



NZ AUDITING  
AND ASSURANCE  
STANDARDS BOARD

## EXPLANATORY GUIDE Au6

### Applying PES 3 Proportionately with the Nature and Size of a Firm

Issued February 2013

This Explanatory Guide sets out how the design of Professional and Ethical Standard 3 (Amended) *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance Engagements* (PES 3) enables it to be applied in a manner proportionate with the nature and size of a firm. Specifically, while PES 3 applies to all firms, this document focuses on matters that are likely to be of particular relevance to the application of PES 3 in the context of smaller firms. Smaller firms, as well as smaller public sector audit organisations, should find this publication helpful in achieving an effective and efficient implementation of PES 3. Others (including, but not limited to, regulators and audit oversight bodies) with responsibilities for or relating to services provided by firms of professional accountants may also find this document helpful<sup>1</sup>.

This publication does not constitute an authoritative pronouncement of the XRB nor does it amend or override PES 3. Further, this publication is not meant to be exhaustive and reading this document is not a substitute for reading PES 3.

This Explanatory Guide is an explanatory document and has no legal status.

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<sup>1</sup> Acknowledgement

The information in this Explanatory Guide is adapted from the IAASB Staff Questions and Answers - Applying ISQC 1 Proportionately with the Nature and Size of a Firm published by the International Federation of Accountants (IFAC), at:

[http://www.ifac.org/sites/default/files/publications/files/Staff%20QA%20ISQC%201%20Proportionality\\_FINAL.pdf](http://www.ifac.org/sites/default/files/publications/files/Staff%20QA%20ISQC%201%20Proportionality_FINAL.pdf)

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## EXPLANATORY GUIDE Au6

## APPLYING PES 3 PROPORTIONATELY WITH THE NATURE AND SIZE OF A FIRM

*Issued by the New Zealand Auditing and Assurance Standards Board*

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## Background

Quality control is central in enhancing users' confidence in the services provided by a firm. A robust system of quality control addresses quality control with respect to engagement performance as well as leadership responsibilities for quality within the firm, compliance with relevant ethical requirements, acceptance and continuance of client relationships and specific engagements, human resources and monitoring. PES 3 helps serve this important purpose.

PES 3 applies to firms of all sizes that provide services covered by the New Zealand Auditing and Assurance Standards Board (NZAuASB)'s Standards. The term "firm" includes a sole practitioner, partnership or corporation or other entity undertaking assurance engagements.<sup>2</sup> The NZAuASB's Standards cover, but are not limited to, the following:

- Audits of historical financial statements (International Standards on Auditing (New Zealand) (ISA (NZ)s) )
- Reviews of historical financial statements (Statement on Review Engagements Standards (RS 1))
- Assurance engagements other than audits or reviews of historical financial statements, such as assurance engagements on greenhouse gas statements (International Standards on Assurance Engagements (ISAE (NZ)s))

In developing PES 3, the NZAuASB was alerted to the needs of smaller firms, a constituency that is particularly affected by "standards-overload". Therefore, the NZAuASB was mindful of the importance of setting requirements that would be applicable on a proportionate basis relative to the nature and size of a firm.

An understanding of the design and intent of PES 3 will help smaller firms to apply PES 3 in a relevant and cost-effective way. Among other important features, there are a number of concepts embedded in PES 3 that are useful to achieving proportionate application, including that:

- Firms need only comply with those requirements that are relevant to the services provided.
- Firms can exercise appropriate judgement in implementing a system of quality control, for example, in deciding how formal certain processes need to be to comply with the requirements of PES 3 or in documentation of the system.
- Firms can draw on external resources to meet some of the requirements of PES 3.

Smaller firms will find that effective and proportionate implementation may be best

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<sup>2</sup> See PES 3, paragraph NZ12.4 (g).

achieved by first studying the provisions of PES 3 and then, in light of the nature and size of a firm and the services the firm provides, developing policies and procedures tailored to the firm's circumstances.

In the context of audits of financial statements, PES 3 works in tandem with ISA (NZ) 220<sup>3</sup> to establish a framework for quality control in two specific dimensions: at the firm and engagement levels. Together, these two standards address a variety of areas where auditors and firms can take specific action to promote and safeguard audit quality. PES 3 also works in tandem with the requirements addressing engagement-level quality control in the NZAuASB's standards on reviews of historical financial statements (Statement on Review Engagements Standards (RS 1) and assurance engagements other than audits or reviews of historical financial statements (ISAE (NZ)s).

