International Standard on Quality Management

International Standard on Quality Management (ISQM) 1 (Previously International Standard on Quality Control 1)

Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements

IAASB International Auditing and Assurance Standards Board

About the IAASB

The Staff of the International Auditing and Assurance Standards Board prepared this document, and it does not constitute an authoritative pronouncement of the IAASB. The document does not amend, extend or override the International Standards on Quality Management, International Standards on Auditing or other of the IAASB's International Standards.

The objective of the IAASB is to serve the public interest by setting high-quality auditing, assurance, and other related services standards and by facilitating the convergence of international and national auditing and assurance standards, thereby enhancing the quality and consistency of practice throughout the world and strengthening public confidence in the global auditing and assurance profession.

The IAASB develops auditing and assurance standards and guidance for use by all professional accountants under a shared standard-setting process involving the Public Interest Oversight Board, which oversees the activities of the IAASB, and the IAASB Consultative Advisory Group, which provides public interest input into the development of the standards and guidance. The structures and processes that support the operations of the IAASB are facilitated by the International Federation of Accountants (IFAC).

BASIS FOR CONCLUSIONS:
ISQM 1, QUALITY MANAGEMENT FOR FIRMS THAT PERFORM AUDITS OR REVIEWS OF FINANCIAL STATEMENTS, OR OTHER ASSURANCE OR RELATED SERVICES ENGAGEMENTS

The Staff of the International Auditing and Assurance Standards Board (IAASB) has prepared this Basis for Conclusions. It relates to, but does not form part of, ISQM 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements,* or the conforming and consequential amendments to International Standards on Auditing (ISAs).

ISQM 1 was approved with affirmative votes of 17 out of 18 IAASB members, and the conforming and consequential amendments to ISAs were approved with the affirmative votes of 18 out of 18 IAASB members.[1]

Section A – Introduction

Background

1.   The project to revise ISQC 1[2] commenced in 2014 to respond to key findings from:

   (a)   The ISA Implementation Monitoring Project[3] completed in 2013;

   (b)   Respondents' feedback to the consultations undertaken in developing the IAASB's Strategy for 2015–2019: *Fulfilling Our Public Interest Mandate in an Evolving World*[4] and related Work Plan for 2015–2016: *Enhancing Audit Quality and Preparing for the Future.*[5]

   (c)   Feedback from ongoing outreach activities; and

   (d)   Findings from audit regulators' inspection reports.

2.   Considerations relevant to ISQC 1 that were noted from these various activities included:

   (a)   Whether aspects of the *Framework for Audit Quality* need to be addressed within ISQC 1, for example relating to:

      (i)   The competence and capabilities of the engagement team, recruitment and training, and changes in firm's resource models (e.g., use of shared service centers).

      (ii)   Internal monitoring reviews, including the scope and extent of such reviews.

      (iii)   Governance structures of firms and networks.

   (b)   The need to address remediation and acknowledge the importance of root cause analysis.

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[1]   For a full record of the voting on ISQM 1, including the rationale of the IAASB member who abstained from the vote, see https://www.iaasb.org/meetings/iaasb-board-meeting-virtual-videoconferencing-1.

[2]   International Standard on Quality Control 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements and Other Assurance and Related Services Engagements*

[3]   *Clarified International Standards on Auditing–Findings from the Post-Implementation Review*

[4]   https://www.ifac.org/system/files/publications/files/IAASB-Strategy-2015-2019_0.pdf

[5]   https://www.ifac.org/system/files/publications/files/IAASB-Work-Plan-2015-2016.pdf

(c)   The need for additional guidance to demonstrate how ISQC 1 could be applied proportionately by small- and medium-sized practitioners (SMPs), including clarifying how it can be applied to reviews, other assurance, and related services engagements.

(d)   Addressing multiple issues related to engagement quality control reviews (e.g., the selection of the engagement quality control reviewer and their independence from the engagement team, the professional skepticism exercised by the reviewer and the objective, extent, timing, and documentation of the review).

3.   In order to further understand the issues identified through the post-implementation review of the clarified ISAs, inspection findings and ongoing outreach, and how they may be best addressed, the IAASB released the Invitation to Comment (ITC), *Enhancing Audit Quality: A Focus on Professional Skepticism, Quality Control and Group Audits*,[6] in December 2015. Respondents generally agreed that the IAASB should take action to address the issues presented in the ITC. Furthermore, respondents' feedback provided valuable insight in formulating the actions the IAASB would take to address the issues.

4.   In December 2016, the IAASB approved a combined project proposal[7] to address revisions of ISQC 1, ISA 220[8] and ISA 600.[9] In relation to ISQC 1, the project proposal included the following objectives:

(a)   Propose revisions to ISQC 1 to strengthen and improve a firm's management of quality for all engagements performed under the IAASB's International Standards by incorporating a quality management approach at the firm level, fostering the ability of the standard to be applied to a wide range of circumstances, and enhancing the requirements and application material.

(b)   Propose consequential amendments to other standards that may be necessary as a result of revisions to ISQC 1.

(c)   Determine whether non-authoritative guidance and support tools should be developed by the IAASB or others to supplement the revisions.

5.   At its December 2018 meeting, the IAASB approved proposed ISQM 1 (ED-ISQM 1)[10] for public exposure, in conjunction with proposed ISQM 2,[11] proposed ISA 220 (Revised)[12] and proposed conforming amendments to the ISAs.[13] The exposure drafts were published on February 8, 2019 for comment by July 1, 2019. Comment letters on ED-ISQM 1 were received from 100 respondents, including investors and analysts, regulators and audit oversight authorities, national auditing standard setters, accounting firms, public sector organizations, International Federation of Accountants (IFAC)

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6   https://www.iaasb.org/publications/invitation-comment-enhancing-audit-quality-public-interest-1

7   *Enhancing Audit Quality: Project Proposal for the Revision of the IAASB's International Standards Relating to Quality Control and Group Audits*

8   International Standard on Auditing (ISA) 220, *Quality Control for an Audit of Financial Statements*

9   ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

10   Proposed ISQM 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*

11   Proposed ISQM 2, *Engagement Quality Reviews*

12   Proposed ISA 220 (Revised), *Quality Management for an Audit of Financial Statements*

13   *The IAASB's Exposure Drafts for Quality Management at the Firm and Engagement Level, Including Engagement Quality Reviews*

Member Bodies and other professional organizations, academics and individuals. Responses were received from four Monitoring Group members.[14]

6.   In addition to the quality management exposure drafts, an overall explanatory memorandum provided background to the three exposure drafts and an explanation of the significant issues pervasive to the three exposure drafts, including a discussion of scalability and the interrelationship of the three proposed standards. It also set out the IAASB's proposals regarding the effective date and the related implementation period for the three proposed standards, as well as the IAASB's planned implementation support activities.

7.   During the exposure period, the IAASB undertook various outreach activities to help stakeholders understand the proposals, including webinars, videos, and roundtables.

Public Interest Issues

8.   The table below shows the public interest issues identified by the IAASB in the project proposal that were relevant to ISQM 1. It also highlights the subsequent decisions made by the IAASB to enhance the standard in the public interest, taking into account the comments received in response to ED-ISQM 1 (paragraph references in this table are to ISQM 1).

Public Interest Issues	**IAASB Decisions**
Fostering an appropriately independent and challenging skeptical mindset of the auditor—professional skepticism is a fundamental concept and core to audit quality. These projects will further consider how the standards can articulate the requirements for auditors, especially engagement partners, to appropriately demonstrate the application of professional skepticism in carrying out the audit and also how the standards can address the firm's contribution to fostering the appropriate environment for effective application of professional skepticism.	The IAASB responded by: • Including paragraph 15 of ISQM 1, which is essential explanatory material to the objective of the standard explaining how the system of quality management (SOQM) enables the consistent performance of quality engagements. In particular, it explains how quality engagements are achieved, and clarifies that doing so involves exercising professional judgment and, when applicable to the type of engagement, exercising professional skepticism. • Adding a quality objective in paragraph 31(c) of ISQM 1 that states, "engagement teams exercise appropriate professional judgment and, when applicable to the type of engagement, professional skepticism." • In paragraph A78 of ISQM 1, explaining how ISA 220 (Revised) addresses impediments to the exercise of professional skepticism at the engagement level, unconscious auditor biases that may impede the exercise of professional

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[14]   The Monitoring Group comprises the Basel Committee on Banking Supervision (BCBS), the European Commission, the Financial Stability Board, the International Association of Insurance Supervisors (IAIS), the International Forum of Independent Audit Regulators (IFIAR), the International Organization of Securities Commissions (IOSCO) and the World Bank. Responses to ED-ISQM 1 were received from BCBS, IAIS, IFIAR, and IOSCO.

Public Interest Issues	IAASB Decisions
	skepticism, and possible actions that the engagement team may take to mitigate such impediments.
Keeping the ISAs and ISQC 1 fit for purpose—as the standards are revised, consideration will be given to how the standards can, and continue to, be robust and adaptable to a wide range of circumstances in an evolving and increasingly complex environment.	The IAASB responded by: • Incorporating a principles-based approach in the standard that is focused on risk, so that firms adapt the SOQM based on the evolving environment. • Concentrating on achieving outcomes by including requirements in the standard that are focused on achieving outcome-based quality objectives. At the same time, the standard maintains, and has enhanced, its robustness, given that the quality objectives are comprehensive and address the requirements of extant ISQC 1, as well as new requirements to address key public interest issues. • Including a requirement in paragraph 25(a) of ISQM 1 for the firm to understand the conditions, events, circumstances, actions or inactions that may adversely affect the achievement of the quality objectives, and in doing so, understanding a number of specific factors set out in the standard, which includes the environment in which the firm operates. • In paragraph 27 of ISQM 1, requiring the firm to establish policies or procedures that are designed to identify information that indicates additional quality objectives, or additional or modified quality risks or responses, are needed due to changes in the nature and circumstances of the firm or its engagements. Such changes may include changes in the firm's environment.
Encouraging proactive management of quality at the firm and engagement level—consideration will be given to how the quality control standards, ISQC 1 and ISA 220, can encourage effective management of quality in the context of the firm and engagement that is fostered by proactive firm leadership and management, reinforced by a firm's culture and strategy.	The IAASB responded by introducing quality objectives in paragraph 28 of ISQM 1 to enhance governance and leadership, including quality objectives that: • Address the firm's commitment to quality through a culture that exists throughout the firm, reinforce the firm's role in serving the public interest by consistently performing quality engagements and address the responsibility of

Public Interest Issues	IAASB Decisions
	all personnel for quality and their expected behavior.
	• Address the importance of quality in the firm's strategic decisions and actions, including the firm's financial and operational priorities.
	Furthermore, the concept of proactive management of quality has been embedded throughout the standard through the firm's risk assessment process and monitoring and remediation process. In addition, the standard includes new requirements in paragraphs 53–55 of ISQM 1 for leadership to undertake an annual evaluation of the SOQM and conclude thereon.

Exploring transparency and its role in audit quality—as transparency reporting increases globally, the IAASB will consider further actions in relation to how firms provide transparency about how they support and achieve effective quality management.	The IAASB responded by:
	
	 • Introducing a quality objective in paragraph 33(d)(ii) of ISQM 1 addressing external communication. The quality objective states, "information is communicated externally when required by law, regulation or professional standards, or to support external parties' understanding of the SOQM."
	
	 • Requiring firms, through paragraph 34(e) of ISQM 1, to establish policies or procedures that:
	  o Require communication with those charged with governance when performing an audit of financial statements of listed entities about how the SOQM supports the consistent performance of quality audit engagements;
	  o Address when it is otherwise appropriate to communicate with external parties about the firm's SOQM; and
	  o Address the information to be provided when communicating externally, including the nature, timing and extent and appropriate form of communication.
	
