



Auditing and Assurance Research Network  
School of Accounting  
UNSW Business School  
Sydney - Australia

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Mr Willie Botha  
Technical Director  
International Auditing and Assurance Standards Board  
International Federation of Accountants  
529 5th Avenue, 6th Floor  
New York, NY, 10017  
United States of America

Dear Willie,

**Re: Proposed International Standard on Quality Management ISQM1 (ED-ISQM1)  
Quality Management For Firms That Perform Audits or Reviews of Financial Statements, or  
Other Assurance or Related Service Engagements**

The Auditing and Assurance Research Network at UNSW Sydney (Australia) is pleased to comment on the International Auditing and Assurance Standards Board's Proposed International Standard on Quality Management ISQM1 'Quality Management For Firms That Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements. The Auditing and Assurance Research Network at UNSW Sydney is one of the eight research clusters within the UNSW Business School, leveraging off global research strengths.

The response combines the views of two network members; Associate Professor Noel Harding and Dr Wei Chen. In preparing our response, we focus on our own areas of expertise and our own research, together with research of other network members, and other research that provides additional elaboration on our views. Our response does not represent a census of all research, and we do not comment on all questions. Specifically, we provide a response to Questions 1(b), 3, 4, 6(c), 12(a) and 12(d)ii.

If helpful, we would be pleased to provide further elaboration on the research cited and/or the views expressed. In this regard, please contact either of the undersigned.

Yours Sincerely

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We begin by commending the work that has been done on quality management. Quality management at the firm level, and the application of quality responses at the engagement level, are the foundation on which quality is built. In this regard, research (Aobdia 2019) finds that quality control (management) deficiencies are associated with lower audit quality.

Overall, we support the proposed standard and believe that it will enhance firms' management of engagement quality and facilitate an improvement in quality in the public interest. However, on the basis of our own research, and that of others, we have identified a number of instances where the requirements of the proposed standard, and the application and other explanatory material, may be such that the potential of the proposed standard is not fully realized. In addition, we have identified a number of instances where we believe the standard can be further improved so as to more effectively support quality management. We note that our comments do not represent a census of all research and we do not comment on all questions. Specifically, we provide a response to Questions 1(b), 3, 4, 6(c), 12(a) and 12(d)ii. If helpful, we would be pleased to provide further elaboration on the research cited and/or the views expressed.

#### Question 1(b)

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

*(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?*

We believe that the proposals associated with the eight components of the system of quality management will, on the whole, generate benefits for engagement quality, including the appropriate exercise of professional skepticism. On the basis of our own research, and that of others, our view is, however, that there are opportunities to further improve the standard. We structure our response around the components of a firm's system of quality management for which we have a comment to make (we make no comment on 'relevant ethical requirements', 'acceptance and continuance of client relationships and specific engagements').

#### Governance and Leadership

While we strongly support this component, we feel that insufficient attention has been given to the role of governance and leadership in providing a fulfilling environment for, and leveraging off the motivation and commitment of, the firm's personnel.

Illustrating the importance of a fulfilling environment to the achievement of quality, research highlights that the self reported incidence of quality threatening behavior (e.g., inadequate team member supervision) is positively associated with the extent to which firms fail to meet expectations relating to professional aspects of auditing (autonomy, training, collegiality) (Herrbach 2001). Similarly, Herda, Cannon and Young (2019) find that helping auditors appreciate the importance of their work to the broader community is associated with greater work place mindfulness and a reduced likelihood of quality threatening behaviors (i.e., premature sign off).

While evidence on whether professional and firm commitment is associated with behaviors positively impacting quality is mixed (e.g., Malone and Roberts 1996; Herda and Martin 2016), to the extent that commitment impacts turnover intentions (e.g., Nouri and Parker 2013), a failure to foster professional and firm commitment may impact the firm's ability to retain qualified personnel and have a negative impact on quality.

With regard to motivation, research has found that intrinsic motivation is associated with, for example, improved auditor judgments and a greater willingness to raise audit issues, and that the firm can emphasize and leverage off an individual's intrinsic motivation so as to make the quality enhancing behaviors more likely (e.g., Kadous and Zhou 2019; Kadous, Proell, Rich and Zhou 2019).