## Questions and Answers

**Q1. *How does PES 3 address the fact that the characteristics of a smaller firm are significantly different from those of a larger firm?***

The objective of implementing a system of quality control is the same for all firms regardless of their nature or size. However, this does not mean that all firms have to design and implement exactly the same specific policies and procedures, or policies and procedures at the same level of detail, to achieve the objective and requirements of PES 3. PES 3 recognises that the nature and extent of the specific policies and procedures to be developed by a firm to comply with PES 3 will depend on various factors, such as the size and operating characteristics of the firm and whether it is part of a network.<sup>4</sup> PES 3, therefore, does not suggest a specific approach to implementation.

A particularly important provision in PES 3 relative to its proportionate application is the requirement for the firm to comply with each requirement of the standard *unless, in the circumstances of the firm, the requirement is not relevant to the services provided* in respect of audits and reviews of financial statements, and other assurance and related services engagements.<sup>5</sup>

PES 3 also acknowledges the importance of exercising appropriate judgement in implementing a system of quality control. For example, PES 3 indicates that the form and content of documentation evidencing the operation of each of the elements of the system of quality control is a matter of judgement and will depend on a number of factors.<sup>6</sup>

**Q2. *How might the implementation of PES 3 in a smaller firm differ from that in a larger firm?***

Generally, the organisational structure of a smaller firm will be simpler than that of a larger firm, for example:

- Smaller firms may use less structured means and simpler processes and procedures to achieve their objectives.
- Communications may be more informal in smaller firms.

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<sup>3</sup> ISA (NZ) 220, Quality Control for an Audit of Financial Statements.

<sup>4</sup> PES 3, paragraph NZ4.1.

<sup>5</sup> PES 3, paragraph 14.

<sup>6</sup> PES 3, paragraph A73.

Consequently, implementation of PES 3 in a smaller firm will likely be simpler than in a larger firm. Smaller firms will also find that proportionate implementation may be best achieved by first thoroughly familiarising themselves with the provisions of PES 3 and then, in light of the nature and size of a firm and the services the firm provides, developing policies and procedures tailored to the firm's circumstances. While this is true for firms of all sizes, in the context of a smaller firm, it assists in determining which of the requirements of PES 3 are relevant in the circumstances of the firm. For example, for a sole practitioner with no staff, requirements to establish policies and procedures for the assignment of appropriate personnel to the engagement team, for review responsibilities, and for the annual communication of the results of monitoring of the system of quality control to engagement partners within the firm will not be relevant.<sup>7</sup> Nevertheless, as a smaller firm grows in size, it is necessary to be mindful of relevant requirements of PES 3 to ensure continued compliance with the standard.

Further, some requirements of PES 3 may be easier for smaller firms to implement. For example, in relation to the requirement<sup>8</sup> that addresses the importance of promoting an internal culture recognising that quality is essential, smaller firms may be able to achieve this simply through leading by example and various communications between staff and leadership as they occur on a regular basis.

Finally, the approach to establishing quality control policies and procedures in a smaller firm may be less formal and structured. For example, smaller firms may employ less formal methods in carrying out performance evaluations for their staff.

**Q3. How does PES 3 help guide smaller firms in implementation of a system of quality control?**

PES 3 includes numerous specific considerations, labelled *Considerations Specific to Smaller Firms*, to assist smaller firms in understanding or applying the requirements. For instance, PES 3 states that a firm needing to consult externally (for example, a firm without appropriate internal resources) may take advantage of advisory services provided by:

- Other firms;
- Professional and regulatory bodies; or
- Commercial organisations that provide relevant quality control services.

PES 3 states that, before contracting for such services, consideration of the competence and capabilities of the external provider helps the firm to determine whether the external provider is suitably qualified for that purpose<sup>9</sup>.

PES 3 also provides other guidance that smaller firms may find helpful in implementing the requirements of the standard. For example, in relation to the requirements of PES 3 addressing the need for sufficient personnel with the competence and capabilities to perform engagements in accordance with professional standards<sup>10</sup>, firms may use a suitably qualified external person, for example, when internal technical and training resources are unavailable<sup>11</sup>. Often, this will likely be an effective (and cost effective) way to achieve the

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<sup>7</sup> PES 3, paragraph A1.

<sup>8</sup> PES 3, paragraph 18.

<sup>9</sup> PES 3, paragraph A40.

<sup>10</sup> PES 3, paragraph 29.

<sup>11</sup> PES 3, paragraph A27.

aims of the requirements.

