

Quality Management (Firm level): Proposed Revisions to ISQC 1¹

The minutes from the IAASB's discussion on quality management in December 2016 are included in the Appendix of this Agenda Item. **Agenda Item 2** includes the minutes of the IAASB's March 2017 discussion in relation to engagement quality control reviews that form part of ISQC 1.

Objective of the IAASB Discussion

The objective of this Agenda Item is to obtain the IAASB's input on the Quality Control Task Force's (QCTF) proposals on the revisions to ISQC 1. In particular, the QCTF seeks the IAASB's views on the following matters:

- How the quality management approach (QMA) has been incorporated into ISQC 1.
- The overall structure of ISQC 1, including how the components interrelate, and how they would be implemented in practice.
- The scalability of the revisions to ISQC 1 and its application by small and medium sized practices (SMPs).
- The robustness of the proposed revised ISQC 1.
- The proposed direction in relation to the requirements addressing:
 - Governance and leadership, including organization, culture and strategy.
 - Information and communication.
 - The quality management process (QMP), including monitoring and remediation.
- The appropriate location of the requirements and application material in relation to engagement quality control (EQC) reviews.
- How the proposals would change firm behaviors.

The input from the IAASB on these matters will assist the QCTF in further developing the revisions to ISQC 1.

Introduction

1. In 2013, the IAASB published its findings on its post-implementation review of the clarified International Standards on Auditing (ISAs) that highlighted the need for further consideration about aspects of quality control. Issues in relation to firm's systems of quality control have been consistently highlighted in inspection findings by audit regulatory bodies and audit oversight bodies, and in dialogue with these stakeholders. In addition to these issues, the IAASB recognizes the increasing needs of SMPs, including the adaptability of ISQC 1 to the nature and size of the firm.
2. In December 2015 the IAASB published the Invitation to Comment (ITC), *Enhancing Audit Quality: A Focus on Professional Skepticism, Quality Control and Group Audits*, in order to explain the issues in relation to ISQC 1 and to obtain stakeholder's feedback on possible actions the IAASB could take to address the issues. Many respondents to the ITC agreed that the public

¹ International Standard on Quality Control (ISQC) 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance Engagements and Related Services Engagements*

interest issues highlighted in the ITC were relevant and agreed that further actions should be pursued to address them.

3. As a result, in December 2016 the IAASB approved a project proposal for the revision of ISQC 1 to strengthen and improve a firm's management of quality for all engagements performed under the IAASB's International Standards by enhancing the requirements and application material and more explicitly incorporating a QMA.
4. At the December 2016 IAASB meeting, the QCTF introduced their initial recommendations on integrating a QMA within ISQC 1. This included recommendations on how the structure of ISQC 1 would be revised and how the scalability² principles of a QMA could be encapsulated in the standard, while maintaining the robustness of ISQC 1. Furthermore, in March 2017 the QCTF presented these proposals to the CAG. The appendix includes the minutes of the IAASB's December 2016 meeting and extracts of the draft minutes of the CAG's March 2017 meeting relevant to this paper. This Agenda Item discusses the QCTF's further recommendations on the proposed revisions to ISQC 1 and includes recommendations in response to the IAASB and CAG's feedback.
5. **Agenda Item 2–B, Agenda Item 2–C and Agenda Item 2–D** accompany this issues paper. **Agenda Item 2–B** includes a working draft of ISQC 1 and **Agenda Item 2–C** includes the QCTF's proposed prescribed quality objectives, quality risks and responses (i.e., the application of the QMA). The purpose of these accompanying agenda items is to demonstrate to the IAASB how the proposals of the QCTF would be executed. However the proposed requirements and application material require further refinement and development once the IAASB has provided its views on the matters set out in this Agenda Item. **Agenda Item 2–D** contains a mapping of the requirements in extant ISQC 1 to the proposed requirements in **Agenda Item 2–B** and **Agenda Item 2–C**.
6. This paper sets out the QCTF's proposals in relation to:
 - (a) Governance and leadership, including organization, culture and strategy;
 - (b) Information and communication (excluding documentation); and
 - (c) The QMP, including monitoring and remediation.

These proposals are based on the feedback from the IAASB and the CAG, as well as the comments from respondents to the ITC (the Supplement to **Agenda Item 2** includes an analysis of the comments from respondents on these topics).

