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<https://www.ifac.org/publications-resources/submit-comment?exposure-draft=273189>

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Dear Willie

Comments on the IAASB's Exposure Draft on proposed ISQM 1, Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements

The Independent Regulatory Board for Auditors (IRBA) is both the audit regulator and national auditing standard setter in South Africa. Its statutory objectives include the protection of the public by regulating audits performed by registered auditors, and the promotion of investment and employment in South Africa.

We appreciate this opportunity to comment on the IAASB's Exposure Draft on proposed ISQM 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*, developed by the International Auditing and Assurance Standards Board (IAASB).

In the compilation of this letter we have sought the inputs of representatives from large and medium-sized firms, academics, the Auditor-General South Africa, quality management consultants, the Johannesburg Stock Exchange and the South African Institute of Chartered Accountants. Internal IRBA consultations with our Inspections and Investigations departments, brought regulatory perspectives such as an understanding of the expected impact of the proposed quality management standards on regulatory processes, and existing inspections and investigations findings related to quality management.

The comments are presented under the following sections:

- A. Overall comments;
- B. Overall questions; and
- C. Specific questions.

Kindly e-mail us at creintjes@irba.co.za, or phone directly on +27 87 940 8828, if further clarity is required on any of our comments.

Yours faithfully,

Signed electronically

Bernard Peter Agulhas
Chief Executive Officer

A. OVERALL COMMENTS

- a) The IRBA welcomes and supports the IAASB's proposed new ISQM 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*; to ensure robust requirements and improved guidance to:
- i. Modernise the standards for an evolving and increasingly complex environment, including addressing the impact of technology, networks and use of external service providers;
 - ii. Increase firm leadership responsibilities and accountability, and improve firm governance;
 - iii. Ensure more rigorous monitoring of quality management systems and remediate deficiencies;
 - iv. Enhance the engagement partner's responsibility for audit engagement leadership and audit quality; and
 - v. Address the robustness of engagement quality reviews, including engagement selection, documentation and performance.
- b) The extant ISQC 1 is now 10 years old. During this period the audit environment changed substantially, and in many countries audit quality challenges have been encountered. In the current environment where there is a need to restore trust in the auditing profession in several countries, the IAASB's project on quality management is commended.
- c) We have advocated in our various publications, and as part of the IRBA's restoring confidence strategy, that a key component of quality management is firm leadership, and that leadership commitment leads to improvements in audit quality. We therefore support the central role assigned to firm leadership in the proposed quality management standards.
- d) The risk assessment approach is supported. We are confident that the new approach will improve quality, if implemented as required. The extant standard, ISQC 1, is focused on compliance, while this new approach of being responsive to quality risks encourages integrated and systems thinking. Where firms have already implemented aspects of quality management, we believe that the risk assessment approach will be a helpful step to formalising, widening and embedding such practice.
- e) We included the following comment in our June 2019 comment letter to the IAASB on the IAASB's *Consultation Paper: Proposed Strategy for 2020-2023 and Work Plan for 2020-2021*:
- "It is important that the IAASB's new or revised standards, for example ISQM 1, ISQM 2 and ISA 220 (R), do not allow excessive discretion on the part of the audit firms. Auditors, in general, tend towards doing less audit work due to the commercial interests of their businesses. Therefore, there is a potential risk to the public interest if, for example ISQM 1 permits policies and procedures to become too discretionary in setting the level of compliance. This will lead to audit regulators finding it difficult to reliably measure the effectiveness of the firm's quality control system and identify deficiencies during inspections of audit files. Audits might ultimately not be able to detect misstatements in the annual financial statements, leading to more corporate audit failures. The IAASB should ensure consistent application of the standards as opposed to permitting excessive levels of discretion and judgement, as this will in turn ensure the consistency in the quality of work performed by auditors."

- f) We have observed the frequent use of the word “may”, in both the introductory material and the application material. We encourage the IAASB to reflect on the relevance of this usage throughout the standard, and to consider alternative language that would be more helpful in achieving consistent high quality.
- g) We have encountered a lapse in focus on quality when firms are involved in mergers and restructuring. We therefore recommend that ISQM 1 should address the need that, before mergers or takeovers of firms become effective, the new firm must have a new system of quality management in place and that such a system is fully compliant with ISQM 1. This provision is necessary as the risk assessment process of firms is unlikely to automatically envisage the objective or a response that relates to the merger of systems of quality management from two or more firms.
- h) A key consideration in the implementation by firms of a system of quality management, is whether firms are guided alone by the letter of the standards, or aim also to achieve the spirit of the standards. Compliance with the requirements of the standards is a necessary benchmark, but in the realm of a risk based approach to quality management, it will be necessary for firm leadership and those with overall responsibility for the system of quality management to recognise that in their quest to achieve more than compliance in quality management, they will need to identify and implement best practice that instils the spirit of quality management.

B. OVERALL QUESTIONS

Question 1

Does ED-ISQM 1 substantively enhance firms’ management of engagement quality, and at the same time improve the scalability of the standard? In particular:

- a) *Do you support the new quality management approach? If not, what specific attributes of this approach do you not support and why?*
- b) *In your view, will the proposals generate benefits for engagement quality as intended, including supporting the appropriate exercise of professional skepticism at the engagement level? If not, what further actions should the IAASB take to improve the standard?*
- c) *Are the requirements and application material of proposed ED-ISQM 1 scalable such that they can be applied by firms of varying size, complexity and circumstances? If not, what further actions should the IAASB take to improve the scalability of the standard?*

- a) We support the new quality management approach. However, its success will depend on the resolution of feedback received during this exposure period, and in the successful implementation by firms.
- b) We believe that the proposals will generate benefits for engagement quality as intended. However, we suggest that the IAASB includes more emphasis on professional skepticism in ISQM 1. The lack of evidenced professional skepticism is a recurring finding in our inspections. We urge the IAASB to emphasise professional skepticism in all the individual component’s requirements, but at a minimum in the governance and leadership component, the acceptance and continuance of client relationships and specific engagements component, and the relevant ethical requirements component. Also, in paragraphs where “when applicable” is a condition attached to the exercise of professional skepticism, we recommend that this condition be removed (paragraphs 36(b), A94 and A95). Professional skepticism is always applicable.

