

Proposed ISQM 2¹: Issues and Recommendations

Objectives of the IAASB Discussion

The objectives of this Agenda Item are to:

- (a) Obtain the Board's views about the recommendation of the ISQM 2 Task Force (the Task Force) relating to engagements subject to an engagement quality (EQ) review in accordance with paragraph 41A(e) (previously paragraph 41A(c)) of proposed ISQM 1;² and
- (b) Obtain the Board's feedback on the revised draft of proposed ISQM 2.

Please note this paper represents the ISQM 2 Issues paper for the March 2020 IAASB meeting and is provided to the CAG Representatives for context, as appropriate. Specific questions for CAG Representatives are included in Agenda Item G.1 (ISQM 2 Presentation)

Introduction

Structure of this Paper

1. This agenda item is organized as follows:
 - **Section I** describes the recommendation of the Task Force relating to engagements subject to an EQ review in accordance with paragraph 41A(e) of proposed ISQM 1, as presented in **Agenda Item 5-A**;
 - **Section II** covers the changes to the requirements and application material of proposed ISQM 2, as described in **Agenda Item 5-C**;
 - **Section III** sets out due process considerations; and
 - **Section IV** includes the Task Force's views on the way forward.

Appendices

2. This paper includes the following appendices:
 - **Appendix 1** provides an overview of the Task Force activities, including outreach and coordination with other task forces during the first quarter of 2020.
 - **Appendix 2** includes an extract of the draft minutes of the December 2019 IAASB meeting.

Other Agenda Papers Accompanying this Issues Paper

Agenda Item 5-A	Draft of Paragraph 41A(e) of Proposed ISQM 1 and Related Application Material - Marked from December 2019
Agenda Item 5-B	Draft of Paragraph 41A(e) of Proposed ISQM 1 and Related Application Material - Clean
Agenda Item 5-C	Discussion of Changes to Requirements and Application Material of

¹ Proposed International Standard on Quality Management (ISQM) 2, *Engagement Quality Reviews*

² Proposed 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*

	Proposed ISQM 2
Agenda Item 5-D	Draft of Proposed ISQM 2 - Marked from December 2019
Agenda Item 5-E	Draft of Proposed ISQM 2 - Clean

Discussions with Other IAASB Task Forces and IESBA Representatives and Staff

3. Discussions were held with the ISQM 1 Task Force Chair and Staff about the changes to the firm's risk assessment process in proposed ISQM 1, in particular the factors the firm is required to understand in identifying and assessing quality risks that may adversely affect the achievement of quality objectives (see paragraph 22E of proposed ISQM 1, as presented in **Agenda Item 4-A**). Because those factors include factors relating to the nature and circumstances of the firm and the nature and circumstances of the engagements performed by the firm, the Task Force wanted to better understand the relationship of those factors to the firm's determination of engagements for which an EQ review is an appropriate response to assessed quality risks in accordance with paragraph 41A(e) of proposed ISQM 1. The Task Force's recommendation and proposed revisions resulting from these discussions (as reflected in **Agenda Item 5-A**) are explained in **Section I** of this paper. The ISQM 1 Task Force Chair and Staff are supportive of these proposed revisions.
4. Proposed revisions relating to the application material in proposed ISQM 2 regarding considerations for an EQ review for a group audit (as reflected in **Agenda Item 5-D**) were discussed with the ISA 600 Task Force. The ISA 600 Task Force was supportive of these proposed revisions. Refer to the explanation of these proposed revisions in **Agenda 5-C**.
5. Discussions were also held to update IESBA Representatives and Staff about the recommendations of the Task Force relating to engagements subject to an EQ review, and relating to the objectivity, including a mandatory cooling-off period, for an individual being appointed as an EQ reviewer after previously serving as the engagement partner. The rationale for the proposed revisions resulting from these discussions (as reflected in **Agenda Item 5-D**) are explained in **Agenda Item 5-C**.