7. This Agenda Item also explores the options in relation to the location of the requirements and application material with respect to EQC reviews.
8. As noted above, this paper includes a discussion on "information and communication" that forms part of the component "information, communication and documentation". This paper does not include a discussion on "documentation" since the QCTF is of the view that this can only be properly considered once all of the other components of ISQC 1 have been further developed.
9. The QCTF continues to deliberate the other discrete topics that form part of a firm's system of quality management, including EQC reviews, transparency reporting, engagement partner performance and rewards, and engagement partner competency and human resources. The

² The QCTF recognizes that there are different interpretations of the meaning of the terminology "scalability" and "proportionality." For the purposes of this paper, the term "scalability" has been used to represent both scalability and proportionality, and therefore scalability means (i) whether or not the requirement applies to the firm based on its circumstances; and (ii) if the requirement applies, the extent to which the requirement can be applied in a manner commensurate with the size and complexity of the firm.

QCTF is of the view that these topics could affect the following aspects of the proposals set out in the accompanying agenda items:

- (a) The prescribed quality objectives, quality risks and responses in **Agenda Item 2–C** are likely to be affected by the QCTF’s proposals in relation to EQC reviews, engagement partner performance and rewards, and engagement partner competency and human resources. Furthermore, although the prescribed quality objectives, quality risks and responses in **Agenda Item 2–C** are based on the requirements in extant ISQC 1, the QCTF has yet to fully consider these requirements, for example, whether additional or more enhanced requirements are necessary or how to further introduce scalability into these requirements.
- (b) The information and communication component in **Agenda Item 2–B** may be affected by the QCTF’s proposals with respect to transparency reporting.

The QCTF plans to further consider these topics after the June 2016 IAASB meeting and will present its recommendations to the IAASB in September 2017.

Components of ISQC 1 and Terminology

10. In December 2016 and March 2017, the QCTF presented the proposed components of the firm’s quality management to the IAASB and the CAG respectively. Both were generally supportive of the proposed components and provided various additional suggestions. Nevertheless, the QCTF noted the IAASB’s confusion regarding the use of terminology in describing the quality management system, for example, the difference between “quality management” and the “quality management process”, as well as what is considered to be components of quality management and elements of applying the QMP. While the QCTF recognizes that certain components of quality management are not strictly part of a “system”, the use of the term “system of quality management” is easier to comprehend and is similar to the current terminology in ISQC 1 (i.e., “system of quality control”). Furthermore, this term would assist in differentiating the entire system of quality management from the “QMP”. Accordingly, the QCTF proposes that throughout ISQC 1, the term “system of quality management” should be used.
11. The QCTF deliberated the use of the terms “foundational component”, “component” and “element” that were used to describe the various parts of the firm’s system of quality management. The QCTF noted that while these terms would have limited use in ISQC 1, it is important to use them consistently to avoid unnecessary confusion. Accordingly, the QCTF determined that the following terms would have the related meaning:
 - (a) Component refers to the three interactive concepts within the system of quality management (as illustrated in the diagram in paragraph 16):
 - Governance and leadership, including organization, culture and strategy.
 - Information, communication and documentation.
 - QMP

The requirement in paragraph 21 of **Agenda Item 2–B** requires the firm to establish and maintain a system of quality management that includes these components.

- (b) Element refers to the elements of the firm’s system of quality management that exist in extant ISQC 1, however exclude leadership responsibilities for quality within the firm and

monitoring as these form part of the components described above.³ It is noted that the elements have not been retained in their current state in the proposed revisions to ISQC 1, as further explained in paragraph 82.