- c) While, from a regulatory perspective, we agree that the requirements and application material of ED-ISQM 1 are scalable such that they can be applied by firms of varying sizes, complexity and circumstances, similar views were not held by the firms. Both large firms and SMPs are of the view that it is not clear how ED-ISQM 1 could be scalable for SMPs, and how SMPs could still evidence their compliance with it.
- d) In the context of scalability, the extent of documentation requirements was also frequently mentioned. SMPs are challenged by the documentation requirements and would prefer more specificity and clarity on how certain measures can be documented in the environment of a small firm, where, for example, the demonstration of leadership actions may be more informal than at a large firm. Our expectation as a regulator is that all firms do work of the highest standard in the public interest, and that the evidence supporting the system of quality management must be sufficient and appropriate. The IAASB should guide SMPs more clearly on how this can be achieved.
- e) A concern was also raised where scalability follows a “top down” approach. In other words, where an SMP is part of a large network, and the network policies and procedures need to be applied, these could be difficult to scale back for the SMP. In this case, the network requirements section of ISQM 1 should address the responsibilities of the SMP.

Question 2

Are there any aspects of the standard that may create challenges for implementation? If so, are there particular enhancements to the standard or support materials that would assist in addressing these challenges?

- a) Concerns were expressed around some implementation considerations, and possible unintended consequences of the new approach:
 - i. The length of the application material in ED-ISQM 1 has been raised as a concern by some stakeholders. There is extensive application material, draft FAQs, draft examples and discussion around further implementation guidance. Is this an indication that the requirements should be clarified? If requirements should be clarified, this may necessitate less application and other implementation material. Short examples could be included in application material, whereas long examples could be included in FAQs or implementation examples and guidance.
 - ii. We request that the extent of documentation required to provide evidence that the requirements have been met be clarified and expanded upon. Documentation requirements should not be onerous and prescriptive, i.e. a tick box approach of documenting for the sake of documenting should not be an outcome. Rather, guidance or a framework on how to decide on what needs to be documented could be provided. Paragraph 66 of ED-ISQM 1 provides the overarching principles for documentation requirements. However, these requirements are described at a very high level, and this has already created uncertainty. These challenges could be addressed meaningfully by considering minimum documentation requirements, with an explicit condition that these are only minimum requirements that must be complied with; and that further documentation may be required in order to comply with the standard and provide evidence of this compliance to the monitoring function. The standards need to be clear to firms regarding what the firms need to document in order to satisfy interested parties that the quality management system has been designed and implemented effectively by the firm. A possible solution is to strengthen paragraphs A211-A214 of ED-ISQM 1.

- iii. The firm should demonstrate compliance with and implementation of all the requirements of the standard. Documentation should provide sufficient and appropriate evidence of the genuine effort in ensuring compliance. In our experience, firms will state that they have considered certain matters, but they cannot prove that to external inspectors. The documentation requirement should also be established at a level that will ensure that the logic applied, the line of thinking and the reasons for conclusions on any decisions in terms of this standard have been recorded. A cross-reference to paragraph 8 of ISA 230, *Audit Documentation*, could be included so that the exact process followed can be demonstrated through documented evidence, as this is all that external inspectors can look at to verify compliance with the standard.
- iv. We recommend that material regarding the archiving of working papers from specialist areas of the engagement, such as IT, be added. These working papers should form part of the engagement file. We have noted findings where the IT division of a firm had its own working papers, apart from the financial statement audit team's working papers. Only the financial statement audit team had archived its working papers in terms of the archiving policy, and the IT-related working papers had not been archived. All audit evidence should be included in the audit file and not just in the final report of the evidence extracted from the IT system. Alternatively, procedures should be documented in sufficient detail to enable an experienced auditor to come to the same conclusion without the IT-related working papers.
- v. The timing of the documentation requirements of paragraph 67 of ED-ISQM 1 need to be clarified.
- vi. The requirements for the application of professional judgment are not clear. Also, the requirements on how to document that professional judgment has been applied are not clear. Concerns have been raised that monitoring or inspections findings may result if the application of professional judgment has not been adequately documented. From a regulatory perspective, professional judgment will need to be inspected and, more than ever before, challenged by regulators during inspections, which will require more time and resources. Application material on the documentation of professional judgment could include the documentation of the basis of decisions, the logic applied, lines of thought, reasons, factors considered, "for and against" explanations and so on. If audit regulators discover a flaw in the logic, the appropriate application of professional judgment can be challenged.
- vii. Professional judgment is required at the identification of quality objectives and quality risks stages, particularly, and guidance could be provided as to how this would be evidenced. Documentation requirements should result in evidence that the spirit, not only the letter, of ISQM 1 has been achieved.
- viii. Although ED-ISQM 1 applies to audits, reviews, other assurance and related services engagements, the requirements and application material focus mainly on audits. We suggest that a more balanced approach, with requirements referring to all the different types of engagements (where relevant), be considered. However, some requirements may be too extensive and onerous for engagements other than audits, and we encourage this to be considered.
- ix. Several stakeholders commented on their perception that the explanatory memorandum was useful and, in some places, easier to understand than parts of ED-ISQM 1 due to the use of simple language. We would support steps to further simplify the language in the quality management standards. Definitions could be simplified e.g. the definition of deficiency. We also urge the IAASB to consider when repetition can be avoided.