	 Application material further explains a number of considerations including:
	  o Matters that may influence the firm's decisions about when to otherwise communicate with external parties;

Public Interest Issues	IAASB Decisions
	o Information that may be provided to external parties when communicating with them, and the attributes of useful information; and o The form of communication that may be appropriate.
Focusing more on firms (including networks) and their internal and external monitoring and remediation activities—consideration will be given to more explicitly addressing expected actions to remediate audit deficiencies from inspection findings, and to bring more emphasis to external inspections. The IAASB will also consider how accounting firms communicate internally and with other firms in the network, and how they respond to findings from internal inspections.	The IAASB responded by more robustly addressing monitoring and remediation through new requirements and enhancements to existing requirements. In particular, the IAASB: • Focused on monitoring activities that address the SOQM as a whole and provide a basis for the identification of deficiencies, in paragraphs 35–36 of ISQM 1. • Included a requirement in paragraph 37 of ISQM 1 for the firm to determine the nature, timing and extent of the monitoring activities taking into account a number of factors, such as the design of SOQM, the circumstances of the firm, changes in the SOQM, and other relevant information. Other relevant information includes information from external inspections. • Enhanced the requirement in paragraph 38 of ISQM 1 addressing the inspection of completed engagements and supporting application material, by including an increased focus on the appropriate selection of engagements and engagement partners taking into consideration risk and other monitoring activities. • Introduced a framework in paragraphs 40–41 of ISQM 1 for evaluating findings and identifying deficiencies, and evaluating the severity and pervasiveness of deficiencies. The framework includes a requirement to investigate the root cause(s) of deficiencies. • Improved the appropriate remediation of deficiencies in paragraphs 42–44 of ISQM 1, and included a new requirement for leadership to determine that remedial actions are effective. The IAASB also introduced requirements in paragraphs 50–51 of ISQM 1 that address network-level monitoring activities, and include requirements that require the firm to:

Public Interest Issues	IAASB Decisions
	• Determine the effect of the network-level monitoring activities on the firm's monitoring activities; and • Understand the overall scope of the monitoring activities undertaken by the network across the network firms, and obtain information from the network about the results of such activities.
Reinforcing the need for robust communication and interactions during the audit—the IAASB will consider how to strengthen the standards in relation to interactions and communications from those involved in the audit.	The IAASB responded by introducing a number of quality objectives in paragraph 33(a)–33(c) of ISQM 1 addressing obtaining, generating or using information, and communicating information within the firm on a timely basis to enable the design, implementation and operation of the SOQM. Among the matters addressed in the quality objectives are: • The need for an information system; • Having a culture that recognizes and reinforces the responsibility of personnel to exchange information with the firm and with one another; and • Exchanging and communicating relevant and reliable information between the firm and engagement teams.

Other Quality Management Standards

9. ISQM 1 deals with the firm's responsibility to establish policies or procedures addressing engagements that are required to be subject to engagement quality reviews (paragraph 34(f) of ISQM 1). ISQM 2 deals with the appointment and eligibility of the engagement quality reviewer, and the performance and documentation of the engagement quality review. ISQM 1 was approved by the IAASB in conjunction with ISQM 2. The Basis for Conclusions: ISQM 2 explains the IAASB's decisions on all matters related to engagement quality reviews, including with respect to the requirements of ISQM 1 addressing engagements that are required to be subject to engagement quality reviews.

10. ISA 220 (Revised) deals with the specific responsibilities of the auditor regarding quality management at the engagement level for an audit of financial statements and the related responsibilities of the engagement partner. ISQM 1 was approved by the IAASB in conjunction with ISA 220 (Revised). The Basis for Conclusions: ISA 220 (Revised) explains the IAASB's decisions on matters related to ISA 220 (Revised).

Section B – The General Approach to Quality Management and Scalability

Background

11.   Among the public interest issues identified by the IAASB at the outset of the quality management project were the need for proactive management of quality and keeping the standard fit for purpose. The IAASB also identified scalability as a key issue, so that the standard can be applied by a variety of firms of different size and complexity. To address these issues, the IAASB proposed that the standard adopt a new approach to managing quality, termed "quality management," which would be focused on proactively identifying and responding to risks to quality.

12.   The explanatory memorandum to ED-ISQM 1 explained that the new focus on quality management would encapsulate an integrated approach to quality management that reflects upon the SOQM as a whole, focuses on risk, and requires a firm to customize the design, implementation and operation of its SOQM based on the nature and circumstances of the firm and the engagements it performs. It further explained many benefits to this approach, including a tailored and proactive system that is more robust and effective, and focused on ongoing improvement.

13.   In issuing ED-ISQM 1, the IAASB sought respondents' views on the overall quality management approach, including the benefits of the approach, and whether respondents believed the standard was scalable such that it could be applied by firms of varying size and complexity.

Summary of Comments Received on Exposure

14.   In general, respondents supported the new quality management approach, however there were pervasive concerns about the scalability of ED-ISQM 1. In particular, respondents raised concern about the prescriptiveness of the standard, noting that the standard consisted of a hybrid of a risk-based approach and prescriptive requirements. They further commented on the length and complexity of the standard, and emphasized the difficulties that would be experienced in implementing the standard in its current form. On the contrary, there were other respondents who thought that the standard should be developed in a manner that supports effective oversight and enforcement action. There were also respondents who highlighted the importance of larger firms doing significantly more in addressing matters of audit quality beyond the minimum requirements in ED-ISQM 1 (i.e., scaling-up).

15.   Respondents provided a number of suggestions to address the scalability, prescriptiveness, complexity, understandability and length of the standard. Some of these suggestions included:

(a)   Restructuring the standard.

(b)   Revising the required quality objectives and required responses, for example, reducing the prescriptiveness or adjusting them to be more overarching.

(c)   More explicitly addressing quality risks, for example, by introducing quality risks.

(d)   Revising the requirements that are more relevant to larger firms to be clearly conditional, i.e., a bottom-up approach.

16.   There were also comments about the application of ED-ISQM 1 by firms who only perform engagements other than audits under the IAASB's standards, such as related services engagements, and whether ED-ISQM 1 was suitable for such firms.

IAASB Decisions

17.   Given the extent of concerns on scalability, prescriptiveness, complexity, understandability and length, the IAASB identified the following key areas of focus in further developing the standard:

(a)   The scalability of the standard and encouraging firms to appropriately tailor the SOQM for their circumstances;

(b)   The complexity and prescriptiveness of the requirements; and

(c)   Developing a standard that can be applied in all circumstances, including when firms only perform related services engagements.

18.   The IAASB took a number of actions to address the key areas of focus. Highlights of the actions taken include:

(a)   Reorganizing the structure of ISQM 1 to simplify and clarify the standard and facilitate easier navigation.

(b)   As explained in Section E, refining the quality objectives and responses, and in doing so, underscoring the principles-based approach through more outcome-based quality objectives and increased focus on achieving the quality objectives.

(c)   Simplifying and clarifying the firm's risk assessment process.

(d)   As explained in Section F, including conditions, events, circumstances, actions or inactions that the firm is required to understand in identifying and assessing quality risks, which are focused on the nature and circumstances of the firm and the engagements it performs. This increases the focus on scalability and tailoring the SOQM.

(e)   Drafting and presenting the requirements and application material in a manner that is easier to understand, and to reduce the overall length of the standard. This included:

(i)   Redrafting the standard using shorter and simpler sentence structures.

(ii)   Placing examples in the application material in separate boxes, and clearly signposting examples that demonstrate scalability.

(f)   Critically analyzing the standard to remove material that is only relevant on first time implementation and removing duplicative material, including explanations in the introduction, appendix and application material.

(g)   Increasing the emphasis on the need for the firm to exercise professional judgment in paragraph 19 of ISQM 1, thereby enhancing the focus on the need for firms to scale-up or scale-down.

Many of these actions also addressed other important issues further described in the sections that follow.

19.   The IAASB considered, but did not support, developing separate requirements or a separate standard for firm-level quality management over related service engagements. The IAASB reiterated its view that ISQM 1 needs to be truly risk-based and adopt a scalable, principles-based approach, such that it can be applied by firms of varying size and complexity, including those that perform only certain types of engagements.

Section C – Objective of the Standard and Public Interest

Background

20.   The explanatory memorandum to ED-ISQM 1 explained that:

(a)   The *objective of the firm* in the context of the standard is to design, implement and operate a SOQM.

(b)   The SOQM is designed to provide the firm with reasonable assurance that it achieves the following two objectives:

(i)   The firm and its personnel fulfill their responsibilities in accordance with professional standards and applicable legal and regulatory requirements, and conduct engagements in accordance with such standards and requirements; and

(ii)   Engagement reports issued by the firm or engagement partners are appropriate in the circumstances.

21.   ED-ISQM 1 also proposed a more explicit reference in the introduction to the firm's role in serving the public interest, with supporting explanations of what this means (i.e., the consistent performance of quality engagements). In issuing ED-ISQM 1, the IAASB sought respondents' views on whether it is clear how achieving the objective of the standard relates to the firm's public interest role.

Summary of Comments Received on Exposure

22.   In general, respondents supported the objective of ED-ISQM 1. Various further comments included a need to clarify the meaning of reasonable assurance and explain the multiple layers of objectives embedded in the standard.

23.   Respondents had mixed views about the reference to public interest in the standard, which included:

(a)   Views that a more explicit reference to public interest should be in the objective of the standard or elsewhere in the requirements.

(b)   Concerns about referring to the public interest given the wide interpretation of the meaning of public interest.

IAASB Decisions

24.   During the course of the project, the Public Interest Oversight Board (PIOB) had, as one of its public interest issues, the need for the objective to include a focus on high quality audits. In light of this issue and respondents' feedback about the reference to public interest, the IAASB deliberated whether, and if so how, the objective of the standard could be more focused on quality engagements. The IAASB noted that:

(a)   The objective of the standard needs to provide a clear outcome-based reference for the firm in evaluating whether the objective has been achieved. An objective that incorporates aspirational elements, such as the achievement of high-quality engagements, is by its nature not capable of clear and consistent evaluation.

(b)   A quality engagement is achieved when the practitioner fulfils their responsibilities in accordance with professional standards and applicable legal and regulatory requirements, conducts the engagement in accordance with such standards and requirements, and issues an engagement report that is appropriate in the circumstances.

(c)   The role of the firm is to enable the consistent performance of quality engagements through designing, implementing and operating a SOQM that provides the firm with reasonable assurance that the objectives in paragraph 14(a) and (b) of ISQM 1 are achieved. Accordingly, the objective of ISQM 1 should remain focused on the firm establishing a SOQM to enable the performance of quality engagements, rather than the firm individually managing the quality of engagements.

25.   As a result, the IAASB concluded that the objective of the standard in paragraph 14 of ISQM 1 remains appropriate. However, noting respondents' suggestions to improve the linkage between the public interest and the objective, the IAASB relocated the introductory material explaining the public interest to paragraph 15 of ISQM 1, such that it is in closer proximity to the objective. The new location of this material:

(a)   Clarifies how the public interest and consistent performance of quality engagements are related to the objective of the standard;

(b)   Improves the prominence of the public interest in the standard; and

(c)   Facilitates a proper understanding of the objective of the standard and how the requirements are designed to achieve the objective.

26.   In response to suggestions to clarify the meaning of reasonable assurance, the IAASB added:

(a)   Paragraph A190 of ISQM 1 to explain that the operation of the system as a whole provides the firm with reasonable assurance that the objectives of the SOQM are being achieved; and

(b)   Paragraph A195 of ISQM 1 to emphasize that the firm is not required to obtain an independent assurance report on its SOQM.

27.   The IAASB plans to explain the multiple layers of objectives embedded in the standard through illustrations in the implementation support materials.

Section D – Components and Structure

Background

28.   ED-ISQM 1 was organized according to eight components, reflecting a combination of existing elements in ISQC 1, including some that were broadened and adapted (i.e., governance and leadership and resources), and two new components (the firm's risk assessment process and information and communication). ED-ISQM 1 explained the integrated nature of the components and how they are interrelated. The IAASB emphasized that although the standard is organized according to eight components, firms are not required to organize their systems according to these discrete components.