- (c) QMA refers to the concept of a risk-based approach to managing quality that forms the basis for the revisions to ISQC 1.
 - (d) QMP refers to the component within the firm's system of quality management that establishes requirements for firms in relation to quality objectives, quality risks and responses, and includes monitoring and remediation.
12. The QCTF also considered the various other suggestions from the IAASB related to the use of terminology, for example, replacing the term "responses" with "controls". The QCTF continues to believe that the terminology used by the QCTF in its initial drafting remains appropriate in order to minimize confusion with other frameworks that use similar terms with different meanings, for example, the use of the word "controls" in the COSO Internal Control – Integrated Framework.⁴
13. The QCTF considered whether the component of "organization, culture and strategy that foster quality" should be a stand-alone component, as recommended by the IAASB. As explained in paragraphs 26–33, the QCTF is of the view that the firm has a responsibility to establish governance principles in relation to quality and implement such principles through various actions, including through assigning responsibility and accountability for quality to firm leadership. In this context, the QCTF debated how "organization, culture and strategy that foster quality" would exist as a stand-alone component since these concepts are encompassed within the governance principles and the responsibilities of firm leadership. Accordingly, the QCTF recommends that the component of "governance and leadership" should instead be titled "governance and leadership, including organization, culture and strategy", as these are all linked and inseparable. Furthermore, by including "organization, culture and strategy" together with leadership, the QCTF is of the view that leadership's responsibility for these factors is further emphasized.
14. The QCTF also considered the following:
- (a) Whether "documentation" is a subset of information and communication, i.e., whether it should be incorporated in the title of the component. The QCTF is of the view that documentation has many purposes, which may be additional to the function of information and communication, for example, documentation is a mechanism to evidence the firm's compliance with ISQC 1. Accordingly, the QCTF recommends that "documentation" remain in the title of this component.
 - (b) The prominence of the component "monitoring and remediation" in the context of the firm's system of quality management. The QCTF remains of the view that this forms part of the QMP, and has sufficient prominence in ISQC 1 (paragraphs 38–50 of **Agenda Item 2–B**).
 - (c) Whether "re-evaluating the QMP" should be a discrete component. The QCTF agreed that the firm should re-evaluate their QMP, however this would be part of the iterative, ongoing cycle within the QMP, rather than a periodic step. This iterative, ongoing evaluation is established through the proposed requirements and application material in the working draft. In particular:

³ These elements comprise (i) relevant ethical requirements, (ii) acceptance and continuance of client relationships and specific engagements, (iii) human resources, and (iv) engagement performance.

⁴ Committee of Sponsoring Organizations of the Treadway Commission (COSO), Internal Control – Integrated Framework

- In establishing quality objectives and identifying and assessing quality risks (including considering the continued relevance of the quality objectives and quality risks), the firm needs to be responsive to changes in the factors and circumstances affecting the firm (e.g., a new service offering, changes in the firm’s environment) or other information (e.g. the results of monitoring activities) (paragraphs A52, A57 and A70 of **Agenda Item 2–B**).
 - As part of the monitoring activities, the firm is required to design monitoring activities that include an evaluation of the QMP, including the appropriateness of the quality objectives and whether the QMP is appropriately identifying, assessing, and responding to the quality risks (paragraph 39(c) of **Agenda Item 2–B**).
 - As part of the remediation process, when deficiencies are identified, the firm’s evaluation of the effects of the deficiencies include a consideration of the continued relevance of the firm’s quality objectives, including whether all quality risks have been identified and appropriately assessed and whether the responses to quality risks remain appropriate (paragraph 46(b) of **Agenda Item 2–B**).
15. It was suggested by the CAG that the term “applying the QMP” was misleading since “applying a process” is illogical and may not be sufficiently clear that this component includes requirements. Paragraphs 58–86 of this Agenda Item further explore the QCTF’s recommendations in relation to the prescribed quality objectives, quality risks and responses that have been developed based on the elements of a system of internal control set out in extant ISQC 1 and how these would be integrated into ISQC 1.
16. Based on the recommendations of the QCTF set out above, the proposed structure of ISQC 1 would be as follows:
- (a) Governance and leadership, including organization, culture and strategy.
 - (b) Information, communication and documentation.
 - (c) QMP:
 - (i) Establish quality objectives;
 - (ii) Perform quality risk assessment;
 - (iii) Design and implement responses to quality risks; and
 - (iv) Monitor and remediate.



Matter for IAASB Consideration

1. Does the IAASB agree with revising the terminology to refer to the “firm’s system of quality management” instead of “the firm’s quality management”?

[Note: Further questions on the specific components and the proposed changes have been included in the respective sections of this Agenda Item addressing such components.]