- x. A further suggestion is that the diagrams that are included in the explanatory memorandum be included in ISQM 1. We suggest that, at a minimum, the “house” diagram on page 7 of the explanatory memorandum be included in ISQM 1. Stakeholders were of the view that this diagram aids in understanding how the components interrelate. We see no reason in our jurisdiction why such a diagram would not be a welcome addition to the standards. We suggest that diagrams be included in the introductory paragraphs, in the application material or as supplements in the standard, not in the supporting guidance material only.
 - xi. More guidance or a framework on how to identify and assess quality risks could also be included. It needs to be clear to both the audit regulator and the firms that the firms have properly applied the quality risk assessment requirements.
- b) Paragraph 21 of ED-ISQM 1 states that the firm shall comply with each requirement of this ISQM, unless the requirement is not relevant to the firm because of the nature and circumstances of the firm or its engagements. We recommend that firms be required to document the reasons for concluding that certain requirements do not need to be complied with. This is a reasonable expectation for all those involved in quality management to have around the sufficiency and appropriateness of audit evidence.

Question 3

Is the application material in ED-ISQM 1 helpful in supporting a consistent understanding of the requirements? Are there areas where additional examples or explanations would be helpful or where the application material could be reduced?

- a) Please refer to the responses to questions 1, 2, 6 and 9-13.

C. SPECIFIC QUESTIONS

Question 4

Do you support the eight components and the structure of ED-ISQM 1?

- a) We support the eight components in ED-ISQM 1.
- b) In terms of the structure of ED-ISQM 1, and as evidenced in the diagram on the interrelationship of the components on page 7 of the explanatory memorandum, we suggest that the relevant ethical requirements component be positioned or emphasised as an overarching component.
- c) The extended introductory material in paragraphs 7-15 of ED-ISQM 1 creates extensive duplication. This material could be reduced.
- d) We suggest that the requirement for the evaluation of whether the system of quality management provides reasonable assurance that the objectives have been achieved be located earlier on in the standard. The requirement is included in paragraph 55 of ED-ISQM 1 toward the end of the component requirements.
- e) Paragraph A3 of ED-ISQM 1 states that: “... Such limitations include reality that human judgment in decision making can be faulty and that breakdowns in the firm’s system of quality management

may occur, for example, due to human error or behaviour or failures in the firm's IT applications." While we recognise that such language is already used elsewhere in the standards, we are concerned that this sentence in this context creates a loophole in the standard and should therefore not be included. It appears to pre-empt failures in the system of quality management and findings thereon.

- f) Regarding the assessment of acceptance and continuance of client relationships and specific engagements:
- i. Paragraph 34 of ED-ISQM 1 states that: "The firm shall establish the following quality objectives that address the acceptance and continuance of client relationships and specific engagements that are appropriate in the circumstances." It is not clear what "that are appropriate in the circumstances" means in this context. This condition may imply that quality objectives that address acceptance and continuance are not always appropriate, or that in some circumstances the quality objectives are not relevant or applicable? Who would assess this, and what would such circumstances entail?
 - ii. In the current economic climate, we are aware that fee pressures, tighter profit margins and audit fees that remain largely stagnant may have affected the work of some auditors. This has resulted in some firms accepting audits that they may not be competent to perform and to accept clients that may lack integrity; in turn, these instances may result in ethical breaches by the auditors. Numerous issues have been identified, including firms not sufficiently weighing up the risks in relation to the perceived benefits of taking on an audit client; commercial interests outweighing audit quality considerations; the risk of association with clients whose integrity may be lacking; and a general risk of damaging the reputation of not only the firm but also the profession as a whole. While firms may perform procedures to assess whether a client should be accepted, the procedures to assess continuance of client relationships are not sufficiently robust.
 - iii. This means there is no reassessment of whether the firm remains competent to perform the audit as clients evolve and grow; whether the firm remains compliant with relevant ethical and independence requirements after a client has been accepted; and whether the client continues to maintain integrity or whether new information that suggests that the client lacks integrity may have emerged. Many of the audit deficiencies identified during inspections and recent audit failures can be attributed to a lack of regular, honest and robust assessment of competence, ethics and client integrity in the firm's client acceptance or continuance process, an indication that leadership has not obtained the required level of reasonable assurance in this regard¹. The strengthening of client acceptance and continuance requirements is therefore strongly supported.
 - iv. ED-ISQM 1 does not set out which individual/s within the firm should be responsible for carrying out the client acceptance and continuance assessment. In our experience, it is usually the audit engagement partner who is tasked with carrying out the initial client acceptance assessment and the subsequent client continuance assessments. Where the firm provides both audit and non-audit services, it seems that a common approach is for the non-audit engagement teams to defer to the judgments and decisions of the audit engagement partners regarding client acceptance and continuance. It seems sensible that the (prospective) engagement partner should be responsible for performing the client acceptance/continuance assessment, since the engagement partner would likely have the most information regarding the client or prospective client. However, in some circumstances

¹ Extracted from the IRBA's Public Inspections Report 2018, which is available at <https://www.irba.co.za/upload/IRBA%20Inspections%20Report%202018.pdf>.

the engagement partner might be less objective in his/her assessment, for example, in order to safeguard fee income. Guidance in this regard could be provided, or further precautions could be included in ISQM 1 to address the risk (and threats) that engagement partners do not include all the adverse information in the client acceptance or continuance assessment.

- v. We recommend that a requirement (similar to extant paragraph 26 of ISQC 1), in the form of a response to quality risks, that firms should terminate client relationships if there are indications or evidence that the client (including management and, when appropriate, those charged with governance (TCWG)) lacks integrity be included, as:
- Management and TCWG are charged with safekeeping and the appropriate application of shareholders' resources;
 - Management and TCWG account to shareholders for their stewardship, inter alia, through the preparation of annual financial statements;
 - Both the stewardship and the accounting thereof through financial reporting rely heavily on the integrity of management and TCWG; and
 - The likelihood that auditors will detect fraud perpetrated by management or TCWG is restricted by several limitations inherent in an audit.

This proposed requirement which could lead all available firms to decline the audit engagement of a client that lacks integrity. In turn, this would create a vacancy in the office of the auditor. In South Africa, such a vacancy would attract the scrutiny of several regulators (we presume that this would also be the case in other jurisdictions around the world). This scrutiny would, in turn, lead to pressure being put on the client to deal with its integrity issues so that an auditor could again be willing to accept the audit engagement.