Summary of Comments Received on Exposure

29.   Respondents supported the eight components, and the increased emphasis on the interrelationship of the components. Respondents also appreciated the flexibility provided to firms in organizing their systems. However, there were various suggestions regarding the description of the components and structure of the standard, including:

(a)   Emphasizing that the firm's risk assessment process and monitoring and remediation process are processes, and therefore different in nature from the other components.

(b)   Relocating the firm's risk assessment process as the first component in the standard to provide better context and improve the readability of the standard.

(c)   Considering whether information and communication and resources should be integrated into the other components.

(d)   Considering whether the monitoring and remediation process should also be subject to the firm's risk assessment process.

IAASB Decisions

30.   The IAASB agreed with respondents' views that the firm's risk assessment process and monitoring and remediation process are of a different nature to the other components, since they are processes that are applied to the other components. Accordingly, in order to better differentiate these components and emphasize that they are processes the firm needs to establish, the IAASB introduced a requirement in each of these two components focused on establishing a process (paragraphs 23 and 35 of ISQM 1). The IAASB's decisions about whether the firm's risk assessment process should be applied to the monitoring and remediation process is discussed in Section I.

31.   The IAASB considered, but did not agree to, the suggestion that information and communication and resources be incorporated as a consideration in each component.

32.   Given pervasive concerns about the complexity, readability and understandability of ED-ISQM 1, and recognizing respondents' suggestions to relocate the firm's risk assessment process as the first component in the standard, the IAASB agreed to restructure the standard from ED-ISQM 1 as follows:

(a)   The firm's risk assessment process component was moved before the governance and leadership component.

(b)   The requirements dealing with assigning responsibilities for various aspects of the SOQM, and for the SOQM overall, were relocated to paragraphs 20–22 of ISQM 1, under the section "System of Quality Management." The IAASB is of the view that the prominent location of the leadership responsibilities is necessary to emphasize the importance of these responsibilities, and that they are a prerequisite in setting up a SOQM.

(c)   Given the importance of governance and leadership to a system, and the need to bring prominence to this component, essential application material was added in paragraph 19 of ISQM 1 under the section "System of Quality Management" to highlight the governance and leadership component.

33.   In addition, various other aspects of the standard were restructured as follows:

(a)   A new section was introduced in the standard, "specified responses," comprising all responses required by the standard (paragraph 34 of ISQM 1).As discussed in Section E, following the IAASB's efforts to refine the quality objectives and responses across the components, there were only a few specified responses remaining in ISQM 1. Accordingly, all six responses were relocated to the "specified responses" section.

(b)   The requirements dealing with leadership's evaluation of the SOQM were moved to a discrete section towards the end of the standard, together with the requirement dealing with the performance evaluations of leadership (paragraphs 53–56 of ISQM 1). The relocation facilitated an emphasis on the fact that the evaluation is undertaken on the SOQM as a whole. Furthermore, the IAASB is of the view that the outcome of the evaluation of the SOQM is an

indicator of the performance of leadership, and therefore the requirements would be better located in close proximity to each other.

Section E – The Approach to Prescribing Quality Objectives, Quality Risks and Responses

Background

34.   ED-ISQM 1 included quality objectives that all firms are required to establish, which were organized by component. The explanatory memorandum to ED-ISQM 1 explained that the quality objectives required by the standard comprised important aspects of extant ISQC 1 that were retained, as well as quality objectives that had been introduced to address key public interest issues or because they were necessary for a SOQM. The IAASB's view was that the quality objectives in ED-ISQM 1 were comprehensive and, if properly established and achieved by a firm, would result in the system providing reasonable assurance that its objectives have been achieved. Furthermore, ED-ISQM 1 emphasized that given the outcome-based nature of the quality objectives, how they are achieved is determined by the firm, thereby improving the scalability of the standard.

35.   ED-ISQM 1 also included responses in the components that all firms would be required to design and implement. However, unlike the quality objectives in the components, the explanatory memorandum to ED-ISQM 1 emphasized that the responses are not comprehensive, noting that certain components did not include any required responses. As a result, the standard aimed to drive the firm to design and implement their own responses to address the quality risks, in addition to the responses required by the standard. Furthermore, the explanatory memorandum to ED-ISQM 1 emphasized that the responses required by the standard would need to be tailored by the firm taking into account the quality risks, and the nature and circumstances of the firm and the engagements it performs.

36.   ED-ISQM 1 did not prescribe any quality risks in the components.

Summary of Comments Received on Exposure

37.   Respondents agreed with the IAASB's view that the quality objectives in ED-ISQM 1 are comprehensive and, if properly established and achieved by a firm, will result in the system providing reasonable assurance that its objectives have been achieved. However, a number of respondents raised concern about the prescriptiveness of the quality objectives. On the contrary, other respondents urged the IAASB to include more prescriptive requirements to support consistent enforcement through inspections undertaken by audit regulators.

38.   With respect to the responses in ED-ISQM 1, respondents indicated that the required responses are too prescriptive, and cautioned that it could perpetuate a checklist mentality, rather than promoting a proactive thinking approach to managing quality. They further noted that it could drive a "comply or explain" approach, creating the need for documentation, and expressed concern that firms may fail to establish their own responses that are needed to address quality risks. There were also observations that having required responses in the standard without having required quality risks is illogical and counterintuitive.

39.   Respondents had varying suggestions to refine the quality objectives and responses in the components, including making the quality objectives more overarching, introducing quality risks or risk factors, or reducing the prescriptiveness of responses. Other suggestions included having required responses that are more preventative and proactive.

IAASB Decisions

40. As highlighted in Section B, there were extensive concerns on scalability, prescriptiveness, complexity, understandability and length. The IAASB observed that many of these concerns were driven by the approach to the quality objectives and responses in the components.

41. The IAASB agreed that actions were needed to address the approach to the quality objectives and responses in the components. In doing so, the IAASB recognized the need to delicately balance improving the scalability and perceived prescriptiveness of the standard, but at the same time retain the robustness of the standard. Therefore, the IAASB reconsidered and revised the quality objectives and responses in the components as follows:

    (a) Various responses that had a clear relationship to an objective were recaptured as an element of the related quality objective;

    (b) Duplication between the quality objectives and responses was removed;

    (c) Some quality objectives were combined;

    (d) Quality objectives were redrafted to be more clearly outcome-based, rather than action-based; and

    (e) In a few instances, more granular aspects of the requirements were relocated to application material.

42. Given that very few responses remained in the standard, the IAASB concluded that it would be more appropriate for the responses required by the standard to be located in a single section of the standard ("specified responses" in paragraph 34 of ISQM 1), than in the individual components. The location of the required responses in a single section of the standard also addressed a number of other issues, in particular:

    (a) Reinforcing the risk-based approach and focusing on achieving the outcomes of the quality objectives (i.e., the revised approach results in the components only having quality objectives).

    (b) Improving the integration of the components since many of the remaining responses relate to multiple components.

    (c) Addressing misconceptions about whether, or the extent to which, firms should design and implement their own responses.

    (d) Addressing suggestions to emphasize the need for firms to scale-up and be proactive in managing quality.

    (e) Improving consistency across the components and removing the perception that some components are more important than others (i.e., given that some components had more required responses than others).

43. The IAASB explored introducing quality risk considerations in the components as a step between the quality objectives and responses. Section F further addresses the IAASB's considerations in this regard.

Section F – The Firm's Risk Assessment Process

Background

44.   Given the new focus on quality management, ED-ISQM 1 embedded a risk-based approach through introducing a new component, the firm's risk assessment process. ED-ISQM 1 explained the process as follows:

(a)   Establish quality objectives:

ED-ISQM 1 explained that the quality objectives established by the firm consist of objectives that, when achieved by the firm, collectively provide the firm with reasonable assurance that the objectives of the SOQM are achieved.

As already covered in this document (see Section E), ED-ISQM 1 included quality objectives in the components. Furthermore, ED-ISQM 1 required the firm to establish additional quality objectives beyond those required by the standard when those objectives are necessary to achieve the objective of the standard. This requirement was added to recognize the fact that the nature and circumstances of firms and the engagements they perform will vary, which may drive the need for additional quality objectives.

(b)   Identify and assess quality risks:

ED-ISQM 1 included a process for identifying and assessing quality risks, and explained that it is not reasonable or practicable for firms to identify and assess every possible risk, and to design and implement responses for every risk. The explanatory memorandum to ED-ISQM 1 described the process as a two-step process of identifying quality risks using a threshold, and assessing the identified quality risks through a detailed consideration of the degree of the likelihood of the quality risks occurring and the significance of the effect of the identified quality risks on the achievement of the quality objectives. The process had many similarities to the principles in the IAASB's Exposure Draft, ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement* (ED-315).

(c)   Design and implement responses:

ED-ISQM 1 explained that the firm is required to design and implement responses to address the quality risks. Furthermore, as explained previously (see Section E), the standard included some required responses in the individual components.

(d)   Identify changes in the nature and circumstances of the firm or its engagements:

ED-ISQM 1 required the firm to identify changes in the nature and circumstances of the firm or its engagements and modify the quality objectives, quality risks or responses, as appropriate, in response to such changes. ED-ISQM 1 also included a requirement for the firm to revise its quality objectives, quality risks or responses as a result of information arising from the firm's monitoring activities.

45.   The explanatory memorandum to ED-ISQM 1 indicated that the firm's risk assessment process would be applied to the other seven components and sought respondents' views on this approach.

Summary of Comments Received on Exposure

46. Overall, respondents indicated that the firm's risk assessment process was complex, and could be challenging to implement, especially relating to the identification and assessment of quality risks. There were also views that it was too prescriptive.

47. Respondents questioned the extent to which firms are expected to identify additional quality objectives, noting that the standard does not provide clear direction on when additional quality objectives should be developed. There were suggestions to be more explicit in the standard that additional quality objectives are not always required, as well as suggestions to change the requirement to "a consideration" of whether additional quality objectives are necessary to achieve the objective of the standard.

48. Respondents supported having a threshold for identifying quality risks, noting that it leads to a more consistent approach to risk identification and assessment and allows firms to focus resources on risks that meet the threshold. However, respondents were in general concerned with the threshold described in the standard for various reasons, including inconsistent interpretation of the level of the threshold and views that it was too low. Other comments related to the identification and assessment of quality risks included:

    (a) Suggestions to take into account findings from regulators in identifying and assessing quality risks, and quality risks arising from the firm's business model.

    (b) A lack of clarity in the starting point for quality risks, i.e., whether firms are expected to consider all potential risks, or only those risks that meet the threshold.

    (c) Views that the two-step process of identifying and assessing quality risks is confusing and overengineered.

    (d) Suggestions to clarify the meaning of "significant effect on the achievement of a quality objective." In particular respondents noted that in the context of the ISAs, significance or magnitude is grounded in the concept of materiality.

49. Respondents suggested that the standard more robustly address how frequently a firm should re-assess its quality objectives, quality risks and responses, and suggested that a periodic re-evaluation should be required.

50. In response to the question about whether the firm's risk assessment process should be applied to the other seven components, respondents in general did not agree that the firm's risk assessment process be applied to the monitoring and remediation process given that the requirements in monitoring and remediation were already so specific.

IAASB Decisions

51. The IAASB identified that ISQM 1 could be improved to focus on the integrated nature of the components and how information from a component feeds into other components as part of the proactive and continual approach to managing quality. As such, the IAASB introduced paragraph A41 of ISQM 1 to explain the information sources that enable the firm to establish quality objectives, identify and assess quality risks and design and implement responses. Some of the information sources form part of the firm's information and communication component, and include the results of the firm's monitoring and remediation process. Other information sources may be internal or external to the firm, and the application material provides examples in this regard.