Robustness and Scalability

17. **Agenda Item 2–B** demonstrates how the proposals of the QCTF would be executed, and **Agenda Item 2–D** contains a mapping of the requirements in extant ISQC 1 to the proposed requirements in **Agenda Item 2–B** and **Agenda Item 2–C**. The QCTF is of the view that the robustness of ISQC 1 has been retained and enhanced through:
- (a) Establishing governance principles in relation to quality that firms are required to implement through various actions, thereby providing a consistent guideline for firms in creating an environment that sustains and improves quality, and enhancing the requirements addressing the responsibilities of firm leadership.
 - (b) Improving the requirements related to information and communication, to give more recognition to the continual, iterative process of obtaining or generating and communicating information in order to support the functioning of the firm’s system of quality management, and emphasize the importance of both internal and external communication.
 - (c) Introducing the “QMP” that compels the firm to think about the relevant quality objectives and quality risks, based on its circumstances and environment, and identify responses that are targeted to addressing such risks. By identifying and managing quality risks, the firm is focused on areas of quality risk and opportunities for improvements may be identified. Furthermore, the QCTF is of the view that such a process encourages the firm to respond on a periodic and ongoing basis to changes in the firm’s circumstances or other information relevant to the firm’s system of quality management.
 - (d) Improving the requirements related to monitoring and remediation, and introducing the concept of a causal analysis that compels the firm to understand the underlying cause(s) of deficiencies, thereby improving how the firm responds to those deficiencies through remedial actions. The proposals also require the firm to take into consideration information from external inspections in establishing the scope and frequency of its monitoring activities and in identifying and remediating deficiencies.
 - (e) Retaining the requirements that exist in the elements of extant ISQC 1 through establishing them as prescribed quality objectives, quality risks and responses that are applicable to all firms.⁵
18. In accordance with the proposals in the ITC, the QCTF is continuing to explore the other topics that may require further enhancement in ISQC 1 that may also improve the robustness of the standard, including EQC reviews, networks, transparency reporting, engagement partner performance and rewards, and engagement partner competency and human resources.
19. While the robustness of ISQC 1 has been improved, the QCTF is cognizant of feedback from respondents that the standard needs to be scalable to the size, nature and structure of the firm. Accordingly, when developing the proposed requirements in ISQC 1, the QCTF considered different strategies for specifically conveying the intended scalability of the standard. In particular, the QCTF considered the following:
- (a) Are the requirements essential to a firm’s system of quality management, i.e., “think small first”?
 - (b) Are the requirements applicable to all firms in all circumstances, for example, perhaps the requirement should be conditional for certain circumstances?

⁵ **Agenda Item 2–C** includes the QCTF’s proposed prescribed quality objectives, quality risks and responses, as well as a mapping of these proposals to the extant requirements in ISQC 1.

- (c) How could the requirements be articulated to demonstrate their scalable application, for example, could application material explain the flexibility of the application?

For example, with respect to the requirement for the firm to establish governance principles in relation to quality and implement them through various actions, the QCTF noted that audit firm governance codes have been established in some jurisdictions, which contain detailed requirements for firm's governance, and corporate governance codes also typically contain many specific requirements. The QCTF determined that granular requirements would be too onerous for many firms and not relevant in all circumstances, and accordingly developed the four essential principles (paragraph 22 of **Agenda Item 2-B**), which the QCTF believes to be relevant in all cases. These principles are also outcome-based to further promote scalability, i.e., it is up to the firm to determine how these principles are actually achieved. The proposed application material acknowledges that jurisdictional codes may exist or firms may identify more extensive governance principles, in order to encourage firms to determine whether additional governance principles are relevant. However, for SMPs the four essential principles may be adequate.

20. The basis of the QMP is that the firm determines quality objectives and quality risks, based on its circumstances and environment and identifies responses that are targeted to address such risks. Nevertheless, as a safeguard to support the consistent and robust application of the QMP by firms, the standard includes prescribed quality objectives and quality risks that exist across all firms, and for which there are required responses (**Agenda Item 2-C**). Undertaking the QMP will necessitate effort by the firm in identifying quality objectives, quality risks and responses relevant to the firm that are supplementary to those set out in the standard, particularly in the first year of implementation. However, the outcome of this, if properly undertaken by the firm, will result in an improved system of quality management that focuses the firm's resources on areas of risk, and may eliminate any redundant activities currently performed by the firm. Although the firm will have a responsibility to reconsider the quality objectives, quality risks and responses as a result of changes and other information, the frequency of such considerations will depend on a variety of factors, for example, the rate of change of the firm's circumstances and deficiencies identified (i.e., if the system of quality management is effective and there are no changes in the firm's circumstances, the need to reconsider the quality objectives, quality risks and responses would be less likely).
21. There are other areas in the QCTF's proposals that introduce and highlight the flexibility and scalability of the standard. In addition to those described above, some examples include:
- (a) The outcome-based nature of the requirements related to information and communication.
 - (b) Allowing the firm to choose the nature of the response to quality risks, i.e., whether the firm chooses policies, procedures, processes or other methods as a response.
 - (c) Empowering the firm to determine the scope and frequency of the monitoring activities, which are driven by a variety of factors.
 - (d) Requiring the firm to consider the nature, timing and extent of the causal analysis procedures based on the nature of the deficiencies.
 - (e) Highlighting in application material how the quality objectives and quality risks may be established within the firm, i.e., that larger and more complex firms may establish quality objectives at a firm level, and cascade more granular quality objectives to various levels within the firm, while smaller and less complex firms may cascade more granular quality objectives directly to the engagement level.