- vi. We recommend that the IAASB consider including a requirement that when new negative reports regarding serious matters related to a client, its management or its major shareholders, and which may have an impact on the audit, are published in the media, a review of the client's most recent acceptance/continuance assessment by the engagement partner should be triggered.
- vii. The engagement quality review process could also include a requirement to consider whether the most recent acceptance/continuance assessment decision should be revised, or additional safeguards should be put in place, if there are indicators that the acceptance/continuance decision may have either been incorrect or information is now available that would lead to a change in the decision.

g) Regarding resources:

- i. Paragraph 38(d) states that: "Personnel demonstrate a commitment to quality through their actions and behaviours, develop and maintain the appropriate competence to perform their roles, and are held accountable through timely evaluations, compensation, promotion and other incentives." We recommend that consequences or actions to be taken by the firm for personnel who demonstrate actions or behaviours that negatively affect quality, such as those mentioned in paragraph A123, be embedded into a requirement.

Question 5

Do you support the objective of the standard, which includes the objective of the system of quality management? Furthermore, do you agree with how the standard explains the firm's role relating to the public interest and is it clear how achieving the objective of the standard relates to the firm's public interest role?

- a) The explanatory memorandum and ED-ISQM 1 refer to the objective of the standard, the objective of the firm and the objective of the system of quality management. Reference to "objectives" in different contexts adds complexity to the standard. It is recommended that these objectives be consolidated into one objective, which should feature early in the standard.
- b) We recommend that the objective should also refer to the public interest. The firm should demonstrate that it has acted in the public interest, considering the needs of stakeholders.

Question 6

Do you believe that application of a risk assessment process will drive firms to establish appropriate quality objectives, quality risks and responses, such that the objective of the standard is achieved? In particular:

- a) *Do you agree that the firm's risk assessment process should be applied to the other components of the system of quality management?*
- b) *Do you support the approach for establishing quality objectives? In particular:*
 - i. *Are the required quality objectives appropriate?*
 - ii. *Is it clear that the firm is expected to establish additional quality objectives beyond those required by the standard in certain circumstances?*
- c) *Do you support the process for the identification and assessment of quality risks?*
- d) *Do you support the approach that requires the firm to design and implement responses to address the assessed quality risks? In particular:*
 - i. *Do you believe that this approach will result in a firm designing and implementing responses that are tailored to and appropriately address the assessed quality risks?*
 - ii. *Is it clear that in all circumstances the firm is expected to design and implement responses in addition to those required by the standard?*

We believe that the proper understanding and application of a risk assessment process will drive firms to establish appropriate quality objectives, quality risks and responses. In this regard, please consider the following responses:

- a) We agree that the firm's risk assessment process is to be applied to the other components of the system of quality management.
- b) Although we agree with the principle of establishing quality objectives, we recommend that the process to establish quality objectives be clarified. This could possibly include a decision-making framework, or "factors to consider", on how to establish additional quality objectives, either as clarified requirements or additional application material. Populations, boundaries and thresholds could be considered in this context. The risk that a significant quality objective is not identified should be mitigated. We encourage the IAASB to also develop requirements to support having

more detailed, subdivided and specific quality objectives being set by firms. These more granular quality objectives will provide a better foundation for quality risk identification and assessment and responses to be developed.

- c) Scalability has been introduced by using the phrase “when those objectives are necessary to achieve the objectives of this ISQM” in paragraphs 10 and 26 of ED-ISQM 1. It is not clear what is meant by this condition, when it will be applicable and how the correct application will be measured. Where quality objectives (or quality risks or responses) are conditional, we suggest that this be clear, with further guidance clarifying when a quality objective may not be necessary, in order to avoid having firms use the condition as a loophole.
- d) ED-ISQM 1 is silent as to when and how often firms need to modify quality objectives, quality risks or responses, as appropriate, in response to changes in the nature and circumstances of the firm or its engagements. We recommend that a requirement that firms reassess quality objectives at least twice annually be considered.
 - i. We believe that the required quality objectives are appropriate.
 - ii. We suggest that the requirements for establishing quality objectives for each of the components should repeat that the firm is expected to establish additional quality objectives beyond those required by the standard in certain circumstances, as per paragraph 26. Paragraphs 32, 34, 36, 38, 40 and 42 should also include this requirement.
- e) We support the process for the identification and assessment of quality risks (i.e. the principle that this is the next step after the establishment of quality objectives in the firm’s system of quality management). Emphasis can be placed in *each* requirement that the firm is expected to identify and assess additional firm-specific quality risks beyond those required by the standard in certain circumstances.
- f) Firms need to identify quality risks at the appropriate level of detail. In order to achieve this, we recommend that:
 - i. Additional or more granular quality objectives be set by firms (see response in b) above).
 - ii. Guidelines for establishing quality risks be developed; and
 - iii. The standard should emphasise that the process for identifying and analysing quality risks must be dynamic and demonstrate continuous improvement.

Strengthening of these requirements will enable firms to more effectively assess quality risks, develop related responses and prioritise such responses, so that the allocation of appropriate resources to the response can also be more effectively managed.

We suggest that there should be an explicit requirement, in the form of a response to a quality risk, for firms to consider inspection findings from audit regulators as part of their quality risk assessment process.

Paragraph 31 of the explanatory memorandum mentions a “threshold” for identifying quality risks. The threshold for identifying quality risks includes those risks for which (a) there is a reasonable possibility of the risk occurring; and (b) if the risk were to occur, it may individually, or in combination with other quality risks, have a significant effect on the achievement of a quality objective(s). More guidance is required to assist the firms in determining whether this threshold has been reached or not, how this would be documented, and whether further action would be required.

ED-ISQM 1 is silent as to when and how often firms need to assess their quality risks. Paragraph A53 states that the identification and assessment process *may* involve a combination of ongoing and periodic procedures. We recommend that a requirement that firms should assess quality risks

at least twice annually be included. In addition, we recommend that a list of criteria that could be considered as “triggers” to determine when further quality risks may have arisen be provided.