**Q4. *How do sole practitioners or firms with few partners comply with PES 3's requirements relating to engagement quality control review?***

PES 3 requires an engagement quality control review for all audits of financial statements of issuers<sup>12</sup>. This requirement does not apply if the firm does not perform such engagements.

PES 3 also requires firms to set out criteria against which all other audits and reviews of historical financial information and other assurance and related services are to be evaluated to determine whether an engagement quality control review should be performed<sup>13</sup>. In this regard, PES 3 provides guidance on possible criteria that may be used for this purpose, such as the nature of the engagement, the identification of unusual circumstances or risks in an engagement, and whether laws or regulations require an engagement quality control review<sup>14</sup>. Often, none of a sole practitioner's or a smaller firm's engagements may meet the criteria that would subject the engagement to such a review.

PES 3 requires the firm to establish policies and procedures to maintain the objectivity of the engagement quality control reviewer. In the case of firms with few partners, PES 3 explains that suitably qualified external persons may need to be contracted where sole practitioners or small firms identify engagements requiring engagement quality control reviews. PES 3 indicates that some sole practitioners or small firms may alternatively wish to use other firms to facilitate engagement quality control reviews<sup>15</sup>.

**Q5. *What are relevant considerations for smaller firms, including sole practitioners, as it relates to the "monitoring" element of PES 3?***

Monitoring is an essential element of a robust system of quality control. PES 3 requires that the firm establish a monitoring process designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, and operating effectively<sup>16</sup>.

In the case of smaller firms, PES 3 explains that monitoring procedures may need to be performed by individuals who are responsible for the design and implementation of the firm's quality control policies and procedures, or who may be involved in performing the engagement quality control review. It also explains that a firm with a limited number of persons may choose to use a suitably qualified external person or another firm to carry out engagement inspections and other monitoring procedures. Alternatively, the firm may establish arrangements to share resources with other appropriate organisations to facilitate monitoring activities<sup>17</sup>. Such arrangements can form a part of a firm's quality control policies and procedures. However, the existence of an independent external audit inspection program, such as those conducted by an audit regulator, does not act as a substitute for the firm's own internal monitoring program<sup>18</sup>.

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<sup>12</sup> PES 3, paragraph 35(a).

<sup>13</sup> PES 3, paragraph 35(b).

<sup>14</sup> PES 3, paragraph A41.

<sup>15</sup> PES 3, paragraph A50.

<sup>16</sup> PES 3, paragraph A48.

<sup>17</sup> PES 3, paragraph A48.

<sup>18</sup> PES 3, paragraph A67.

Also, PES 3 requires the inspection of at least one completed engagement for each engagement partner on a cyclical (not necessarily annual) basis and specifically prohibits the use of personnel involved in performing an engagement from also performing an inspection of files for that engagement. In these circumstances, smaller firms may consider making arrangements with other smaller firms to perform inspections of each other's files.

PES 3 also requires the firm to establish policies and procedures designed to provide it with reasonable assurance that it deals appropriately with complaints and allegations that work performed by the firm fails to comply with professional standards and applicable legal and regulatory requirements, and allegations of non-compliance with the firm's system of quality control.

As applicable, the firm is required to take appropriate actions when deficiencies and non-compliance are identified<sup>19</sup>. PES 3 explains that it may not be practicable, in the case of firms with few partners, for the partner supervising the investigation into a complaint or allegation not to be involved in the engagement. In these circumstances, firms may use the services of a suitably qualified external person or another firm to carry out the investigation<sup>20</sup>.

***Q6. How might the documentation considerations for a system of quality control for a smaller firm differ from those of a larger firm?***

PES 3 requires a firm to establish policies and procedures requiring appropriate documentation to provide evidence of the operation of each element of its system of quality control<sup>21</sup>.

Documentation of the system of quality control will assist firms in demonstrating compliance with PES 3 and facilitate improvements in the system of quality control in the future.

PES 3 indicates that the form and content of documentation evidencing the operation of each of the elements of the system of quality control is a matter of judgement and depends on a number of factors, including the following:

- The size of the firm and the number of offices
- The nature and complexity of the firm's practice and organisation.

Also, PES 3 explains that smaller firms may use more informal methods in the documentation of their systems of quality control such as manual notes, checklists and forms<sup>22</sup>.

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<sup>19</sup> PES 3, paragraph 55-56.

<sup>20</sup> PES 3, paragraph A71-A72.

<sup>21</sup> PES 3, paragraph 57.

<sup>22</sup> PES 3, paragraph A75.