Furthermore, the introductory section and related application material explains the importance of scalability, for example, by referring to the system of quality management being tailored to the circumstances of the firm.

22. In considering mechanisms to enhance the scalability of ISQC 1, the QCTF debated whether to retain the sections in the application material “Considerations Specific to Smaller Firms”. The QCTF noted that for a proper understanding of how the firm’s system of quality management should be set up and tailored to the circumstances of the firm, it is necessary to explain examples and considerations in relation to SMPs in the application material in the context of the matter, rather than discrete pieces that may be out of context or misunderstood if read in isolation. Furthermore, the QCTF is of the view that this guidance may be equally applicable to other firms, given that the system of quality management is inherently scalable. Accordingly, with a few exceptions, the sections in relation to “Considerations Specific to Smaller Firms” have been integrated into the application material as examples.
23. The QCTF recognizes that several new requirements have been introduced, and other requirements have been enhanced. The QCTF is of the view that the volume of the application material may need to increase in order to provide the necessary information to assist firms in understanding the new requirements and enable consistent application in practice (the QCTF notes the support from respondents to the ITC for additional application material across many topics). These revisions, together with extensive application material that has been proposed by the QCTF, may appear overwhelming. In this regard, the QCTF will continue to explore how to position the application material, in order to facilitate a reduced volume, for example, through the use of appendices or possibly a Staff Publication to assist with initial implementation. The QCTF also plans to continue consideration of how the ISQC 1 can be enhanced to address scalability as it further progresses the draft of the standard.

Matters for IAASB Consideration

2. Is the IAASB of the view that the proposals would result in the robustness of ISQC 1 being retained, and in some cases enhanced?
3. The IAASB is asked to share their views regarding the QCTF’s proposals to improve and emphasize the scalability of ISQC 1. In particular:
 - (a) Does the IAASB have any further recommendations on how scalability could be introduced in the standard, while retaining the necessary robustness?
 - (b) Does the IAASB agree with the QCTF’s recommendation to include examples and considerations in relation to SMPs in the application material in the context of the matter, rather than retaining the sections “Considerations Specific to Smaller Firms”?

Governance and Leadership, including Organization, Culture and Strategy

24. The ITC noted that ISQC 1 does not address firm governance, nor contain much detail as to what is expected from firm leadership in relation to firm governance, and therefore included various suggestions to address firm governance and enhance the role of firm leadership in sustaining and continually improving audit quality. These suggestions included:
 - (a) Seeking opportunities to enhance ISQC 1 to emphasize the importance of governance and a focus on quality at all levels within a firm, including through the use of a QMA.
 - (b) Clarifying leadership responsibilities to more explicitly incorporate commonly used and familiar terminology (e.g., “tone at the top” and “leading by example”).

- (c) Emphasizing the importance of firm leadership setting an appropriate culture for the firm and for taking responsibility and being accountable for extending that culture throughout the firm.
- (d) Considering whether there should be a requirement for accountability of firm leadership, or appropriate personnel within firm leadership, for matters related to quality.
- (e) More specifically requiring a firm to identify appropriate personnel within the firm's leadership to be responsible and accountable for independence matters.
- (f) Explicitly incorporating the concept of the public interest into ISQC 1 and emphasizing the importance of relevant public interest considerations in relation to the design of the firm's system of quality control.

The QCTF recognized the overall support from respondents for the proposed actions, although any actions would need to be flexible to accommodate different jurisdictions and firm structures.