We suggest that guidance be provided regarding how to document the process for the identification and assessment of quality risks, and at what detail these should be documented. This guidance could possibly be included in the examples that will be provided as supporting material once the standards are issued. For example, this could be a risk matrix showing how risks can be rated (where formal ratings are used).

Stakeholders indicated that it is not clear what is meant by “significant effect” in paragraph 28(b) of ED-ISQM 1. An example might help to clarify this in paragraph A56.

It is not clear in ED-ISQM 1 whether when an identified quality risk that does not have a reasonable possibility of occurring and if it were to occur, may not individually or in combination with other quality risks, have a significant effect on the achievement of a quality objective (paragraph 28 of ED-ISQM 1), needs to be documented, with the above explanations and reasoning included, in order to demonstrate that a quality risk that needs to be responded to has not been identified. Paragraph A214 includes some guidance in this regard, but stakeholders have indicated that the extent of the documentation is not clear.

Paragraph A54 states that, under this ISQM, not every quality risk needs to be identified and further assessed. We are concerned that this is a loophole in the standard that the firms may use when they have either intentionally or accidentally omitted quality risks. Proposed wording could read as follows: “Under this ISQM, the firm is reasonably expected to identify relevant quality risks and to further assess such risks.”

A further suggestion is that an example could be provided in the application material regarding how a firm will ensure that employees are kept up to date with the most recent quality risk assessments and responses required, especially if quality risk assessments are performed at different levels, in different organisational structures or at different locations. It is understood that the policies and procedures that result from the implementation of the system of quality management at the firm are “live documents”; however, we encourage the IAASB to take practical implications into account.

SMPs have indicated that they will wait for guidance on how to identify and assess quality risks. This is possibly an indication that ED-ISQM 1 is not regarded by some users as being sufficiently scalable. We suggest that further guidance or clarification on where scalability can be applied be included in the standard.

- g) We support the approach that requires the firm to design and implement responses to address the assessed quality risks (points i. to iv. below address both questions d) i. and ii.).
- i. If implemented correctly, we agree that this approach will result in a firm designing and implementing responses that are tailored to and appropriately address the assessed quality risks.
 - ii. It is not clear that the firm is expected to design and implement responses in addition to those required by the standard. We suggest that paragraph 30 of ED-ISQM 1 be rephrased to:
“The firm shall design and implement the responses required by this ISQM to address the assessed quality risks. The firm shall also design and implement additional responses beyond those required in this ISQM, as responses to the additional quality risks specific to the firm that have been identified. The design of the responses shall be based on, and responsive to, the reasons for the assessments given to the quality risks.”

This clarifies that, firstly, the responses that are required by ISQM 1 are designed and implemented, and that over and above that, the firm-specific responses are designed and implemented.

- iii. We recommend that paragraphs 33, 35, 37, 39, 41 and 43 include the updated requirement set out in (ii).
- iv. We further recommend that the approach to design and implement additional firm-specific responses to address the assessed quality risks be clarified. This could possibly include a decision-making framework, or “factors to consider”, on how to design and implement responses to address the additional assessed quality risks, either as clarified requirements or additional application material.

Question 7

Do the revisions to the standard appropriately address firm governance and the responsibilities of firm leadership? If not, what further enhancements are needed?

- a) A foundation of success in quality management is the role of firm leadership, with the tone at the top being critical in achieving improved audit quality through the successful implementation of a system of quality management.
- b) Recent inspections findings have arisen across the entire spectrum of ISQC 1 elements. These findings, most of which relate to engagement performance, speak directly to the inadequate establishment of policies and procedures designed to promote an internal culture that recognises quality as essential when performing audit engagements. The significant findings have a direct bearing on leadership’s tone at the top in driving a culture of consistent, sustainable high audit quality within the firm. Recurring inspection findings indicate that firm leadership is not sufficiently promoting a quality-orientated internal culture or fulfilling its responsibilities to ensure quality within the firms, in some cases. These recurring findings do not only occur on follow-up visits to firms and engagement partners, but have also been observed on new inspections of different engagement partners within firms that were not previously inspected. This indicates that the tone at the top is not adequately promoting quality.
- c) Although we agree that the revisions to the standard progressively address firm governance and the responsibilities of firm leadership, we encourage the IAASB to consider the following points:
 - i. Could a non-practitioner CEO for a firm performing audits be this individual? As an audit regulator, we have raised concerns with firms where the CEO is not a practitioner. An audit regulator’s mandate may not extend to non-practitioners. Also, how would the firm demonstrate that the individual has the required understanding, if the individual is not a practitioner?
 - ii. Who could be regarded as an “equivalent” of the CEO or managing partner?
 - iii. Delegation of the operational implementation of the system of quality management should not result in the reassignment of responsibility and accountability.
- d) SMPs have raised the concern that, as ED-ISQM 1 requires the firm to assign ultimate responsibility and accountability for the system of quality management to the firm’s chief executive officer or its managing partner (or equivalent) or, if appropriate, the managing board of partners (or equivalent) (paragraph 24(a) of ED-ISQM 1), in other words, to an individual or individuals, a practical problem exists where a very small firm may have only a handful of partners or a sole practitioner. We therefore suggest that this requirement be conditional, i.e. that scalability be

introduced here. Although paragraph A32 includes guidance on firms of various sizes, the paragraph could include more clarity on scalability.

- e) We encourage the IAASB to include a requirement for firms to include engagement quality as a key performance indicator in the performance evaluation of *all* engagement partners and engagement teams, with an appropriate weighting for quality. Such a requirement is included in paragraph 24(b) of ED-ISQM 1, but does not apply to all partners and engagement teams.

Question 8

With respect to matters regarding relevant ethical requirements:

- a) *Should ED-ISQM 1 require firms to assign responsibility for relevant ethical requirements to an individual in the firm? If so, should the firm also be required to assign responsibility for compliance with independence requirements to an individual?*
- b) *Does the standard appropriately address the responsibilities of the firm regarding the independence of other firms or persons within the network?*

- a) We support the requirement that firms assign responsibility for relevant ethical requirements to an individual in the firm. We recommend that the firm also be required to assign responsibility for compliance with independence requirements to an individual in the firm. We understand this to mean that operational responsibility will be assigned to an individual such as a chief ethics officer. It is necessary to clarify whether the chief ethics officer will report directly to the individual assigned ultimate responsibility and accountability in paragraph 24(a).