Establish Quality Objectives

52. The IAASB is of the view that circumstances when firms may need to establish additional quality objectives is not expected to be common, and ED-ISQM 1 was disproportionately focused on addressing these uncommon circumstances. As a result, the IAASB revised the requirement addressing the need to establish additional quality objectives, by focusing on the firm's _consideration_ of whether additional quality objectives are necessary to achieve the objectives of the SOQM. Furthermore, an example was added in paragraph A42 of ISQM 1 to explain when additional quality objectives may be appropriate, and paragraph A43 of ISQM 1 was added to emphasize that the firm may not find it necessary to establish additional quality objectives.

53. The definition of quality objectives was revised to improve the clarity of the definition, in particular to remove the circularity embedded in the definition.

Identify and Assess Quality Risks

54. As a result of respondents' views about the complexity and prescriptiveness of ISQM 1, including relating to the firm's risk assessment process, the IAASB focused on improving the simplicity of the requirements dealing with identifying and assessing quality risks. This included:

    (a) Condensing the two-step process into a single requirement to identify and assess quality risks, to address views that there appeared to be multiple assessments of the likelihood and magnitude of the risks embedded within the two steps. In its discussions, the IAASB acknowledged that a firm may still choose to undertake the quality risk identification and assessment as two discrete steps, however this is not required or expected.

    (b) Refocusing the requirement away from a step-by-step process, to an outcome-based requirement (i.e., the outcome is quality risks that have been identified and assessed to provide a basis for the design and implementation of responses).

    (c) Relocating the threshold for the identification of quality risks to the definition of quality risks. This relocation also assists in clarifying that not all risks are quality risks, because only those risks that meet the threshold embedded in the definition of quality risks need to be taken into account in the SOQM. This point is explicitly stated in paragraph A46 of ISQM 1.

55. The IAASB considered the threshold for identifying quality risks, as set out in the definition of quality risks in paragraph 16(r) of ISQM 1, taking into account the final changes to the concepts and principles in ISA 315 (Revised 2019),[15] as follows:

    (a) The IAASB noted respondents' concerns about the terminology used to describe the threshold, i.e., "reasonable possibility" and "more than remote." In finalizing ISA 315 (Revised 2019), the IAASB retained the term "reasonable possibility" to describe the threshold for a risk of material misstatement in paragraph A15a of ISA 200,[16] although did not retain the term "more than remote." The IAASB concluded that it is most appropriate to take a consistent approach across its standards and continue to use the same term and concept in ISQM 1.

    (b) The IAASB agreed that it is not appropriate to refer to "_significant_ effect on the achievement of a quality objective(s)" in the threshold of quality risks because:

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[15] ISA 315 (Revised 2019)_, Identifying and Assessing the Risks of Material Misstatement_

[16] ISA 200, _Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing_

(i)   In the context of the achievement of the quality objectives, there is a varying degree to which risks may affect the achievement of a quality objective. If a matter has a significant effect on the achievement of a quality objective, it would likely be so significant that it could result in the firm not achieving reasonable assurance overall, and this threshold is too high for purposes of risk identification.

(ii)   The threshold embedded in the definition of quality risks is "reasonable possibility," and therefore adding the concept of significance blurs that threshold.

Accordingly, the definition has been revised to refer to "*adversely* affecting the achievement of one or more quality objectives." Furthermore, application material was added in paragraph A46 of ISQM 1 to emphasize that there is a degree to which risks may affect the achievement of a quality objective. This explanation forms part of emphasizing the firm's professional judgment in determining whether a risk is a quality risk, and explaining the quality risk threshold.

56.   The IAASB observed an overall theme from respondents' comments about the need to provide clarity and guidance for firms in identifying and assessing quality risks, such as providing quality risks or risk factors. The IAASB explored a number of approaches, such as quality risk considerations in each component, however agreed that a principles-based approach that is relevant across the components would be most suitable, given concerns about the overall prescriptiveness, scalability and length of the standard.

57.   In order to provide a starting point for firms in identifying quality risks, the IAASB has included in paragraph 25(a) of ISQM 1 conditions, events, circumstances, actions or inactions that may adversely affect the achievement of the quality objectives, which the firm is required to understand. This approach has similarities to Appendix 2 of ISA 315 (Revised 2019), which provides examples of conditions or events that may indicate the existence of a risk of material misstatement. The conditions, events, circumstances, actions or inactions that the firm is required to understand have been focused on the nature and circumstances of the firm and the engagements it performs, which underscores the scalability of the standard and the need to tailor quality risks to the firm. The inclusion of these conditions, events, circumstances, actions or inactions also addresses other comments from respondents, in particular:

(a)   Improving the robustness and inspectability of the firms' risk assessment process because the factors to be considered by the firm are clearer.

(b)   Suggestions to more directly address the firm's business model as part of risk identification, as well as the external environment.

Examples of conditions, events, circumstances, actions or inactions, and how they may give rise to quality risks, have been included in paragraph A46 of ISQM 1, to further assist firms and demonstrate how the quality risks may be identified and assessed.

58.   The IAASB has clarified in paragraph 25(b) of ISQM 1 that not all conditions, events, circumstances, actions or inactions would give rise to quality risks, because there is a varying degree to which they may affect the quality objectives. This requirement also intends to guide firms through the risk identification and assessment process by encouraging firms to think about how the conditions, events, circumstances, actions or inactions affect the achievement of the quality objectives, and the degree of their effect.

59.   The IAASB is of the view that the conditions, events, circumstances, actions or inactions indicated in the standard are not exhaustive, and therefore paragraph A45 of ISQM 1 highlights that there may

be other conditions, events, circumstances, actions or inactions that may need to be understood by the firm.

Design and Implement Responses

60.   As outlined in Section E, the IAASB observed that reducing the required responses and relocating them to a discrete section in the standard will assist in clarifying that in all cases firms are expected to design and implement responses in addition to those required by the standard. The IAASB also restructured paragraph 26 of ISQM 1 to further clarify that the firm needs to design and implement responses in addition to those set out in the standard.

Information that Indicates Additional Quality Objectives, or Additional or Modified Quality Risks or Responses Are Needed, Due to Changes in the Nature and Circumstances of the Firm or Its Engagements

61.   Given respondents' suggestions that the standard address how frequently a firm should re-assess its quality objectives, quality risks and responses, the IAASB reconsidered whether a more robust approach was needed to identify information that may indicate the need to modify the quality objectives, quality risks or responses. The IAASB noted it would not be appropriate to prescribe how frequently a firm should re-evaluate its quality objectives, quality risks and responses because they should be modified when changes affecting the system occur, or when deficiencies are identified. However, the IAASB has revised the requirement in paragraph 27 of ISQM 1 to drive the firm to have policies or procedures in place to proactively identify information that may indicate changes affecting the SOQM.

62.   In revising paragraph 27 of ISQM 1, the IAASB noted a need to also clarify what is intended by modifying the quality objectives, given the robustness of the quality objectives in the standard. The IAASB is of the view that the quality objectives prescribed in the standard may not be modified by the firm, although firms may choose to have sub-objectives to break up the quality objectives into more discrete parts to facilitate identifying and assessing quality risks. Therefore, only the additional quality objectives established by the firm (if any) may be modified by the firm or the firm may identify that the additional quality objectives are no longer needed.

Applying the Firm's Risk Assessment Process to the Other Components

63.   The IAASB's considerations about whether the monitoring and remediation process should also be subject to the firm's risk assessment process are discussed in Section I.

Section G – Resources, Including Service Providers

Background

64.   One of the public interest issues front of mind for the IAASB was to keep ISQM 1 fit for purpose. Given the need to modernize the standard, and recognizing firms' increasing use of technology in performing engagements and in the SOQM, ED-ISQM 1 introduced new requirements addressing technological resources. The explanatory memorandum to ED-ISQM 1 explained that the approach was principles-based because the types of technologies, and the extent to which they are being used, are continually evolving. In addition, ED-ISQM 1 included requirements for intellectual resources, which were similar to the requirements for technological resources. A number of other enhancements were also made to human resources in ED-ISQM 1.

65.   ED-ISQM 1 also recognized the growing use of service providers for activities related to the SOQM, including using resources from service providers to assist with performing engagements. ED-ISQM 1 therefore proposed new requirements to deal with the use of service providers, with a particular focus on the firm determining that it is appropriate to use resources from the service providers in the SOQM.

Summary of Comments Received on Exposure

66.   Respondents supported how ED-ISQM 1 addressed technology, however sought clarity on the scope of technology that needs to be taken into consideration as part of the firm's SOQM.

67.   Respondents also supported addressing service providers, however indicated a need to be clear about the scope of service providers contemplated by the standard. Respondents also raised concern about the requirements being too onerous, particularly given possible challenges in obtaining information from the service providers.

68.   There were suggestions to also more explicitly address how service delivery centers are managed by the firm and the responsibilities of engagement partners and teams when using work performed by service delivery centers.

IAASB Decisions

69.   The IAASB observed respondents' comments about the overarching nature of resources and the need to integrate resources into the components (these comments formed part of views about the structure and components of the standard). The IAASB agreed that resources are relevant to any component of the SOQM. As a result, in the firm's risk assessment process, one of the conditions, events, circumstances, actions or inactions the firm is required to understand in identifying and assessing quality risks is the resources of the firm, including those provided by service providers. The intention is that this would trigger the firm to understand what resources are needed across the components, and how resources could affect the achievement of the quality objectives.

70.   The IAASB clarified the scope of technological resources by adding paragraph A99 of ISQM 1. This paragraph also demonstrates how the technological resources may vary depending on the nature and circumstances of the firm, further addressing how ISQM 1 is scalable to the nature and circumstances of the firm.

71.   Paragraph A77 of ISQM 1 was added to bring emphasis to service delivery centers and how the firm's policies or procedures may address service delivery centers, in particular with respect to direction, supervision and review.

Service Providers

72.   The IAASB agreed with respondents' views that the scope of service providers was not clear in ED-ISQM 1, and that it may not be possible to obtain from service providers the extent of information suggested in ED-ISQM 1. The IAASB is of the view that the nature, timing and extent of the firm's responses to address service providers would depend on the risks associated with using the service provider, which may be affected by a number of factors such as:

(a)   The nature of resources from the service provider and how and the extent to which the resource will be used by the firm;

(b)   The characteristics of the service provider, for example, whether the service provider is commonly known, or for IT resources, whether the resource is an industry standard package, or has been customized for the firm; or

(c)   The firm's experience with the service provider.

73.   In order to clarify the scope of service providers, and incorporate a risk-based and practical approach that improves how firms address service providers, the IAASB:

(a)   Introduced a new definition of service providers in paragraph 16(v) of ISQM 1. In doing so, paragraph A28 of ISQM 1 was added to clarify that service providers include component auditors from other firms not within the firm's network (see the further discussion in paragraphs 79–81 regarding component auditors).

(b)   Relocated service providers to the resources component in paragraph 32 of ISQM 1. This relocation also highlights that the other quality objectives in the resources component are also relevant to resources from service providers.

(c)   Simplified the requirements dealing with service providers into a principles-based quality objective in paragraph 32(h) of ISQM 1. The quality objective is supported by application material in paragraph A107 of ISQM 1 that describes the factors or matters the firm may consider in using resources from a service provider.

74.   The IAASB noted that the combination of the quality objective for service providers with the other quality objectives for resources appropriately and robustly addresses service providers without the need for prescriptive requirements.

Human Resources

75.   Although respondents did not comment extensively on human resources in ED-ISQM 1, the IAASB identified the need to further address and clarify certain aspects of human resources in ISQM 1, in conjunction with various revisions made to ISA 220 (Revised).