Given the fundamental importance to quality of providing a personally fulfilling environment, as well as leveraging off the motivation and commitment of firm personnel, we feel that firms should be required to establish quality objectives that address these issues. We recommend that paragraph 23 be expanded, either by listing an additional objective or by expanding a current objective, to give sufficient attention to providing a fulfilling environment for, and leveraging off the motivation and commitment of, the firm's personnel.

### The Firm's Risk Assessment Process

We note that the risk assessment process bears similarities to the risk assessment process presented in ED-ISA315 in that risks are identified before consideration of any responses (in ED-ISA315 inherent risk is determined before consideration of the controls). Research highlights that auditors incorporate an expected level of control effectiveness when making assessments of inherent risk (Miller, Cipriano and Ramsay 2012), and to the extent that this could also mean that anticipated responses intrude on the assessment of quality risks, the possibility of occurrence and significance of effect (paragraph 28a) may be underestimated. Given that this may mean that quality risks are not subject to further assessment (see paragraph A54), we believe that paragraph A54 should reinforce the requirement that the preliminary consideration of the possibility of the quality risks occurring, and the effect on the achievement of the quality objectives, is before consideration of any responses.

In addition, we note that no guidance is provided with regard to whether the assessment of quality risks with reference to possibility of occurrence and the significance of effect in paragraph 28 is a joint or separate assessment. Recent research (Simon, Smith and Zimbleman 2018) reports that decomposition of fraud risk assessments into likelihood and magnitude components (compared to a holistic / joint assessment) lead auditors to "...discount their fraud risk assessments for higher risk fraud schemes" (p. 274). To the extent that this translates into assessments of quality risks, separately assessing possibility and significance may result in critical quality risks being under-assessed. We recommend that consideration be given to amending paragraph A54 to suggest a joint consideration of possibility and significance.

For further consideration, given the importance of identifying quality risks to the firm's system of quality management, we propose that discussion be noted in the application material relating to paragraph 28 as a means of identifying quality risks, similar to the requirement in paragraph 16 of ISA240 when identifying where the entity's financial report may be susceptible to material misstatement due to fraud. Our research (Chen, Khalifa and Trotman 2015; Chen, Khalifa, Morgan and Trotman 2018), as well as that of other network members (Trotman, Simnett and Khalifa 2009) and others (e.g., Carpenter 2007) highlights the benefit of team discussion in identifying fraud risks for further consideration, and we believe that such an approach may be beneficial in identifying a broad range of quality risks that can then be the subject of a preliminary consideration. We suggest that paragraphs A53 to A54 be expanded to note team discussion as a possible mechanism through which quality risks may be identified.

Finally, we are concerned that 'reasonable possibility' is explained in paragraph A55 as being 'more than remote'. This may give rise to confusion and mean that too many quality risks will need to be assessed and responded to.

Research suggests that 'reasonable possibility' and 'more than remote' are not equivalent. In 2016, the Korean Accounting Standards Board and the Australian Accounting Standards Board reported results of a survey eliciting Korean and Australian preparers' and auditors' interpretation of linguistic probability statements contained in International Accounting Standards. Australian preparers and auditors perceived remote to mean a probability of 9.0% (range: 3.2% to 12.1%). However, these same preparers and auditors perceived reasonably possible to mean a probability of 57.2% (range: 49.7% to 72.7%). Similar results are reported in Amer, Hackenbrack and Nelson (1994), that is, remote: 12.33%; reasonably possible: 58.57%.

To the extent that paragraph 28(a) captures quality risks for which the likelihood of occurrence is more than remote (i.e., more than approximately 10%), a considerably larger number of quality risks will be identified for further assessment, and a considerably larger number of quality risks will require a response. Given that the objective of the firm is to implement a system of quality management that provides *reasonable* assurance, we believe that reasonable possibility is the appropriate threshold for quality risks to be subjected to further assessment and for which a response may be required.