It is likely that more due care will be taken with this requirement if it is assigned to an individual. However, relevant ethical requirements, like many other requirements included in the ED-ISQM 1, cannot be implemented in isolation. The individual will need to ensure that there is a consultative, monitoring and enforcement approach in executing their responsibilities.

- b) We believe that ED-ISQM 1 appropriately addresses the responsibilities of the firm regarding the independence of other firms or persons within the network.
- c) “Relevant ethical requirements” are defined as “principles of professional ethics and ethical requirements that are applicable to professional accountants when undertaking the audit engagement. Relevant ethical requirements ordinarily comprise the provisions of the International Ethics Standards Board for Accountants’ *International Code of Ethics for Professional Accountants (including International Independence Standards)* (IESBA Code) related to audits of financial statements, together with national requirements that are more restrictive”. Like some other audit regulators and standard setters, the IRBA has adopted Parts 1, 3, 4A and 4B of the IESBA Code. Part 2 of the IESBA Code has not been adopted. As a portion of the IESBA Code has not been adopted, a question arises regarding the suitability of the relevant ethical requirements definition. Can a firm or engagement partner state that he/she has complied with all relevant ethical requirements if the firm or engagement partner has not complied with Part 2 of the IESBA Code (or equivalent local Code), as Part 2 is not a jurisdictional requirement for auditors? How would this adoption of only relevant aspects of the IESBA Code be referenced in an audit report and any other external reporting?

Question 9

Has ED-ISQM 1 been appropriately modernized to address the use of technology by firms in the system of quality management?

- a) We recommend that ISQM 1 be further modernised with respect to technological resources. Quality risks related to technological resources pose a high risk to the system of quality management. Technological resources will likely affect most, if not all, of the system of quality management (and quality management at the engagement level). Paragraphs A124-A131 of ED-ISQM 1 contain generic wording regarding technological resources. Both the requirement (paragraph 38 of ED-ISQM 1) and the application material do not state that the pace of change in technology contributes to quality risks, including technological resources themselves and their impact on other components. We urge the IAASB to address this.
- b) Reliance on software providers may become problematic as software is a technological resource. Service providers may not be able to provide any “assurance” on the product. Firms will still need to determine that it is appropriate to use that resource in the system of quality management. We suggest that greater clarity be provided in the standard as to how the firms will “determine that it is appropriate to use that resource”.

Question 10

Do the requirements for communication with external parties promote the exchange of valuable and insightful information about the firm’s system of quality management with the firm’s stakeholders? In particular, will the proposals encourage firms to communicate, via a transparency report or otherwise, when it is appropriate to do so?

- a) Although we agree that the information and communication requirements will promote the exchange of valuable and insightful information about the firm’s system of quality management with the firm’s stakeholders, we urge the IAASB to take a decisive step forward and include the preparation and communication of transparency reports specifically as a requirement for certain firms, particularly those with clients that are entities that the firm determines are of significant public interest.
- b) With the current unprecedented level of scrutiny of firms, it is in firms’ best interests and in the public interest for firms to be transparent, and for the audit industry to embrace the attitude of disclosure and transparency that is encouraged among their clients.
- c) The IAASB is well positioned to drive this change toward greater transparency in the public interest. Mandatory transparency reporting will result in more detailed and consistent information being made available to the market, with firms required to reflect deeply on their achievement of quality objectives. This should result in improved quality management and therefore quality.
- d) We suggest that the requirement includes a minimum description of what should be included in transparency reports in respect of quality systems and management, such as reporting on the application and implementation of and compliance with ISQM 1, which would effectively form the reporting framework for transparency reports. We recommend that jurisdictional requirements also be referenced.
- e) Application material to this requirement could then include further guidance as to how these items could be included in the transparency report and any further items that could be included.

- f) The IAASB could then issue further supporting guidance beyond the standard. This could take the form of a practice note to ISQM 1, implementation guidance or examples.

Question 11

Do you agree with the proposals addressing the scope of engagements that should be subject to an engagement quality review? In your view, will the requirements result in the proper identification of engagements to be subject to an engagement quality review?

- a) We support the proposals addressing the scope of engagements that should be subject to an engagement quality review. We are confident that the requirements will result in the proper identification of engagements to be subject to an engagement quality review.
- b) Some stakeholders that we consulted were of the view that the interpretation of “entities that the firm determines are of significant public interest” may lead to different interpretations as to which engagements are subject to an engagement quality review. We, however, believe that the guidance in the application material is sufficient to address this concern. There is a risk that audit regulators may interpret this requirement differently from how firms interpret it. However, this risk can be mitigated by audit regulators issuing jurisdictional engagement quality review requirements, as allowed for in paragraph 37(e)(iii)(a). Alternatively, paragraph A102 of ED-ISQM 1 could be expanded upon by adding additional factors to consider.

Question 12

In your view, will the proposals for monitoring and remediation improve the robustness of firms' monitoring and remediation? In particular:

- a) *Will the proposals improve firms' monitoring of the system of quality management as a whole and promote more proactive and effective monitoring activities, including encouraging the development of innovative monitoring techniques?*
- b) *Do you agree with the IAASB's conclusion to retain the requirement for the inspection of completed engagements for each engagement partner on a cyclical basis, with enhancements to improve the flexibility of the requirement and the focus on other types of reviews?*
- c) *Is the framework for evaluating findings and identifying deficiencies clear and do you support the definition of deficiencies?*
- d) *Do you agree with the new requirement for the firm to investigate the root cause of deficiencies? In particular:*
 - i. *Is the nature, timing and extent of the procedures to investigate the root cause sufficiently flexible?*
 - ii. *Is the manner in which ED-ISQM 1 addresses positive findings, including addressing the root cause of positive findings, appropriate?*
- e) *Are there any challenges that may arise in fulfilling the requirement for the individual assigned ultimate responsibility and accountability for the system of quality management to evaluate at least annually whether the system of quality management provides reasonable assurance that the objectives of the system have been achieved?*

We are confident that the proposals for monitoring and remediation will improve the robustness of firms' monitoring and remediation.