Use of terms to describe human resources in ISQM 1

76.   Throughout ISQM 1, the applicability of the requirements that are relevant to human resources may variously apply to human resources internal and external to the firm who are involved in the SOQM and performance of engagements. The IAASB therefore identified a need to be clear and consistent in using terminology to describe human resources, with the following terms being used throughout the standard:

(a)   Personnel. The definition in paragraph 16(n) of ISQM 1 has the same meaning as ISQC 1, however it was clarified to emphasize that it relates to people *in the firm*. It is noted that this definition continues to refer to "staff," which is separately defined and remains the same as ISQC 1.

(b)   Individuals. The term individuals is intended to be interpreted in the context in which it is being used in ISQM 1. It may refer to a specific individual, a particular group of individuals, or to all human resources involved in the firm's SOQM or performance of engagements (i.e., the firm's personnel *and* people external to the firm that are used in the firm's SOQM or performance of engagements, such as individuals from a service provider or within the firm's network). For example:

(i)   In paragraph 32(c) of ISQM 1, "individuals" refers to a particular group of individuals (individuals from external sources).

(ii)   In paragraph 32(e) of ISQM 1, "individuals" refers to all human resources involved in the firm's SOQM.

77.   The IAASB recognizes that the policies or procedures designed and implemented by the firm that apply to personnel are likely different from those that apply to individuals external to the firm that are used in the firm's SOQM or performance of engagements. Paragraph A27 of ISQM 1 was added to draw attention to ISA 220 (Revised),[17] which further explains how this may be the case in the context of an audit of financial statements.

78.   The IAASB also clarified in paragraph A34 of ISQM 1 that an individual assigned responsibilities related to the SOQM may not be a partner of the firm as a result of the legal structure of the firm. However, the IAASB has emphasized that the individual is required by paragraph 21(a) of ISQM 1 to have the appropriate influence and authority within the firm to perform their assigned role.

The firm and the engagement partner's responsibilities for human resources, including component auditors

79.   The IAASB determined that more clarity was needed regarding the firm's responsibility for establishing a SOQM that:

(a)   Ensures that the engagement team has access to the appropriate resources to perform the engagement; and

(b)   Supports engagement partners in dealing with the competence and capabilities of individuals assigned to the engagement, including component auditors and other individuals assigned by the network, another network firm or service provider.

80.   In particular, the IAASB considered the firm's responsibilities with respect to component auditors, noting that:

(a)   Component auditors may be engaged in a number of ways. In circumstances when no component auditor has been appointed by the client or component management, the firm would need to identify and engage a component auditor. For example, the firm's policies or procedures that address identifying and engaging component auditors could specify that the engagement partner engage the component auditor on behalf of the firm.

(b)   Irrespective of how the component auditor has been engaged (i.e., whether by the client, component management, the firm or the engagement partner on behalf of the firm), there is a need to determine that the resources from the component auditor are appropriate for use. The requirements in ISQM 1 dealing with network requirements and network services, and the quality objective for service providers, address this principle.

(c)   The firm or the engagement partner is not always able to control, or be responsible for, the assignment of all individuals to the engagement, because there may be a number of firms involved in an engagement. However, through the quality objective in paragraph 32(d) of ISQM 1, the firm's SOQM is expected to support the engagement partner in dealing with the competence and capabilities of the engagement team members. For example, the firm may have policies or procedures to deal with circumstances when the engagement team is not

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[17]   ISA 220 (Revised), paragraphs A23–A25

satisfied with the competence and capabilities of the individuals assigned to the engagement, including component auditors, such as assigning more resources to the engagement, or increased direction, supervision and review.

81.   Accordingly, the following changes were made in ISQM 1:

(a)   The standard was updated to clarify that component auditors are within the scope of the requirements in ISQM 1 dealing with network requirements and network services, and the quality objective for service providers. Specifically, paragraph A175 of ISQM 1 was amended to explicitly indicate that component auditors from other firms within the firm's network are included in network services, and paragraph A28 of ISQM 1 was added to indicate that component auditors from firms not within the firm's network are included in service providers.

(b)   The quality objective in paragraph 32(c) of ISQM 1 was added to be clear that the firm's SOQM needs to address obtaining human resources externally (i.e., from within the network or from a service provider) when the firm does not have the personnel in the firm that are needed to enable the operation of SOQM or performance of engagements. This would include engaging a component auditor when one has not been engaged by the client or component management.

(c)   Paragraphs A95–A97 of ISQM 1 were added to explain how engagement team members may be assigned, and how the firm's SOQM may address the competence and capabilities of engagement team members (including when there are concerns about the competence and capabilities of engagement team members).

Section H – Information and Communication

Background

82.   Firms' transparency and reinforcing the need for robust communication and interactions during the engagement were both identified as key public interest issues. ED-ISQM 1 introduced a new component addressing information and communication, which included requirements dealing with the exchange of information within the firm and communication with external parties. While ED-ISQM 1 did not contain a requirement for firms to publish a transparency report, the proposals required firms to establish policies or procedures addressing communication to external parties, in a transparency report or otherwise, when the firm determines it appropriate to do so. The intention of the IAASB was to promote the exchange of valuable and insightful information about the firm's SOQM with stakeholders without stifling innovation or other developments at a jurisdictional level.

Summary of Comments Received on Exposure

83.   Respondents broadly agreed that the proposed requirements in ED-ISQM 1 would promote the exchange of valuable and insightful information about the firm's SOQM with the firm's stakeholders, and encourage communication externally as appropriate. However, there were mixed views on how ED-ISQM 1 dealt with transparency reports. While certain respondents were concerned with explicitly stating "transparency report" in a requirement, mostly because it could imply that a transparency report is required in all circumstances, others were of the view that the requirement was not strong enough.

IAASB Decisions

84.　Communication externally about the firm's SOQM may be with various stakeholders, and may take a variety of forms. For example, the firm or engagement team may communicate with management or those charged with governance about the firm's SOQM, the firm may produce a transparency report for a broader audience, or there may be information on the firm's website about the SOQM that is accessible to the public.

85.　Although ED-ISQM 1 aimed to take a principles-based approach and encourage communication externally, the IAASB observed that respondents' comments called for clarity about what is expected of firms in communicating externally, including relating to transparency reports. The IAASB also acknowledged the PIOB's recommendation that transparency reports should be required, with ISQM 1 specifying the minimum content of the reports. The IAASB therefore considered the following:

(a)　Whether transparency reports should be explicitly required in ISQM 1;

(b)　Whether there are other stakeholders that the firm would ordinarily be expected to communicate with about the SOQM that should be more explicitly addressed in ISQM 1; and

(c)　What else could be done in ISQM 1 to clarify the expectations for external communications.

Transparency Reports

86.　The IAASB considered global developments regarding transparency reports, in particular focusing on how they have evolved since the IAASB previously undertook information gathering in this regard. The IAASB noted varying interpretations of, and views about, what a transparency report is and the information it should provide, as well as varied evidence of the extent to which transparency reports are being used by intended users in jurisdictions where they are commonly prepared.

87.　The IAASB agreed that given these variances globally, transparency reports are best dealt with by regulators at a jurisdictional level. Furthermore, an explicit requirement would inappropriately focus on transparency reports as the only form or manner of effective communication, when other forms of communication may be better in the firm's circumstances.

Other Stakeholders that the Firm Would Ordinarily Be Expected to Communicate with About the SOQM

88.　Enhanced transparency and communication with those charged with governance has been an important focus of the IAASB in recent years, including as part of the IAASB's project on auditor reporting. ISA 260 (Revised)[18] deals with the auditor's responsibility to communicate with those charged with governance in an audit of financial statements, and explains that effective two-way communication with those charged with governance is important in assisting the auditor and those charged with governance in understanding matters related to the audit in context, and in developing a constructive working relationship.[19]

89.　The IAASB is of the view that transparency with those charged with governance about the firm's SOQM is important because it enables those charged with governance to understand the SOQM and how it supports the consistent performance of quality audit engagements. Such information is particularly relevant to those charged with governance, given their role in providing oversight to the financial reporting process.

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[18]　ISA 260 (Revised), *Communication with Those Charged with Governance*

[19]　Paragraph 4(a) of ISA 260 (Revised)

90.   The IAASB concluded that in the case of audits of financial statements of listed entities, the firm has a responsibility to provide information to those charged with governance about the SOQM. Accordingly, paragraph 34(e)(i) of ISQM 1 requires the firm to establish policies or procedures that require communication with those charged with governance about how the SOQM supports the consistent performance of quality audit engagements. The standard only requires communication with those charged with governance of listed entities for whom the firm performs an audit of financial statements, however the firm may determine that it is also appropriate to communicate with those charged with governance of other entities for whom the firm performs engagements (see paragraph A128 of ISQM 1). The specific information to be provided, and the nature, timing and extent of the communication is determined by the firm, although the application material provides guidance for firms in this regard.

Other Actions to Clarify the Expectations for External Communications

91.   In addition to reorganizing the requirements for information and communication, the IAASB made several changes to clarify the requirements and application material addressing external communication and to further promote effective and appropriate communication externally. In particular:

(a)   The quality objective in paragraph 33(d)(ii) of ISQM 1 was revised to be outcome-based, i.e., that the firm communicates information externally when required by law, regulation or professional standards, or as needed to support external parties' understanding of the SOQM.

(b)   The specified response in paragraph 34(e)(ii) of ISQM 1 focuses the firm on establishing policies or procedures for _when_ it is appropriate to communicate externally (i.e., in addition to any required communication with those charged with governance). The firm may conclude in developing its policies or procedures that there are no external parties with whom the firm needs to communicate, other than those charged with governance of audits of listed entities or those required by law or regulation.

(c)   The application material has been reorganized, improved and clarified to assist firms in determining when it is appropriate to communicate with external parties (paragraph A130 of ISQM 1), and if so, the information to be provided and the nature, timing and extent, and appropriate form of such communication.

Section I – Monitoring and Remediation

Background

92.   The public interest issues and areas of focus for the IAASB in developing ED-ISQM 1 included focusing more on internal and external monitoring activities and modernizing the standard with respect to monitoring and remediation, to promote more proactive and effective monitoring activities that are tailored to the firm, and improve remediation of deficiencies. As a result, a number of proposals were made in ED-ISQM 1, including:

(a)   A new focus on monitoring all aspects of the system, designing the monitoring activities based on a number of different factors, and using information from a variety of sources as part of the firm's monitoring activities, including external inspections.

(b)   A new framework setting out the process for evaluating findings and identifying deficiencies, which included a new definition of deficiencies. ED-ISQM 1 also featured a new requirement to investigate the root causes of deficiencies, to focus the firm on effective and appropriate

remedial action, and enhancements to leadership's responsibilities to determine the effectiveness of remedial actions.

93. The explanatory memorandum to ED-ISQM 1 explained the IAASB's considerations regarding retaining the requirement for the firm to inspect at least one completed engagement for each engagement partner on a cyclical basis and highlighted the improvements made to the standard to address the scalability of this requirement and place emphasis on other types of monitoring activities that may be used. These improvements included a reference to inspections of in-progress engagements, and emphasizing factors the firm may use in determining the nature, timing and extent of the inspection of engagements and the length of the cycle for the selection of engagement partners.

94. Other key revisions related to monitoring and remediation in ED-ISQM 1 included:

    (a)   The need for the firm to monitor the monitoring and remediation process, to determine that it has been designed appropriately and is operating effectively.

    (b)   Application material to highlight the importance of understanding the root cause of positive findings.

Summary of Comments Received on Exposure

95. Respondents agreed that the proposals in ED-ISQM 1 could improve the robustness of firms' monitoring and remediation and encourage more proactive and effective monitoring. However, there were mixed views on the flexibility of this component, with respondents noting the length and prescriptiveness of this component.

96. Respondents in general supported the approach in ED-ISQM 1 dealing with engagement inspections, including the enhancements made from extant ISQC 1 to improve the flexibility of the requirement and focus on other types of reviews. However, there were multiple suggestions to improve this requirement to be more risk-based.