Approach for the Discussion of the Agenda Items

6. The Task Force Chair will present the agenda items in the following order:
 - The Task Force recommendation relating to the scope of engagements subject to an EQ review presented in **Section I** of this paper. The Task Force has provided the marked and clean versions of paragraph 41A(e) and related application material of proposed ISQM 1 in **Agenda Items 5-A** and **5-B**, respectively. The Task Force Chair will refer to the marked version, **Agenda Item 5-A**, as the basis for discussion.
 - The revised draft of proposed ISQM 2. The Task Force has provided the marked and clean versions of proposed ISQM 2 in **Agenda Items 5-D** and **5-E**, respectively. The Task Force Chair will refer to the marked version, **Agenda Item 5-D**, as the basis for discussion. The Task Force Chair will walk through the standard in sections and will take comments on the requirements together with the related application material as noted in the table below. In walking through the standard, the Task Force Chair will refer to the changes to the requirements and application material of proposed ISQM 2, as described in **Agenda Item 5-C**.

Requirements	Application Material
Paragraphs 1–14	—

Requirements	Application Material
Paragraphs 15–20	Paragraphs A1–A21
Paragraphs 21–24	Paragraphs A22–A35
Paragraphs 25–27	Paragraphs A36–A39

Status of Proposed ISQM 2 and Intended Q2 2020 Activities

7. The Task Force intends to update the draft of proposed ISQM 2 during the March 2020 IAASB meeting for Board members' comments. It is proposed that the draft of proposed ISQM 2 as presented on March 20, 2020, amended as appropriate for any final comments, be treated as the final text except for:

- Changes to align with revisions made to the drafts of proposed ISQM 1 and ISA 220 (Revised)³ and the Exposure Draft (ED) of proposed ISA 600 (Revised).⁴
- Any final coordination matters with IESBA Representatives.

As such, Board members will be asked to indicate their support for the text of proposed ISQM 2 at the end of the March 2020 IAASB meeting, with the understanding that only limited changes may be needed as described in the bullet points above.

Section I – Scope of Engagements Subject to an EQ Review

What We Heard from the Board at the December 2019 IAASB Meeting

8. At the December 2019 IAASB meeting, the Board generally supported the Task Force's proposed revisions relating to the scope of engagements subject to an EQ review. Although some Board members expressed support for retaining the separate category of 'due to the nature and circumstances of the engagement or the entity,' other Board members questioned how that category differs from the category of engagements for which an EQ review may be appropriate in response to assessed quality risks.

Task Force Discussion

9. The Task Force noted comments from several Board members that the separate category of engagements subject to an EQ review due to the 'nature and circumstances of the engagement or the entity' was confusing due to the introduction at the December 2019 IAASB meeting of 'quality risk considerations' in proposed ISQM 1. Those quality risk considerations (now referred to as 'factors' in the draft of proposed ISQM 1) included *the nature and circumstances of the firm*, and *the nature and circumstances of the engagements* (emphasis added). An extract of paragraph 22E of proposed ISQM 1 is shown below for reference.

<p>22E. The firm shall identify and assess quality risks to provide a basis for the design and implementation of responses. In doing so, the firm shall: (Ref: Para.A24L)</p> <p>(a) Understand the factors that may adversely affect the achievement of its quality objectives, including: (Ref: Para. A24N)</p> <p>(i) Those relating to the nature and circumstances of the firm:</p>
--

³ Proposed International Standard on Auditing (ISA) 220 (Revised), *Quality Management for an Audit of Financial Statements*

⁴ Proposed ISA 600 (Revised), *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

- a. The complexity and operating characteristics of the firm;
- b. The strategic decisions, actions, and business model;
- c. The characteristics and management style of leadership;
- d. The resources of the firm, including the resources provided by service providers;
- e. Law, regulation, professional standards and the environment in which the firm operates; and
- f. In the case of a firm that belongs to a network, the characteristics of the network requirements and network services, if any.
- (ii) Those relating to the nature and circumstances of the engagements performed by the firm subject to the system of quality management:
 - a. The types of engagements performed by the firm and the reports to be issued; and
 - b. The types of entities for which such engagements are undertaken;
- (b) Consider:
 - (i) Whether, and if so how, the factors could, individually or in combination with other quality risks, adversely affect the achievement of a quality objective; and (Ref: Para. A24P)
 - (ii) The likelihood of the quality risks occurring, and if they were to occur the potential effect on the achievement of a quality objective(s) before consideration of any response. (Ref: Para. A24Q)

10. Based on the discussions with the ISQM 1 Task Force Chair and Staff as described in paragraph 3 above, the Task Force noted the following:

- As part of a firm's risk assessment process (FRAP) in identifying and assessing quality risks to provide a basis for the design and implementation of responses (see paragraph 22E(a) of proposed ISQM 1), the firm is required to understand factors that may adversely affect the achievement of its quality objective.
- Those factors include factors relating to the nature and circumstances of the firm and of the engagements performed by the firm. Therefore, it becomes more challenging to explain how the category of 'due to the nature and circumstances of the engagement or the entity' differs from the category of engagements for which an EQ review is appropriate as a response to assessed quality risks. A firm's decision to perform an EQ review based on the nature and circumstances of the engagement or the entity relates to the engagement performance quality objectives of the firm's system of quality management (i.e., addressed as part of the FRAP).
- In addition to the similarity of the wording of the separate category to the wording of the factors in the FRAP in proposed ISQM 1, some also may hold the view that a separate category that is not in response to assessed quality risks is inconsistent with the underlying principle of a firm's system of quality management that requires the firm to apply a '*risk-based approach*' (emphasis added), as provided in paragraphs 9A-10 of proposed ISQM 1. Consequently, requiring an EQ review in response to reasons that are not risk-based is inconsistent with, and may be viewed as undermining the principle of a risk-based approach

in proposed ISQM 1. Extracts of paragraphs 9A-10 of proposed ISQM 1 are shown below for reference.

9A.	This ISQM requires the firm to apply a risk-based approach in designing, implementing and operating the components of the system of quality management in an interconnected and coordinated manner such that the quality of engagements is proactively managed by the firm. (Ref: Para. A4A)
10.	<p>The risk-based approach is embedded in the requirements of this ISQM through:</p> <ul style="list-style-type: none"> (a) Establishing quality objectives. The quality objectives established by the firm consist of objectives in relation to the components of the system of quality management that are to be achieved by the firm. The firm is required to establish the quality objectives set out in this ISQM and any additional quality objectives beyond those specified by this ISQM that are considered necessary by the firm to achieve the objectives of the system of quality management. (b) Identifying and assessing risks to the achievement of the quality objectives (referred to in this standard as quality risks). The firm is required to identify and assess quality risks to provide a basis for designing and implementing responses. (c) Designing and implementing responses to address the assessed quality risks. The nature, timing and extent of the firm's responses to address the assessed quality risks are based on, and responsive to, the reasons for the assessments given to the quality risks.

11. It was suggested during the December 2019 Board meeting that there may be a way to further distinguish the two categories as both being responses to quality risks, but with different considerations. Although possible to pursue this, the Task Force considers it will be challenging to clearly differentiate the two categories now that proposed ISQM 1 incorporates the concept of factors that may adversely affect the achievement of a firm's quality objectives.
12. The Task Force also considered whether it would be possible to retain the separate category of 'due to the nature and circumstances of the engagement or the entity' and provide additional application material (and supplemental implementation guidance, if necessary) to explain how this category differs from the category of engagements for which the firm determines an EQ review is an appropriate response to assessed quality risks. However, for the reasons noted above, the Task Force concluded that this would be a less desirable option.

Task Force Recommendation

13. In view of the comments from Board members during the December 2019 meeting, the Task Force recommends that the separate category of 'due to the nature and circumstances of the engagement or the entity' be absorbed into the broader category of engagements for which the firm determines an EQ review is an appropriate response to assessed quality risks.
14. The Task Force does not consider that absorbing this separate category would significantly affect the number of engagements subject to EQ review since relevant aspects of the application material (i.e., factors to be considered in identifying engagements subject to an EQ review due to the nature and circumstances of the engagement or the entity) have been incorporated into the application material for the broader category of engagements subject to an EQ review as an appropriate response to assessed quality risks (now part of paragraph A153I in **Agenda Item 5-A**).