- a) The proposals will improve firms' monitoring of the system of quality management as a whole and promote more proactive and effective monitoring activities, including encouraging the development of innovative monitoring techniques.

Coaching could be included as a monitoring and remediation technique.

Application material could be included to address the issue of predictability of engagements selected for internal reviews. Predictability of inspections of engagements may result in a reduced effort to comply with the standard, if the engagement partner and team do not expect an internal review of that engagement.

We support the new quality management system assessment methodology detailed in the *CPAB Audit Quality Insights Report: 2018 Annual Inspections Results* and urge the IAASB to include this approach in ISQM 1:

“This new assessment approach requires firms to demonstrate the effectiveness of their quality management systems. It emphasizes the need to systemically embed audit quality processes (preventative and detective) into ongoing operations across the entire assurance portfolio so that audit deficiencies are identified and corrected in real time or, at a minimum, before the audit opinion is released. Monitoring and inspecting audit quality after the fact is not enough.”

We recommend that the requirement in ISQM 1 address the need for remedial action to be taken in real time. If it is not realistic to include this as a requirement, we recommend including guidance on the timing of remedial action.

- b) We agree with the IAASB's conclusion to retain the requirement for the inspection of completed engagements for each engagement partner on a cyclical basis.

The firm may establish different cyclical periods for the inspection of completed engagements of engagement partners, according to the categories of engagements they perform. For example, the firm may determine that the cyclical period for an engagement partner performing audits of financial statements may be three years, whereas the period may be longer for engagement partners performing compilation engagements. The cycle of the inspection may be based on time (i.e. every three years as illustrated) or another factor, for example, the number of engagements performed. We suggest that the maximum number of years of the cycle be included in the requirements, and that it should be three years for audits.

- c) While we acknowledge the need to evaluate findings and identify deficiencies, we do not fully support the framework for evaluating findings and identifying deficiencies, and we do not support the definition of deficiencies.

Regarding the framework for evaluating findings and identifying deficiencies:

Paragraph 68 of the explanatory memorandum to ED-ISQM 1 states that:

“The IAASB is of the view that findings that do not rise to the level of a deficiency do not need to be subject to additional actions, such as investigating the root cause of the finding or remediating the finding. As a result, the IAASB identified the need for a clear definition of a deficiency in ED-ISQM (see paragraph 19(a) of ED-ISQM 1) and a supporting framework that sets out the process for evaluating negative findings and identifying deficiencies (see paragraphs 47-48 of ED-ISQM 1). The illustration sets out the framework in ED-ISQM 1, and the application material in ED-ISQM 1 provides further guidance to support the firm in working through the framework.”

This explanation and intention have not, however, been clearly translated into requirements. This is partly due to the complexity of the definition of deficiency, and partly due to an unclear process

for evaluating negative findings and identifying deficiencies. Several stakeholders stated that the difference between findings and deficiencies is not clear. Also, it is not clear why only some findings are then determined to be deficiencies and, further, which findings are determined to be deficiencies.

It is unclear how firms are to identify deficiencies if “negative findings” are not subject to root cause analyses. Negative findings might be indicative of deficiencies, and the root cause itself might be a deficiency. If no root cause analysis is performed on negative findings, the firm might miss important indications of systemic weaknesses.

In this regard, the diagrams on pages 23 and 24 of the explanatory memorandum would be very helpful to gain an understanding; and we therefore encourage the IAASB to include these in the standard.

Paragraph 47 states that “the firm shall establish policies or procedures addressing the evaluation of the findings arising from the monitoring activities...” We suggest that the word “prompt” or “timely” be included so that the requirement reads as “the firm shall establish policies or procedures addressing the prompt (or timely) evaluation of the findings arising from the monitoring activities...”

Regarding the definition of deficiencies:

The definition of deficiency has three parts to it that are separated by “or” (paragraphs 19(a)(i), 19(a)(ii) and 19(a)(iii)). This implies that the “level” of the deficiency, or the “seriousness” of the deficiency, is the same/equal for all three parts of the definition. This does not seem to be clear as, theoretically, failure to establish a quality objective is a higher risk than a failure to identify and assess a quality risk, which, in turn, is a higher risk than the failure to respond appropriately to a quality risk.

A further concern raised is the relationship of deficiencies to the definition of “findings” as described by audit regulators for inspections purposes.

- d) We agree with the new requirement for the firm to investigate the root cause of deficiencies.
- i. The nature, timing and extent of the procedures to investigate the root cause is sufficiently flexible.

However, the application material could clarify how much work needs to be done and what the extent of the root cause analysis is, in order to satisfy the requirement of the standard.
 - ii. We agree that the way ED-ISQM 1 addresses positive findings, including addressing the root cause of positive findings, is appropriate.

Requirements to consider positive findings and to embed these in the system of quality management could be included in the governance and leadership component requirements.

We urge the IAASB to consider another term instead of “findings”, as “findings” carries a negative connotation. Terminology could include “practices that have a positive impact on the system of quality management” or similar.

Additionally, paragraph 47 includes a reference to external inspections, and in turn this is referenced to paragraph A173, which provides guidance on positive findings. It may be concluded that external inspections could be expected to report positive findings to firms. We recommend that it be clarified that regulators should not be required to report on positive findings, and usually do not report on positive findings, and may face legal obstacles in reporting such findings.

e) The following possible challenges may arise in fulfilling the requirement for the individual assigned ultimate responsibility and accountability for the system of quality management to evaluate at least annually whether the system of quality management provides reasonable assurance that the objectives of the system have been achieved:

- Paragraph 55 states that “the individual(s) assigned ultimate responsibility and accountability for the system of quality management shall evaluate whether the system of quality management provides reasonable assurance that the objectives stated in paragraph 18(a) and (b) have been achieved...” This is effectively a self-assessment and therefore creates a self-review threat. The individual would not be objective when making this assessment.