97. In general, respondents' comments highlighted that the framework for evaluating findings and identifying deficiencies was not clear, including due to a lack of distinction between a "deficiency" and a "finding." Respondents also expressed mixed views about the definition of deficiencies, with some commentators noting a lack of a materiality concept embedded in the definition. Further comments on evaluating findings and identifying deficiencies included:

    (a)   Emphasizing the iterative nature of identifying and evaluating deficiencies and undertaking a root cause analysis.

    (b)   Suggestions to address the varying severity of deficiencies, such as introducing a concept of "significant deficiencies."

    (c)   Explaining how the severity of deficiencies affects the annual evaluation of the SOQM.

98. Respondents strongly supported the new requirements addressing the investigation of the root causes of the identified deficiencies. Although respondents in general agreed with how positive findings were addressed in the standard, there were suggestions that more could be done to emphasize positive findings and good practice.

IAASB Decisions

99.   As a result of respondents' comments about the prescriptiveness and flexibility of this component, the IAASB considered whether the requirements could be redesigned to be more flexible and scalable. The IAASB concluded that this component is a process, thereby creating the need for more specific requirements than other components, and that scalability has been embedded in the requirements.

100.   As highlighted in Section F, respondents in general did not agree that the firm's risk assessment process should be applied to the monitoring and remediation process. In further considering this point, the IAASB concluded that since the requirements in the monitoring and remediation process are more prescriptive than other components, requiring firms to apply the firm's risk assessment process to the monitoring and remediation process would likely drive firms to merely identify quality risks that match the requirements in the monitoring and remediation component, rather than properly applying the firm's risk assessment process to identify quality risks. The IAASB also thought that the approach would result in the standard being over-engineered and complex. The IAASB agreed that it would be more appropriate to focus on the sufficiency and appropriateness of the monitoring activities in providing a basis for the identification of deficiencies (see paragraph 36 of ISQM 1). Furthermore, the IAASB observed that the concept of risk is embedded in the monitoring and remediation process, for example:

(a)   The factors the firm considers in determining the nature, timing and extent of the monitoring activities have an element of risk integrated into them.

(b)   Considering the severity and pervasiveness of identified deficiencies promotes a risk-based mindset in responding to the deficiencies, since the nature, timing and extent of the firm's remediation of the deficiencies is affected by the severity and pervasiveness of the deficiency.

101.   The IAASB is of the view that monitoring and remediation are critical to a proactive and continual SOQM, and observed respondents' views that the standard could further emphasize this. The IAASB added paragraph A138 of ISQM 1, which aims to emphasize this point, and ensure that firms are not discouraged from identifying and remediating deficiencies because identifying deficiencies should be viewed as constructive to the overall SOQM and an opportunity to continually improve the SOQM.

102.   The IAASB observed that undertaking monitoring activities over the monitoring and remediation process is also important to a proactive and preventative system that promotes continual improvement because the firm needs to have information about whether the monitoring and remediation process itself is effective (i.e., that it is appropriately designed, implemented and operating to achieve its intended purpose outlined in paragraph 35 of ISQM 1). However, the IAASB identified that the need to monitor the monitoring and remediation process was obscured in the standard. Accordingly, the following amendments were made:

(a)   The design of the monitoring and remediation process was added as a factor for the firm to consider in determining the nature, timing and extent of the monitoring activities (see paragraph 37(c) of ISQM 1); and

(b)   Paragraph A144 was included to further emphasize the need to monitor the monitoring and remediation process, with examples to explain how this may be operationalized and scaled for a less complex firm.

Inspection of Completed Engagements

103. The IAASB agreed with respondents' views that more could be done in ISQM 1 to focus on different types of monitoring activities other than inspections of completed engagements, since only performing inspections of completed engagements would likely not provide sufficient and appropriate information to the firm about the SOQM. Furthermore, the standard should not inhibit firms from undertaking monitoring activities that are proactive, preventative, effective and timely.

104. The IAASB also concurred with respondents' recommendations to improve the focus on selecting engagements and engagement partners for inspection of completed engagements based on risk. The IAASB is of the view that in selecting completed engagements for inspection, the firm would ordinarily take into account a combination of:

(a) *Engagements* that need to be selected based on the risks associated with such engagements. For example, the firm may determine that audits of financial statements of listed entities or engagements performed in certain industries need to be subject to inspection on a cyclical basis.

(b) *Engagement partners* that need to be subject to inspection, based on factors such as how long it has been since the engagement partner was subject to inspection, the results of previous inspections of the engagement partner, or the experience of the engagement partner.

105. Accordingly, a number of revisions were made from ED-ISQM 1 as follows:

(a) Paragraph 38 of ISQM 1 was revised to emphasize that it is a combination of engagements and engagement partners that are selected by the firm for inspection of completed engagements.

(b) Paragraph 38 of ISQM 1 was also revised to take into account the nature, timing and extent of other monitoring activities undertaken by the firm in selecting engagements and engagement partners for inspection of completed engagements. This revision, together with application material in paragraph A152 of ISQM 1, emphasizes that monitoring encompasses a combination of monitoring activities, and the information from other monitoring activities, and the nature, timing and extent of those activities, may affect how the firm selects engagements and engagement partners.

(c) Paragraph A151 of ISQM 1 clarifies how the considerations in paragraph 37 of ISQM 1 may be considered by the firm in selecting completed engagements for inspection. Many of the examples have an underlying risk embedded in them.

(d) Paragraph A153 of ISQM 1 was added to explain how the firm may apply a cyclical basis for the inspection of completed engagements for each engagement partner. The example demonstrates a scalable and proactive approach because it describes circumstances when an engagement partner may need to be selected more frequently due to risk, or less frequently because the firm has enough information about the engagement partner from other monitoring activities.

106. The IAASB also removed from the requirement the reference to the inspection of in-process engagements. While the inspection of in-process engagements is beneficial and may affect the extent to which completed engagements are selected for inspection, it was intended to be optional for firms and therefore should not be placed in a requirement.

Evaluating Findings and Identifying Deficiencies, Including Investigating the Root Cause of Deficiencies

Findings

107. The IAASB supported the suggestions from respondents to add a definition of findings, as doing so would assist in highlighting the distinction between a finding and a deficiency, and explain that the firm identifies deficiencies through evaluating findings. In developing the definition of findings in paragraph 16(h) of ISQM 1, the IAASB:

(a) Concluded that the definition forms an important part of the overall framework to evaluate findings and identify deficiencies and therefore needs to be useful in synthesizing the information from the performance of monitoring activities, external inspections and other relevant sources, so that the firm can determine whether deficiencies exist. As a result, the definition includes an important qualifier, i.e., that findings are information from the various sources *which indicates that one or more deficiencies may exist*.

(b) Noted that in synthesizing information from the performance of monitoring activities, external inspections and other relevant sources, the firm may identify information that may otherwise be useful, such as information indicating positive outcomes. Such information may be used by the firm in multiple ways in the context of the SOQM, such as in the manner explained in paragraph A158 of ISQM 1. The IAASB included paragraph A15 of ISQM 1 to address this point, given that it is integral to the process of evaluating findings and identifying deficiencies.

(c) Observed comments from respondents that suggested confusion between engagement-level findings and findings about the SOQM. Accordingly, paragraph A17 of ISQM 1 was included to clarify that engagement-level findings may be indicative of findings in relation to the SOQM.

108. Although respondents in general supported how the standard addresses positive findings, further enhancements were made. A term other than "positive findings" was used to avoid confusion with "findings." In addition, the IAASB added application material to encourage firms to contrast circumstances that have given rise to deficiencies with other similar circumstances, to encourage a culture of improvement and learning (paragraphs A158 and A167 of ISQM 1).

Deficiencies

109. The IAASB considered, but did not support, simplifying the definition of deficiencies by explaining it at a less granular level. In particular, the IAASB observed that a broader definition of deficiencies would be unhelpful in determining whether deficiencies exist. Accordingly, the IAASB retained the specific references to each of the elements of the SOQM in the definition of deficiencies, i.e., quality objectives, quality risks and responses. The IAASB also identified that given a number of changes to the standard, there was a need to include the aspects of the SOQM that are not quality objectives, quality risks or responses in the definition of deficiencies. Paragraph A12 of ISQM 1 explains what constitutes the other aspects of the SOQM, and provides examples of how deficiencies may arise related to those aspects.

110. To further clarify when deficiencies may arise, the IAASB considered each of the elements described in the definition of deficiencies and whether the definition of deficiencies needs to include a threshold for the element, so that deficiencies are identified at the appropriate level. The IAASB's considerations were as follows:

Element	The threshold of when a deficiency may exist
Quality objective	The threshold in this context is what quality objectives are needed to achieve the objective of the SOQM. ISQM 1 includes the quality objectives that firms are required to establish. Not establishing one of those quality objectives, or partially establishing one of those quality objectives, would be non-compliance with the standard, leading to a deficiency (unless the specific quality objective is not relevant to the firm in accordance with paragraph 17 of ISQM 1). Furthermore, any additional quality objectives the firm needs to establish are those considered necessary by the firm to achieve the objective of the SOQM. As a result, a failure to establish the additional quality objectives would also lead to a deficiency.
Quality risk	Given the threshold embedded in the definition of a quality risk, there is already a threshold established for deficiencies related to quality risks. As a result, if a quality risk has not been identified or properly assessed, it would lead to a deficiency.
Response	Firms may design and implement a number of responses to address a quality risk(s), and in some cases firms may have responses that are additional to what is needed to address the quality risks (i.e., the firm may go beyond the requirements of the standard). As a result, the IAASB concluded that a threshold is needed for identifying deficiencies related to responses, since not all responses that are absent or inappropriately designed or implemented are deficiencies. Given that responses are designed to address quality risks, the IAASB concluded that the threshold of when a response is a deficiency is when the response is not designed, implemented or operating in a manner that reduces the quality risk to an acceptably low level. The IAASB considered linking the threshold to the non-achievement of a quality objective (e.g., a response, or combination of responses, is not properly designed, implemented or operating effectively such that a quality objective is not achieved). The IAASB agreed that linking the threshold to the quality objective would bypass the importance of focusing responses on appropriately addressing quality risks. Instead, there is a link to the effect of responses on the achievement of quality objectives through the definition of quality risks.
Other aspects	The other aspects of the SOQM include the firm's risk assessment process, monitoring and remediation process and other specific requirements of the standard. The IAASB noted that if a requirement set out in the standard for these matters is not met, it would be non-compliance with the standard, leading to a deficiency.

Evaluating findings, identifying deficiencies and evaluating identified deficiencies

111. The IAASB made further changes to improve the clarity of the framework for evaluating findings and identifying deficiencies. These included:

(a) Emphasizing that determining whether findings are deficiencies is a matter of professional judgment in the circumstances and depends on many quantitative and qualitative factors (paragraph A159 of ISQM 1).

(b) Restructuring paragraph 41 of ISQM 1 dealing with the evaluation of identified deficiencies to clarify that investigating the root cause of deficiencies and considering the effect of deficiencies on the SOQM contributes to the evaluation of the severity and pervasiveness of deficiencies.

(c) Emphasizing in paragraph A161 of ISQM 1 that evaluating findings and identifying deficiencies, evaluating the severity and pervasiveness of deficiencies and investigating the root causes of deficiencies are part of an iterative and non-linear process.

112. The IAASB considered, but did not support respondents' suggestions to introduce a concept such as "significant deficiencies." The IAASB was of the view that firms should focus on the relative severity and pervasiveness of deficiencies, and how this information drives further actions, including investigating the root causes of deficiencies, responding to deficiencies and considering the impact of deficiencies on the evaluation of the SOQM.

Other Matters Related to Monitoring and Remediation

113. The IAASB identified that the standard did not appropriately address circumstances when the individual(s) assigned operational responsibility for the monitoring and remediation process evaluates the effectiveness of the remedial actions and concludes that they are not appropriately designed and implemented or are not effective. Accordingly, paragraph 44 of ISQM 1 was added to better address this circumstance, and require the individual(s) assigned operational responsibility for the monitoring and remediation process to take appropriate action.