### Engagement Performance

Again, we support the requirement to establish quality objectives that address engagement performance. Particularly with regard to audit review, our own research and that of others (see Trotman, Bauer and Humphreys 2015 for a review of this literature) highlights the quality enhancing characteristics of audit review, and Herrbach (2001) report that the perceived quality of audit review is negatively associated with self reported instances of quality threatening behavior (e.g., inadequate team member supervision). We do note, however, the importance of the term 'appropriate', in that it recognizes the contingent quality impacting nature of the requirements. In this regard, we would recommend that greater elaboration on what factors may impact the appropriateness of a response be provided in the application

and other explanatory material. For example, Andiola, Bedard and Westermann (2019) report the characteristics and potential impact of a good and poor review. Importantly, a poor review not only has the potential to negatively impact quality on the engagement for which the review is being conducted, but also negatively impact quality on future engagements (see also our comments on motivating engagement personnel under the heading of 'resources'). Paragraph 36(a)(ii) refers to the 'appropriate' direction and supervision of the engagement team and review of the work performed. The explanatory material relating to this paragraph, however, does not address what is appropriate. Our own research (e.g., Kim and Harding 2017; Harding and Kim 2019) and that of others (e.g., Wilks 2002; Peecher, Piercy, Rich and Tubbs 2010) highlights that direction and supervision from superiors can sometimes threaten the objectivity of subordinate judgments. While our research (Kim and Harding 2017) highlights that auditors are often appropriately responding to the information value inherent in the direction provided by more knowledgeable engagement team members (and therefore to be encouraged), there remains the potential for auditors to inappropriately bias judgments in favor of the stated or inferred position of their superiors (Harding and Kim 2019). We recommend that the explanatory material, which is currently focused on supervision (paragraph A92) and review (paragraph A95) be expanded to also cover direction, including the importance of limiting direction to process rather than outcome.

Similarly, we recommend that paragraph 38(d) refer to the *appropriate* evaluations, compensation, promotion and other incentives (see also paragraph A122) so as to highlight the contingent impact of these actions. To illustrate, rewarding desired behavior may not always encourage that behavior. For example, Brazel, Leiby and Shaefer 2019 find that rewarding the exercise of skepticism can lead to auditors exercising less skepticism in future tasks.

#### Resources

We strongly support the focus under this objective on human resources. Without competent and capable personnel, the effectiveness of a firm's system of quality management will inevitably be compromised. Of concern in this regard is the ability of the profession to attract and retain appropriately qualified personnel (e.g., Hermanson, Houston, Stefaniak and Wilkins 2016). With this in mind, we believe that objectives should go beyond hiring, developing and retaining personnel (see paragraph 38a), as equally fundamental issues involve making the profession attractive to those capable of performing in it and to motivate those already within it. We believe that consideration should be given to rephrasing paragraph 38(a) to 'The firm *attracts*, hires, develops, *motivates* and retains personnel, including ...', and explanatory material in paragraph A119 expanded to discuss examples of what the firm's response in this regard may include.

We similarly support the recognition given to ensuring that personnel are assigned to engagements and activities such that they have sufficient time to positively contribute to quality (paragraphs 38b and 38c). Research (e.g., McDaniel 1990; Coram, Ng and Woodliff 2004) highlights the threats to quality from time pressure, and a firm's system of quality management must address this threat. We do feel, however, that insufficient attention has been given to the multi-client / multi-task environment in assigning personnel to engagements and tasks. Our own research (Kim, Mayorga and Harding 2017) (see also Mullis and Hatfield 2018) highlights that task switching / multitasking can negatively impact the quality of audit judgments. Other research highlights the threats to quality from an intense period of work pressure (e.g., during 'busy season') (e.g., Hurley 2017; Hurley 2019). In a multi-client environment, research reveals that preparer and reviewer judgments are inappropriately influenced (and have the potential to negatively impact quality) by the outcome of similar judgments made on a different engagement (Bhattacharjee, Maletta and Moreno 2007; Bhattacharjee, Maletta and Moreno 2017) (i.e., preparer and reviewer judgments are subject to contrast effects).

We recommend, therefore, that paragraph 38 be expanded to recognize the need for the firm to establish quality objectives relating to allocating and assigning human resources that take into consideration, not only the time available to complete the task immediately at hand, but also the other tasks that are being completed at the same time, the volume of work that personnel have recently been required to complete, and other engagements that personnel may be, or recently have been, involved with.

