain types of engagement.
28. Major QC deficiencies under QC 1000 are described as 'severely reducing' the likelihood of the firm achieving a reasonable assurance objective or one or more quality objectives. The factors indicating a major QC deficiency in QC 1000.78.a include consideration of 'severity and pervasiveness', but the definition of a major QC deficiency in QC 1000.A.6 only refers to 'severity'.
29. While we understand the pressure to move requirements for audit firms under this standard towards the reporting requirements for companies under the SOX legislation, in practice, firms will seek to align the definitions across standards and eliminate distinctions between these definitions and descriptions - some of which will be lost in translation into different languages anyway.
30. We do not believe that introducing the major QC deficiency category or other differences in QC 1000 will have any incremental impact on audit quality, or the quality control systems operated by audit firms by comparison with ISQM 1. We acknowledge that the IAASB seems likely to seek to accommodate the PCAOB's definitions within ISQM 1 when it next comes up for revision, but that will take time as ISQM 1 has just been revised. We therefore respectfully suggest that the PCAOB considers, before finalising this standard, whether any further alignment is possible.
31. In any case, the inconsistency noted above between QC 1000.78.a and QC 1000.A.6 should be eliminated, and both paragraphs should refer to both terms.

59. Is it appropriate to include in the proposed definition circumstances when a major QC deficiency is presumed to exist? Are the circumstances described in the proposed definition appropriate? Should there be other circumstances that give rise to such a presumption? If so, what are they?

60. Are the proposed factors for determining whether an unremediated QC deficiency is a major QC deficiency appropriate? If not, what other factors should be specified?

32. We do not believe that the two types of presumed major QC deficiencies are necessary. If they are included, more guidance should be provided.
33. The first of the two presumed major QC deficiency indicators in QC 1000.77 (2)(a) relating to governance and leadership is addressed in ISQM 1.A192, in which examples of deficiencies with a pervasive effect include those that are 'fundamental to the system of quality management'. A similar factor added to QC 1000.78.a could achieve the same objective.
34. The second relates to the significance of an engagement or engagements to the firm, including the number of firm personnel and revenue or profits. This could be addressed by expanding the wording in paragraph 78.a.(4) to refer to 'the number of engagements or the significance of one or more engagements that are affected by the un-remediated QC deficiencies or are likely to be affected in the future if the QC deficiencies are not remediated.'

61. Should firms be required to report on the evaluation of the QC system to the PCAOB? If not, why not?

35. The value of the report when not accompanied by independent attestation is likely to be limited. Non-US firms are not inspected annually and firms with no engagements will not be required to make the evaluation.

62. Should we require individual certifications of the evaluation of the QC system? Is the language in Appendix 2 regarding the certifications appropriate? If not, why not?

36. Individual certifications are likely to focus the mind and it seems likely that improvements will be seen as a result of such a requirement. Without independent attestation though, the value of self-certifications will be reduced. Different liability frameworks in different jurisdictions are likely to create resistance to certification in some jurisdictions.

63. Is the proposed date for reporting on the evaluation of the QC system (January 15) appropriate? Is there another specific date that would be more appropriate and if so, what date? Is 45 days after the evaluation date an appropriate reporting date?

37. 45 days is a shorter time period than issuers have to report on controls and might lead to rushed self-certifications, particularly given the holiday period. 60 days would align it with the shortest due date applicable to issuers.