114. Given the restructuring of the provisions addressing service providers, paragraph A172 of ISQM 1 deals with deficiencies related to a resource provided by a service provider. In particular, it clarifies the firm's responsibility related to remedial actions with respect to resources used from a service provider.

115. A number of changes were made to the standard dealing with external communications. The IAASB resolved to remove the requirement in the monitoring and remediation process dealing with external communications, to remove duplication across the requirements.

Section J – Network Requirements or Network Services

Background

116. The explanatory memorandum to ED-ISQM 1 highlighted a number of benefits when networks share common elements, in particular that they can be instrumental in enhancing engagement quality across the firms that belong to the network. It also described concerns that firms place undue reliance on network requirements or network services, and therefore proposed new requirements addressing firms' responsibilities relating to network requirements or network services. The proposals focused on reinforcing that the firm is responsible for its own SOQM.

117. ED-ISQM 1 did not propose requirements that would be imposed on the network. The explanatory memorandum to ED-ISQM 1 explained that such an approach could have the unintended effect of diluting the firm's responsibility for the SOQM. However, it was highlighted that the requirements on firms related to network requirements or network services would likely have an effect on the network, such as improving communication and transparency between the network and network firms.

Summary of Comments Received on Exposure

118. Respondents supported the proposals addressing networks and considered that it would address the issue of firms placing undue reliance on network requirements or network services. Respondents particularly placed emphasis on the importance of the fact that the firm retains responsibility for the SOQM.

119. Respondents provided various further suggestions to enhance and clarify the proposals, including clarity or guidance on how the proposals should be implemented, particularly with respect to the work effort that is necessary to support the evaluation of the network requirements and network services. There were also views that the standard could better emphasize how sharing common elements across a network can be instrumental in enhancing engagement quality.

120. However, there were respondents who thought that further actions at the network-level were needed. There were also views that the firm should be more explicitly required to determine whether the network requirements and network services are appropriate for use.

IAASB Decisions

121. The IAASB noted the PIOB's recommendations to address the network-level in the standard, and focus on consistent quality across the network. The IAASB understood from additional outreach with respondents who thought that further actions at the network-level were needed that these stakeholders' views were also propelled by concerns about consistent quality across firms within a network.

122. The IAASB observed that the purpose of addressing networks in ISQM 1 was to address the issue of undue reliance on networks, which respondents acknowledged had been appropriately addressed. The IAASB remains of the view that it would not be appropriate to establish requirements for networks in ISQM 1. However, the IAASB agrees that networks play an important role in promoting consistent quality throughout the network, through the network requirements and network services. Furthermore, the network's monitoring activities are critical to enforcing the network requirements and ensuring they have been appropriately implemented across the network firms.

123. The IAASB is of the view that the fundamental principle that firms need to tailor the SOQM to the circumstances of the firm needs to be upheld in ISQM 1, including in the context of network requirements and network services. As a result, although _consistent_ quality across a network is beneficial, placing too much focus on it in ISQM 1 could conflict with the need to tailor the firm's SOQM, and adapt and supplement network requirements or network services. The IAASB instead focused on what more could be done to address whether network requirements have been _appropriately_ implemented across the network. As such, a new requirement was added in paragraph 51(a) of ISQM 1 for the firm to understand the network's monitoring activities to determine that network requirements have been appropriately implemented across the network firms.

124. The IAASB considered, but rejected the suggestions that the firm should more directly determine that network requirements and network services are appropriate for use. In particular, the IAASB thought that requiring a firm to determine whether network requirements are appropriate could inadvertently imply that firms may choose to implement a network requirement differently, or not implement a network requirement, which would be contrary to the need to promote consistency across the network.

125. Given suggestions to clarify the proposals, particularly with respect to evaluating the network requirements and network services, the IAASB simplified and clarified the requirements in this section

of the standard, in particular paragraph 49 of ISQM 1. Furthermore, application material was added in paragraph A179 of ISQM 1 with examples of how the network requirements or network services may need to be adapted or supplemented.

126. The IAASB also clarified the application material in paragraph A182 of ISQM 1 addressing information from the network about the results of the network's monitoring activities, to explain the extent or granularity of the information that the firm is expected to obtain from the network.

Section K – Evaluation of the SOQM

Background

127. ED-ISQM 1 introduced new requirements for the individual(s) assigned ultimate responsibility and accountability for the SOQM to evaluate whether the SOQM provides the firm with reasonable assurance that the objectives of the SOQM have been achieved, and taking further appropriate action depending on the outcome of the evaluation. The IAASB was of the view that the new requirements were important to reinforcing the responsibility and accountability of leadership for the SOQM.

128. ED-ISQM 1 required that the evaluation is undertaken at least annually, or more frequently when the identified deficiencies are of a severity and pervasiveness that indicate that the SOQM may not be providing reasonable assurance that the objectives of the SOQM have been achieved.

Summary of Comments Received on Exposure

129. While some respondents commented that the evaluation would reinforce the responsibility and accountability of leadership for the SOQM, respondents focused on the challenges with performing the evaluation, given that the question in ED-ISQM 1 asked about these challenges. Respondents indicated challenges with the frequency of the evaluation and how leadership would collate and consider the information needed to perform the evaluation. Respondents also questioned the effectiveness of the evaluation given that it is a self-assessment.

130. Respondents sought clarity on matters such as:

    (a) What is intended by the reference to "reasonable assurance" in the context of the SOQM.

    (b) How the severity of deficiencies affects the evaluation of the SOQM.

    (c) Whether the evaluation is an ongoing evaluation or a point-in-time evaluation, whether it is an evaluation of the process or the outcome of the process, and whether it is based on a "period ended" or an "as of date."

    (d) How deficiencies that are in the process of being remediated are considered in the context of the annual evaluation.

    (e) When the evaluation should be undertaken more frequently than annually.

IAASB Decisions

131. The IAASB agreed with respondents' observations that the evaluation of the SOQM is, in effect, a self-assessment. The IAASB is of the view that leadership's evaluation of the SOQM is essential to reinforcing leadership's responsibility and accountability for the SOQM. In order to enhance this purpose:

(a)   The requirement for performing the evaluation was relocated to the discrete section in paragraphs 53–56 of ISQM 1, together with the requirement addressing the performance evaluations of leadership.

(b)   The requirement for the performance evaluation in paragraph 56 of ISQM 1 now requires the firm to take into account the outcome of the evaluation of the SOQM as a factor in evaluating the performance of leadership.

(c)   Paragraph A195 of ISQM 1 reinforces that the evaluation is not intended to be independent assurance that the system is effective.

132.   The IAASB observed the need to clarify the responsibility of the individual(s) assigned ultimate responsibility and accountability for the SOQM, and the responsibility of the firm, with respect to the evaluation. As such:

(a)   Paragraph A33 of ISQM 1 explains that the firm remains ultimately responsible for the SOQM and holding individuals responsible and accountable for their assigned roles. It further describes that, in the context of paragraphs 53 and 54 of ISQM 1 that deal with the evaluation of the SOQM, although the firm assigns the evaluation of the SOQM and conclusion thereon to the individual(s) assigned ultimate responsibility and accountability for the SOQM, the firm is responsible for the evaluation and conclusion.

(b)   Paragraph 55 of ISQM 1 now requires the firm to take further appropriate actions (i.e., rather than the individual(s) assigned ultimate responsibility and accountability for the SOQM).

(c)   Paragraph A187 of ISQM 1 explains that the individual(s) assigned ultimate responsibility and accountability for the SOQM may be assisted by other individuals in performing the evaluation, although the individual(s) assigned ultimate responsibility and accountability for the SOQM remains responsible and accountable for the evaluation.

133.   The IAASB considered whether the evaluation of the SOQM is performed at a point-in-time, whether it is an evaluation of the process or the outcome of the process, whether it is based on a "period ended" or an "as of date," and how deficiencies that are in the process of being remediated are considered in the evaluation. The IAASB was conscious that the evaluation should not inhibit a proactive and constructive approach to continual improvement, and therefore the requirements need to encourage identifying and remediating deficiencies in an effective, proactive and timely manner. The IAASB noted that it may not be practicable for firms to fully remediate all deficiencies at the time of the evaluation, as it may take time for some deficiencies to be properly and effectively remediated. Furthermore, implying that all deficiencies need to be fully remediated in order to conclude that the system is effective could drive the wrong behaviors and outcomes. Accordingly, the IAASB agreed that the evaluation should be undertaken at a point in time and consider the combination of the following matters, as outlined in paragraph A190 of ISQM 1:

(a)   The severity and pervasiveness of identified deficiencies, and the effect on the achievement of the objectives of the SOQM;

(b)   Whether remedial actions have been designed and implemented by the firm, and whether the remedial actions taken up to the time of the evaluation are effective; and

(c)   Whether the effect of identified deficiencies on the SOQM have been appropriately corrected, (e.g., correcting engagements where procedures were omitted).

Application material has also been added in paragraph A188 of ISQM 1 to provide examples of the point in time when the evaluation may be undertaken.

134. To provide further clarity, the IAASB has focused the conclusion on whether the SOQM provides the firm with reasonable assurance that the objectives of the SOQM *are being* achieved. This reflects the notion that the conclusion is focused on whether the system provides reasonable assurance that engagements that *are being* performed and reports that will be issued on those engagements will be appropriate. Although the evaluation is focused on the present, it uses information about how the system has performed over a period as the basis for determining whether it is providing reasonable assurance.

135. The IAASB considered, but rejected, suggestions that the evaluation of the SOQM should be undertaken on a cyclical basis for certain firms (e.g., smaller firms), since the intended purpose of the evaluation is to create a responsibility on leadership to be aware and conscious of the effectiveness of the SOQM. However, the IAASB reconsidered whether the frequency of the evaluation proposed in ED-ISQM 1 remains appropriate. The IAASB noted that the requirements in paragraphs 42–44 of ISQM 1 dealing with remedial actions to address deficiencies create a clear expectation on the firm to address deficiencies. In addition, when deficiencies are severe or pervasive, it may take time for the firm to effectively remediate the deficiency and correct the effect of the deficiency. The IAASB is of the view that requiring the firm to undertake an evaluation of the SOQM whenever there are deficiencies that are severe and pervasive could discourage firms from identifying deficiencies and concluding that they are severe and pervasive, and appropriately dealing with them. As a result, the IAASB agreed that ISQM 1 should only require that the evaluation be performed at least annually.

136. The IAASB noted the need to ensure that the appropriate conclusion is reached, and that only having a binary conclusion in the standard (i.e., either the system is effective or is not effective) did not promote a thoughtful consideration of the effectiveness of the system. As a result, paragraph 54 of ISQM 1 caters for three possible outcomes, supported by application material to explain how the individual(s) assigned ultimate responsibility and accountability for the SOQM may reach those conclusions. This includes application material explaining when a deficiency may be considered to have a severe or pervasive effect on the SOQM.

Performance Evaluations of Leadership

137. The IAASB acknowledged concerns that smaller firms may find it challenging to undertake the performance evaluations of leadership. The IAASB is of the view that this requirement is essential to reinforcing leadership's responsibility and accountability for the SOQM, irrespective of the size of the firm. In the case of a smaller firm, the performance evaluations of leadership may be more interconnected with, and dependent on, the outcome of the evaluation of SOQM.

Section L – Other Matters

Governance and Leadership, Including Responsibilities in ISQM 1

Background and Summary of Comments Received on Exposure

138. ED-ISQM 1 was substantially enhanced to improve the robustness of firms' governance and leadership. It introduced requirements addressing the effect of the firm's strategic actions, including financial and operational decisions, on engagement quality. It also enhanced the roles and responsibilities of leadership, including addressing the expected behavior of leadership, the

appropriate qualifications of leadership, managing the firm's resources and a requirement to undertake performance evaluations. As part of the proposals, the IAASB sought respondents' views about assigning responsibility for relevant ethical requirements or responsibility for compliance with independence requirements to an individual in the firm.