15. Accordingly, the Task Force has made the following proposed revisions in **Agenda Item 5-A**:
- Absorbed the separate category of 'due to the nature and circumstances of the engagement or the entity' into the broader category of engagements for which the firm determines that an EQ review is an appropriate response to assessed quality risks in paragraph 41A(e) of proposed ISQM 1.
 - Redrafted the lead-in wording in paragraph A153I (previously paragraph A104) to provide a link to the FRAP with respect to the:
 - Factors (see paragraph 22E(a)(ii) of proposed ISQM 1) relating to the nature and circumstances of the engagements performed by the firm that may adversely affect the achievement of its quality objectives, which the firm is required to understand when identifying and assessing quality risks; and
 - Conditions and circumstances that may lead the firm to determine that an EQ review is the appropriate response in designing and implementing responses to address assessed quality risks relating to the quality objectives of engagement performance.
 - Aligned paragraph A153I with the ISQM 1 Task Force's approach of presenting the examples of such conditions and circumstances in boxes. In addition, the conditions and circumstances in paragraph A153I of proposed ISQM 1 are now further subdivided into:
 - Conditions and circumstances relating to the types and characteristics of engagements performed; and
 - Conditions and circumstances relating to the types of entities for which engagements are undertaken.
 - Reworded some of the bullets in paragraph A153I to be consistent with the new presentation approach in proposed ISQM 1. However, the content of all bullet points in paragraph A104 of the December 2019 draft have been retained.
 - Deleted paragraphs A105A, A105B and A106 of proposed ISQM 1. However, certain parts of the deleted paragraphs have been incorporated into paragraph A153I and the accompanying example box.

Matter for IAASB Consideration

1. Does the IAASB support the proposed changes to the requirements in paragraph 41A(e) of proposed ISQM 1 and related application material relating to the scope of engagements subject to an EQ review?

Section II – Discussion and Feedback on Draft of Proposed ISQM 2

16. Except for minor editorial changes, the description of all changes made by the Task Force in proposed ISQM 2 (as reflected in the marked draft in **Agenda Item 5-D**) to address the comments received during the December 2019 IAASB meeting, and the written comments received thereafter, is presented in **Agenda Item 5-C**. As noted above, the Task Force Chair will refer to the changes in walking through the standard.

Matter for IAASB Consideration

2. The IAASB is asked for its views on the changes to proposed ISQM 2 as presented in **Agenda Item 5-D**.

Section III – Due Process Considerations

17. In the Task Force's view, the significant matters it has identified as a result of its deliberations since the beginning of this project, and its conclusions and recommendations thereon, have been reflected in the agenda materials presented to the IAASB at its meetings. There are no significant matters discussed in the course of this project that have not been brought to the IAASB's attention.
18. The Task Force considers, therefore, that the draft of proposed ISQM 2 as presented in **Agenda Item 5-E** reflects all significant matters raised in the course of the project. The only changes expected to be made in finalizing the draft of proposed ISQM 2 for approval at the June 2020 IAASB meeting will be those arising from the Board discussion at this meeting and feedback from outreach activities and coordination with the ISQM 1, ISA 220 and ISA 600 Task Forces and IESBA Representatives on the matters identified in **Section IV** below.

Section IV – Way Forward

19. The Task Force will work towards the final approval of proposed ISQM 2 as planned at the June 2020 IAASB meeting.
20. After the March 2020 meeting, the Task Force will focus on:
 - Addressing comments received from the Board in March 2020, as well as feedback received from outreach activities with stakeholders noted in **Appendix 1** to this paper and coordination activities with the ISQM 1, ISA 220 and ISA 600 Task Forces and IESBA Representatives.
 - The conforming and consequential amendments to the ISAs arising from proposed ISQM 2.

Appendix 1

ISQM 2 Task Force Activities Including Outreach and Coordination with Other IAASB Task Forces and Working Groups

1. The following sets out the activities of the Task Force, including outreach and coordination with other IAASB task forces and working groups relating to EQ reviews.

Task Force Activities in the First Quarter of 2020

2. In the first quarter of 2020, the Task Force held two teleconferences and met once in person to discuss the Task Force's consideration of the direction received at the December 2019 IAASB meeting and develop the revisions to the requirements and application material for the IAASB's consideration at this meeting.

Coordination with Other IAASB Task Forces and Working Groups and Other Standard Setting Boards

IAASB Task Forces – ISQM 1, ISA 220 and ISA 600 Task Forces

3. On February 5, 2020, the Task Force and the ISQM 1 Task Force Chair and Staff held a teleconference to discuss coordination matters, specifically on the scope of engagements subject to an EQ review based on the 'nature and circumstances of the engagement or the entity' and how this relates to the factors in the FRAP under paragraph 22E(a)(ii) of proposed ISQM 1. Further coordination has also been facilitated between Staff of the ISQM 1 and ISQM 2 Task Forces on the suggested wording of the proposed revisions relevant to the scope of engagements subject to an EQ review.
4. Staff of the Task Force liaised with Staff of the ISA 220 Task Force to align the requirements and application material in proposed ISQM 2 with the wording in proposed ISA 220 (Revised).
5. Staff of the Task Force also liaised with the ISA 600 Task Force and Staff on matters that require coordination, specifically on the group audit considerations provided in paragraphs A28A and A28Ax of proposed ISQM 2.