#### Information and Communication

With reference to information and communication (paragraphs 40 and 41), we feel that the focus as it relates to communication within the firm is too narrowly defined and limited to the quality system itself, rather than also including the outputs of the quality system. To illustrate, we would have anticipated

communication of the findings from root cause analysis to have been specifically addressed in this section. Our own research (Harding and Trotman 2009) shows that an effective information system that communicates how personnel have performed on previous engagements, as well as aggregated information on how personnel at different hierarchical levels have performed on previous engagements, can be effective in reducing the extent to which personnel are overconfident in the competence of their colleagues (e.g., Tan and Jamal 2001; Jamal and Tan 2001; Han, Jamal and Tan 2011). We therefore recommend that paragraphs 40 and A139 be expanded to more explicitly recognize the need to establish quality objectives relating to the communication of outputs of the system of quality management, rather than only focusing on the mechanics of the system itself.

We concur with the requirement in paragraphs 40(c) and 40(d) to establish quality objectives that address the exchange of information as it relates to the operation of a firm's system of quality management and the performance of engagements. Research highlights, however, that personnel may be reluctant to 'speak-up' (e.g., Gold, Gronewold and Salterio 2014; Kadous, Proell, Rich and Zhou 2019), and we would recommend that paragraph A139 be expanded to not only cover how a firm's system of quality management may encourage communication of engagement related matters (paragraph A139 as presently written is focused on communication as it relates to the system of quality management itself and is silent on communication of matters arising when performing engagements), but also matters that may be considered when encouraging open and robust communication. For example, research finds that 'speaking up' is more likely when the engagement partner is team oriented (i.e., emphasizes a group identity and team accomplishment) (Nelson, Proell and Randel 2016), emphasizes intrinsic versus extrinsic goals (Kadous, Proell, Rich and Zhou 2019), when personnel anticipate receiving feedback on the resolution of the issue raised (Griffith, Kadous, and Proell 2019) and when the firm has an open error management climate where mistakes are viewed as an opportunity to learn rather than to impose sanctions (Gold, Gronewold and Salterio 2014).

#### Monitoring and Remediation

We concur with the emphasis that the standard places on root cause analysis with reference to identified deficiencies. We do not, however, agree with the asymmetric focus on deficiencies at the expense of positive findings. While recognizing that paragraph A173 acknowledges that positive findings may be useful and that paragraph A178 acknowledges the benefits of investigating the root cause of positive findings, we feel that investigating the root cause of *significant* positive findings should be required, not only to maintain quality, but also in the public interest, so as to advance quality management and facilitate continuous improvement. Indeed, we believe that this component should be referred to as 'Monitoring and Continuous Improvement' so as to highlight the reason for remediation and the consideration of positive findings. Such an approach may also benefit other objectives. For example, recognizing positive findings may contribute to a rewarding and fulfilling environment. Research of network members (Peecher, Solomon and Trotman 2013) suggests that there is merit in focusing quality management not only on the achievement of a minimum threshold such that deficiencies are avoided, but encouraging (and recognizing and communicating) quality responses that exceed the minimum threshold. We suggest that careful consideration be given to requiring root cause analysis of *significant* positive findings. In the same way that it is not a requirement to undertake root cause analysis on all negative findings, the standard could limit the requirement to undertake root cause analysis to *significant* positive findings. This would realize benefits while at the same time limiting firms' compliance burden (see also our comments under Question 12).

#### 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.*

We believe that the application material is useful, but only to the extent that it elaborates on and provides context for the requirements. We are less supportive of application material that provides illustrations of how the principle may be reflected in practice. By providing these illustrations, not only is the longevity of the standard threatened as new and superior illustrations are identified through, for example, practitioner experience and research, the illustrations threaten principles based standard setting in that they may be seen as being requirements and encourage a checklist mentality in which the

illustrations are applied without question (even if they are inappropriate), potentially at the expense of other, more appropriate, responses.