139. Respondents supported the proposals for governance and leadership, with various further comments such as:

    (a) Ad-hoc suggestions of additional matters to add to the standard, for example, having a learning or improvement-orientated culture, addressing how the culture of the firm's audit and assurance service line may be affected by the culture of the firm as a whole, and bringing more emphasis that the SOQM needs to be integrated into the firm's business processes.

    (b) Views about the prescriptiveness and scalability of this component, particularly regarding the assignment of responsibilities.

140. Respondents expressed mixed views about whether responsibility for relevant ethical requirements or compliance with independence requirements should be assigned to an individual.

IAASB Decisions

141. The IAASB agreed that ISQM 1 should better emphasize the need for quality management to be integrated into the strategy, operations and business processes of the firm, so that quality management does not become a separate compliance function. Accordingly, the following revisions were made:

    (a) Paragraph A30 of ISQM 1 was added to explain that quality management is not a separate function of the firm; it is the integration of a culture that demonstrates a commitment to quality with the firm's strategy, operational activities and business processes.

    (b) Paragraph 25(a) of ISQM 1 requires the firm, in identifying and assessing quality risks, to understand the strategic and operational decisions and actions, business processes and business model of the firm. This requirement drives the firm to consider whether, and how, the firm's strategic and operational decisions and actions, business processes and business model may give rise to quality risks across the components.

142. The IAASB noted respondents' suggestions to address how the culture of the firm's audit and assurance service line may be affected by the culture of the firm as a whole. To address this, the IAASB included in paragraph A46 of ISQM 1 an example of a situation where the firm's overall financial goals are overly dependent on the extent of services provided by the firm not within the scope of ISQM 1.

143. To further embed the notion that leadership roles need to be assigned to the right individuals in the firm, the IAASB enhanced the qualifications of the individuals assigned leadership roles in paragraph 21 of ISQM 1. The qualifications now include having the appropriate influence and authority within the firm.

144. The IAASB acknowledged respondents' mixed views about whether the standard should require assigning responsibility for relevant ethical requirements to an individual, or compliance with independence requirements to an individual. The IAASB noted that given the importance of independence to the performance of audit and assurance engagements and the expectation of stakeholders relying on the firm's reports that the firm is independent, the standard should require assigning responsibility for compliance with independent requirements.

Relevant Ethical Requirements

Background

145. ED-ISQM 1 included a number of revisions relating to relevant ethical requirements. In particular, the requirements were established in a more principles-based manner than extant ISQC 1, given the new risk-based approach in the standard.

IAASB Decisions

146. In further revising ISQM 1, the IAASB engaged extensively with IESBA[20] representatives to solicit their input and views on matters related to ethical requirements.

147. The IAASB noted that further clarifying the scope of the relevant ethical requirements addressed by ISQM 1 would be helpful. As a result:

   (a)   The application material in paragraph A24 of ISQM 1 was enhanced and clarified to explain how the scope of relevant ethical requirements applies in the context of personnel of the firm, focusing on explaining why Part 2 of the IESBA Code[21] may apply in the performance of engagements.

   (b)   The quality objectives in paragraph 29 of ISQM 1 were bifurcated to separately deal with the firm and its personnel, and others external to the firm.

   (c)   The quality objectives in paragraph 29 of ISQM 1 were refined to emphasize that the relevant ethical requirements are those to which the firm and the firm's engagements are subject.

   (d)   The phrase "the relevant ethical requirements that apply to them" was added to the quality objective in paragraph 29(b) of ISQM 1 dealing with others external to the firm, in order to emphasize that there are specific relevant ethical requirements that may apply. In other words, the relevant ethical requirements to which the firm and the firm's engagements are subject would not ordinarily broadly apply to others external to the firm in the same way as they would apply to the firm and its personnel. The application material in paragraph A65 of ISQM 1 further explains how the relevant ethical requirements may apply to others external the firm. In developing this application material, in addition to taking into account how the IESBA Code may apply to others external to the firm, the IAASB noted that ethical requirements contained in law or regulation or jurisdictional codes may include provisions that address networks, network firms, individuals in the network or network firms, or service providers.

Documentation

Background and Summary of Comments Received on Exposure

148. Although the IAASB did not specifically seek respondents' views on documentation in the explanatory memorandum to ED-ISQM 1, respondents provided various comments about documentation. In particular, respondents commented that the documentation expectations in the standard are not sufficiently clear, and therefore were concerned whether documentation expectations would be onerous and excessive. Respondents therefore urged the IAASB to clarify documentation for certain

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[20]   The International Ethics Standards Board for Accountants

[21]   The International Ethics Standards Board for Accountants' *International Code of Ethics for Professional Accountants (including International Independence Standards)* (IESBA Code)

aspects of the standard, such as the firm's risk assessment process, and encouraged the IAASB to provide additional guidance to demonstrate how a firm should document its SOQM.

IAASB Decisions

149. The IAASB is of the view that a principles-based approach to documentation is appropriate and consistent with other IAASB standards, such as ISA 230.[22] The IAASB was concerned that adding further material to the standard to be more specific about documentation requirements would be contrary to the IAASB's efforts to improve the scalability of the standard and address prescriptiveness.

150. Given respondents' suggestions to clarify the documentation with respect to the firm's risk assessment process, the IAASB enhanced paragraph A205 of ISQM 1 to clarify the documentation expectations relating to identifying and assessing quality risks.

Section M – Effective Date

Background and Summary of Comments Received on Exposure

151. The three quality management exposure drafts were accompanied by a covering explanatory memorandum, The IAASB's Exposure Drafts for Quality Management at the Firm and Engagement Level. The covering explanatory memorandum set out the IAASB's proposals regarding the effective date and the related implementation period for the three quality management standards, among other matters. In addition, as part of the explanatory memorandum to ED-ISQM 1, the IAASB sought respondents' input on implementation challenges related to ED-ISQM 1.

152. The IAASB's proposal for an 18-month implementation period was not generally supported by respondents from many stakeholder groups, particularly accounting firms, national auditing standard-setters and member bodies and other professional organizations. By contrast, regulators had mixed views and public sector organizations were mostly in favor of the proposed implementation period.

153. Respondents in support of the 18-month implementation period reiterated matters highlighted by the IAASB in the covering explanatory memorandum, such as the need to balance the public interest of the proposals with providing firms and networks sufficient time to effectively implement the standards. On the other hand, respondents who did not support the proposal emphasized the need for adequate time for implementation and shared suggestions on alternative implementation periods, which in general was at least 24 months following PIOB approval of due process for the standards.

154. Respondents also sought clarity on the meaning of the effective date in ED-ISQM 1, in particular regarding what specific elements of the standard need to be in place and operating in order to satisfy the requirement for the SOQM to be "established." Respondents questioned, for example, whether firms are expected to have performed an evaluation of the SOQM by the effective date, which would involve a full cycle of monitoring and remediation.

155. Respondents variously commented on the implementation challenges that may be experienced in relation to ISQM 1. The most common concern was the time and resources needed to support initial implementation, with respondents pointing out the time and effort needed to entrench a firm-wide mindset change and to influence the culture of the firm, as well as the time needed to adjust organizational structures, redefine roles and responsibilities, obtain and develop resources (e.g., IT systems) and test systems.

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[22]   ISA 230, *Audit Documentation*

IAASB Decisions

Effective Date of the Quality Management Standards

156. Due to COVID-19, the project timelines of the quality management projects changed, and the IAASB's approval of the quality management standards was deferred to September 2020 (previously it was anticipated to be March 2020). Furthermore, the IAASB noted the effects of COVID-19 on implementation efforts, in particular the need for stakeholders to refocus their resources on dealing with the impact of COVID-19 and amending their existing quality control policies and procedures.

157. The IAASB concluded that an 18-month implementation period was not responsive to the concerns expressed in the comment letters and would not allow adequate time for a proper implementation of the standards. The IAASB was concerned that not allowing adequate time for implementation could result in the public interest benefits that were envisioned by the IAASB in undertaking this project not being achieved.

158. The IAASB determined that the quality management standards should have an effective date of December 15, 2022, as this appropriately balances the urgency of the reforms and the risks incurred in a rushed implementation. The IAASB agreed that early adoption of the quality management standards be permitted.

Meaning of the Effective Date in ISQM 1

159. The IAASB's intention is that the SOQM is designed and implemented and ready to commence operation on the effective date. In summary, by the effective date of December 15, 2022, the expectation is that the firm has:

   (a) Established the quality objectives, identified and assessed the quality risks and designed and implemented the responses. The operation of the responses is only required to commence from the effective date.

   (b) Designed and implemented the monitoring activities. The operation of the monitoring activities is only required to commence from the effective date.

160. In order to clarify the IAASB's intention regarding the effective date, the IAASB replaced the term "established" in the effective date in paragraph 13 of ISQM 1 with "designed and implemented."

161. The IAASB's intention with respect to the evaluation of the SOQM is that it would be undertaken within one year following the effective date of the standard, to coincide with the requirement in paragraph 53 of ISQM 1 that requires the individual(s) assigned ultimate responsibility and accountability for the SOQM to evaluate the SOQM at least annually. The IAASB has specifically stated this in paragraph 13 of ISQM 1.

162. The IAASB considered how the evaluation may be undertaken in the first year after implementing ISQM 1, because of the interrelationship of the effective dates of the quality management standards and the time it will take for the quality management standards to fully take effect (e.g., ISA 220 (Revised) and ISQM 2 apply to financial periods beginning on or after December 15, 2022 with respect to audits of financial statements). The IAASB is of the view that:

   (a) As previously described in this basis for conclusions, the intention of the evaluation of the SOQM is to reinforce leadership's responsibility and accountability for the SOQM. It is not intended to provide independent assurance on the SOQM. Therefore, leadership would use information that is available about the SOQM and evaluate the SOQM on that basis.

(b)   ISQM 1 promotes a more proactive approach to quality management, and unlike current systems of quality control, firms will likely need to perform various monitoring activities of the SOQM that are more proactive and timely than inspections of completed engagements. As a result, under the new SOQM, there should be information available about the SOQM on a more timely basis.

(c)   The information available to the firm in the first year of operation will include a combination of information relating to the firm's new SOQM, and policies or procedures designed under the old system of quality control. Although the information may relate to the policies or procedures under the old system of quality control, it may still be useful to the firm in evaluating the SOQM. For example, the firm may consider how findings related to policies or procedures under the old system of quality control have been addressed in the new SOQM, including whether the new SOQM appropriately addresses the areas of the findings.

Section N – Other Activities to Promote Awareness and Understanding and Support Effective Implementation of ISQM 1

Background and Summary of Comments Received on Exposure

163.   The covering explanatory memorandum to the three quality management standards asked respondents for their views about the IAASB's activities to support implementation of the standards. Respondents suggested various forms of implementation materials, including examples, frequently asked questions, templates, case studies, diagrams and webinars or workshops. Respondents also indicated that the IFAC Small and Medium Practices Advisory Group's (SMPAG) *Guide to Quality Control for Small- and Medium-Sized Practices* was helpful and encouraged the IAASB to work with IFAC's SMPAG to update the guide.

164.   Particular areas where respondents sought guidance on ISQM 1 included the firm's risk assessment process, service providers, root cause analysis, network requirements or network services and documentation. A clear theme also emerged about the need for clarity about how ISQM 1 differs from ISQC 1, to help firms determine what may still be relevant from their existing systems.

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165.   The IAASB has committed to perform activities to support awareness, understanding and effective implementation of ISQM 1. Further information on implementation activities are available on the [IAASB's website](#). The IAASB will continue to encourage the IFAC SMPAG to update their *Guide to Quality Control for Small- and Medium-Sized Practices* and the IAASB will provide input as appropriate.