IESBA

6. On January 30, 2020, IESBA released for public comment the ED, [Proposed Revision to the Code Addressing the Objectivity of Engagement Quality Reviewers](#). The explanatory memorandum (EM) to the ED noted that "after giving the matter due consideration, the IESBA considers that it would be more appropriate for the IAASB to determine whether a cooling-off requirement should be introduced in proposed ISQM 2, following the proposed guidance set out in Section 120, and if so, the circumstances in which the requirement should apply, to whom it should apply, and what the minimum cooling-off period should be." For further explanation, please refer to paragraph 17 of the EM to the ED linked above.
7. In the first quarter of 2020, the Task Force Chair and Staff held two teleconferences with IESBA Representatives and Staff to:
 - Discuss how the long association provisions in the IESBA Code and the interrelationship with the proposed mandatory cooling-off period in proposed ISQM 2 could be addressed.
 - Provide updates regarding the requirements and relevant application material for the scope of engagements subject to an EQ review, and the objectivity of and mandatory cooling-off period for an individual being appointed as an EQ reviewer after previously serving as the engagement partner.

Outreach Activities

8. The following outreach activities were held in which proposed ISQM 2 was discussed:
 - Presentation at the International Organization of Securities Commissions' Committee on Issuer Accounting, Audit and Disclosure (Committee 1), Auditing Subcommittee Meeting.
 - Presentation for CPA Australia.
9. Subsequent to the posting of this paper, further project specific outreach activities on the quality management standards are planned prior to, or following, the March 2020 IAASB meeting, with the following stakeholders:
 - International Forum of Independent Audit Regulators' Standards Coordination Working Group;
 - International Federation of Accountants' Small and Medium Practices Committee;
 - Global Public Policy Committee; and
 - Forum of Firms.

Appendix 2

Extract from Draft IAASB Minutes – December 2019⁵

Engagement Quality Reviews – ISQM 2⁶

Mr. Vanker presented the revised proposals to address the key issues noted in Agenda Item 8. The discussion also included a walkthrough of the complete draft of proposed ISQM 2.

SCOPE OF ENGAGEMENT SUBJECT TO AN EQ REVIEW

The Board generally supported the revised proposal on the scope of engagements subject to an EQ review. Some Board members suggested aligning the category based on the 'nature and circumstances of the engagement or the entity' with the quality risk considerations in proposed ISQM 1, and to further consider how this category differentiates from engagements for which an EQ review may be appropriate in response to an assessed quality risk.

OBJECTIVITY AND COOLING-OFF PERIOD

The Board generally supported the revised proposal to require a cooling-off period of two years, or longer if required by relevant ethical requirements, before an engagement partner can assume the role of EQ reviewer, and to apply such requirement to all engagements for which an EQ review is performed.

The Board also expressed its appreciation for the IESBA's recent proposals to address EQ reviewer objectivity in its conceptual framework (i.e., Section 120 of the IESBA Code), with some Board members still noting a preference for objectivity and a cooling-off period to be addressed in the IESBA Code.

OTHER MATTERS

The Board also provided input on the ISQM 2 Task Force's proposals on other matters, including the EQ reviewer's evaluation of the exercise of professional skepticism by the engagement team, and considerations when performing an EQ review for a group audit engagement.

IAASB CAG CHAIR'S REMARKS

Mr. Dalkin noted that CAG Representatives were generally supportive of the revised proposals on objectivity, including a cooling-off period.

PIOB OBSERVER REMARKS

Prof. van Hulle strongly supported the revised proposal on objectivity and cooling-off period, and noted that the objectivity of the EQ reviewer is an important aspect of an EQ review.

WAY FORWARD

The ISQM 2 Task Force will consider the comments received in preparing a revised full draft of proposed ISQM 2 for discussion at the March 2020 IAASB meeting.

⁵ Draft minutes are still subject to IAASB review and may therefore still change.

⁶ Proposed ISQM 2, *Engagement Quality Reviews*