Where illustrations are considered necessary, we raise for the IAASB's consideration, the option of guidance, associated with, but issued separate from the standard, as a means of providing the illustrations of actions fulfilling the requirements of the standard. With such an approach, the illustrations may be updated as necessary, to reflect advancements in achieving quality without having to re-open the standard. This would also allow targeted guidance across the different regions, cultures and engagement/firm size for which the standard must be applied, and reduce the length of the standard.

We also note that while our responses to other questions suggest further elaboration on the application and other explanatory material, sometimes with suggestions to add further illustrations, we believe our suggestions and recommendations would be equally effective if they were applied to guidance outside of the standard.

#### Question 4

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

We support the eight components and structure of ED-ISQM 1. We note and concur with the explicit recognition that firms are not required to organize their systems according to the discrete components, but believe that the structure provides guidance that is necessary for many firms, especially SMPs, to meet the proposed standard's requirements.

We note our detailed response to Question 1(b) which outlines opportunities for improvement at a more granular level.

#### Question 6(c)

*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:*

*(c) Do you support the process for the identification and assessment of quality risks?*

As noted above in our response to Question 1(b), we support the requirements as they relate to the identification and assessment of quality risks, but note in our response threats arising from the intrusion of expected responses in the assessment of quality risks, the joint versus separate assessment of likelihood and magnitude aspects of quality risks, the potential for discussion to identify a broader suite of quality risks for further consideration, and concerns that defining reasonable possibility as more than remote may cause confusion and increase the number of quality risks that will need to be identified and assessed.

#### Question 12(a)

*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?*

As noted above, and below in response to Question 12(d)ii, we feel that the new requirement to investigate root causes should be extended to significant positive findings. We feel that the focus on positive (and negative) findings will encourage greater acceptance and engagement with the monitoring process within the firm and among engagement teams, thereby promoting and facilitating proactive and effective monitoring activities.

#### Question 12(d)ii

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

*(d) Do you agree with the new requirement for the firm to investigate the root cause of deficiencies?*

ii. Is the manner in which ED-ISQM 1 addresses positive findings, including addressing the root cause of positive findings, appropriate?

We agree with the new requirement for firms to undertake a root cause analysis of deficiencies. Research in auditing has recently begun to investigate the merits of root cause analysis in exercising professional skepticism and identifying the core underlying cause of a problem (misstatement). Doxey, Pollard and DeZoort (2019) find that auditors instructed to analyze a misstatement using root cause analysis were more effective in identifying an underlying cause, suggesting that root cause analysis is an effective means by which to analyze identified deficiencies. We note, however, that this research also finds that providing structure to the root cause analysis (i.e., the five whys, fishbone method) increased its effectiveness. We recommend, therefore, that the explanatory material relating to paragraph 48(a) (i.e., paragraphs A178 to A182) highlight that a structured approach to root cause analysis may be more effective in identifying the underlying root causes of an identified deficiency.

We do feel, however, that the emphasis given to positive findings, relative to that given to negative findings, means that an opportunity to improve quality and facilitate continuous improvement in the public interest is lost. As part of the monitoring and remediation process (which we suggest above should be rephrased as *Monitoring and Continuous Improvement*), firms are required to identify and investigate the root cause of deficiencies. The investigation of positive findings is not a requirement, although the benefits of doing so are acknowledged in paragraphs A173 and A178. Research of network members (Peecher, Solomon and Trotman 2013), based on a review of the psychology and economic literatures, suggests that there is merit in focusing quality management, not only on the achievement of a minimum threshold such that there are no deficiencies, but also encouraging (and recognizing and communicating) quality responses that exceed the minimum threshold (see also Aobdia 2018).

We do not, therefore, support the current proposals making the root cause analysis of positive findings optional. The investigation of positive findings may help remedy negative findings, drive continuous improvement, and compliment an environment in which quality is recognized rather than only identifying and punishing a lack of quality (and in doing so, improves the environment within which auditors work – thereby helping firms to attract, recruit and motivate personnel). We do not believe, however, that all positive findings need to be analyzed. Like negative findings, the positive findings for which root cause analysis is required could be limited to *significant* positive findings. Such an approach would allow firms to realize benefits while minimizing the increased compliance burden.

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