Furthermore, is it appropriate to obtain reasonable assurance, which is a high level of assurance similar to an external audit opinion, through self-assessment?

It should be noted that, in our experience, the reasonable assurance requirement in the extant ISQC 1 was generally not met by leadership. We are not certain that the new standard will ensure better compliance, other than introducing a self-assessment.

- Evidence of the objectivity of the individual is difficult to document. We recommend that a requirement that the objectivity of the individual be assessed be included, and that this assessment be included in the documentation requirements, together with the individual’s conclusion on his or her objectivity.
- Evaluating reasonable assurance regarding the system of quality management may be confused with obtaining and expressing reasonable assurance, as per the auditing and assurance standards. Although the term “reasonable assurance” has been carried forward from extant ISQC 1, we urge the IAASB to reconsider its use in a quality management standard.
- Alternatively, we recommend that a framework for assessing reasonable assurance be provided. This may assist in determining when the threshold of reasonable assurance has been reached.
- It is unlikely that an individual will document that he or she has concluded that reasonable assurance has not been provided, and that the objectives of the system have therefore not been achieved. How would it be determined that, although reasonable assurance was not obtained by the individual, he or she failed to document this conclusion and his/her subsequent actions? It would be unlikely that the individual would admit to reasonable assurance not having been provided. Also, if the individual acknowledges that reasonable assurance has not been provided, how would this be communicated externally, for example, in a transparency report?
- Paragraph 56 states that “the evaluation in paragraph 55 shall be undertaken at least annually, or more frequently when the identified deficiencies are of a severity and pervasiveness that indicate that the system may not be providing reasonable assurance that the objectives stated in paragraph 18(a) and (b) have been achieved”. We recommend that the evidence of the evaluation be at a point in time, e.g. beginning of the year, and should be documented in such a manner for implementation to be effectively assessed by external inspectors. Firms should not use the argument of an ongoing system as this will complicate external inspections of their system of quality management.

- Paragraph A190 states that “prompt and appropriate action when the evaluation indicates that the system does not provide reasonable assurance that the objectives stated in paragraph 18(a) and (b) have been achieved may include: ...
 - Obtaining legal advice.”

It is not clear how obtaining legal advice would be relevant in this situation.

Question 13

Do you support the proposals addressing networks? Will the proposals appropriately address the issue of firms placing undue reliance on network requirements or network services?

- a) We support the proposals addressing networks. It is clear in ED-ISQM 1 that each firm remains responsible for its system of quality management, including professional judgments made in the design, implementation and operation of the system, even if designed by another firm in the network.
- b) Paragraph 58 of ED-ISQM 1 requires the firm to “understand” certain requirements. It is not clear how the firm’s “understanding” is to be documented. What is the work effort that is required in order to obtain understanding? How is understanding demonstrated? What is the threshold for understanding?
- c) We recommend that the requirements be expanded upon to include requirements addressing a demonstrated and documented evaluation (at network and/or firm level) and a conclusion by the firm as to whether, and the extent to which, the network resource or service (e.g. audit tools, independence systems) is appropriate to use. The firm needs to demonstrate that it has not placed undue reliance on the network.
- d) We recommend providing clarity on the extent of documentation that each individual firm in the network needs to maintain, when the network has documented requirements for the network. Does the network documentation need to be maintained by each individual firm in the network?
- e) It appears that requirements for the use of service providers are more extensive than those relating to network resources and services. This seems to imply that more work effort is required by the firm regarding service providers. Is this the intention?
- f) The application material (paragraph A195 of ED-ISQM 1) allows for the understanding of network resources and services to be obtained by inquiry alone, and this is not sufficient or appropriate. A greater work effort requirement is recommended, including the inspection of documentation.
- g) We question what work effort should be done to support the “evaluation” referred to in paragraph 59.

Question 14

Do you support the proposals addressing service providers?

- a) We support the proposals addressing service providers. It is clear in ED-ISQM 1 that each firm remains responsible for its system of quality management.

- b) In considering its resource needs, the firm may consider the resources needed to enable consultation, for example, appropriate access to intellectual resources to facilitate research and personnel with the competence and capabilities to provide consultations. In some instances, such as at a smaller firm, human resources to support consultation may only be available externally, for example, from other firms, professional and regulatory bodies, or commercial organisations that provide such services. In such cases, paragraphs 64-65 of ED-ISQM 1 apply. In cases where an external consultant provides consulting services to an audit firm, the firm should ensure that the external consultant is not also involved in the performance of the engagement quality review for that specific engagement or monitoring reviews for the firm. It is the responsibility of the firm to ensure that it has asked the appropriate probing questions regarding the independence of the consulting firm before the consulting firm is appointed.
- c) Paragraph 64(a) of ED-ISQM 1 requires the firm to “understand” the service provider, including determining that the reputation, competence and capabilities of the service provider are appropriate in the context of the intended use of the resource. It is not clear how the firm’s “understanding” is to be documented. What is the work effort that is required in order to obtain understanding? How is understanding demonstrated? What is the threshold for understanding?
- d) We recommend providing clarity on the extent of documentation evidencing compliance with the requirements when firms use service providers.
- e) It appears that requirements for the use of service providers are more extensive than those relating to network resources and services. This seems to imply that more work effort is required by the firm regarding service providers. Is this the intention?
- f) The application material (paragraph A210 of ED-ISQM 1) also allows for the understanding of service providers to be obtained by inquiry alone, and this is not sufficient or appropriate. A greater work effort requirement is recommended, including the inspection of documentation.
- g) Paragraph A99 states that “human resources to support consultation may only be available externally, for example, other firms, professional and regulatory bodies, or commercial organizations that provide such services”. The implication is that firms could consult with the audit regulator. We recommend that this reference be removed.

Question 15

With respect to national standard setters and regulators, will the change in title to “ISQM” create significant difficulties in adopting the standard at a jurisdictional level?

- a) No, the change in the title to ISQM will not create significant difficulties in adopting the standard.