25. The QCTF presented an overview of the proposals in relation to governance and leadership to the CAG at their March 2017 meeting. The CAG Representatives were supportive of the proposed direction, and emphasized the importance of firm leadership assuming ultimate responsibility and accountability for quality. The CAG further encouraged the QCTF to consider the practicality of introducing governance principles in the circumstances of SMPs. Accordingly, in developing the requirements, the QCTF considered the applicability of the governance principles to SMPs and how the requirements could be tailored to the circumstances of a broad range of firms. A further discussion of the QCTF's approach is included in paragraph 19.

Governance

26. A firm's governance is of paramount importance to quality since it is the way in which the firm embeds its culture and ethics and self-regulates, and serves as the framework for how the firm's decisions are made. A firm's governance also affects the public's perception of the firm; a firm without effective governance may be regarded as one that does not operate in the public interest. Accordingly, the QCTF is of the view that establishing governance principles would provide a consistent guideline for firms in establishing an environment that sustains improves engagement quality.
27. The QCTF recognizes that firms operate in a variety of environments and have different structures. Accordingly, the QCTF proposes introducing a requirement for the firm to establish governance principles in relation to quality and implement them through various actions. The proposed requirement also requires the firm to include certain governance principles set out in ISQC 1 (i.e., principles that the QCTF proposes to be applicable to all firms in all circumstances). Such an approach allows firms the flexibility to identify the most suitable governance principles, since in some circumstances more specific governance principles may be appropriate while in other circumstances the essential principles set out in ISQC 1 may be adequate. The proposed principles have been articulated in an outcome-based manner, which provides firms with flexibility in determining how the principles will be achieved.
28. In developing the principles, the QCTF considered numerous sources, including the following:
- *A Framework for Audit Quality: Key Elements that Create an Environment for Audit Quality* (Audit Quality Framework).
 - The United Kingdom [Audit Firm Governance Code](#), revised in July 2016.
 - The draft [Principles for Effective Management of Audit Firms \(The Audit Firm Governance Code\)](#) recently issued in Japan.

- The [Irish Audit Firm Governance Code](#), issued in January 2013.
 - The United Kingdom’s Financial Reporting Council publication [Corporate Culture and the Role of Boards Report of Observations](#).
 - The Royal Netherlands Institute of Chartered Accountants publication [Measures to Improve the Quality and Independence of the Audit in the Netherlands](#).
 - The COSO [Enterprise Risk Management Framework](#) (June 2016 edition exposed for public commentary).
 - The Organization for Economic Co-operation and Development (OECD) [G20/OECD Principles of Corporate Governance](#).
 - The [King IV Report on Corporate Governance for South Africa \(2016\)](#).
29. The QCTF noted that any governance principles would need to be internationally applicable and relevant to the overall objective of ISQC 1, i.e., supporting quality. Many of the sources highlighted above address governance from a commercial perspective, and the QCTF is of the view that given the scope of ISQC 1, it would be inappropriate to extend the governance principles beyond those necessary to support quality. Furthermore, while some of these sources include principles or requirements that may be highly effective in addressing quality, certain of these principles or requirements are not practically applicable to all types of firms, or would be difficult to mandate at an international level, for example, the creation of a separate governing board. Accordingly, although the governance principles recommended by the QCTF are based on these sources, they are not established at a similar level of specificity.
30. The four overarching governance principles that have been identified by the QCTF are as follows (paragraph 22 of **Agenda Item 2–B**):
- (a) *The firm’s internal culture fosters quality, including professional and ethical values, to support the firm’s public interest role:*

The firm’s internal culture is an important factor in influencing how the firm’s personnel function in the interests of the public, while at the same time working towards the accomplishment of the firm’s commercial goals. Paragraph 18 of extant ISQC 1 requires the firm to establish policies and procedures to promote an internal culture that recognizes the importance of quality. However, it does not explain the importance of quality in supporting the firm’s public interest role. In addition, the fundamental responsibility of firm leadership in embedding such a culture is not evident. Accordingly, along with the introduction of the governance principle set out above, the QCTF has proposed creating a more explicit link to firm leadership’s responsibilities in relation to culture (paragraph 23(a) of **Agenda Item 2–B**).

In addition to these improvements, the QCTF has proposed the addition of detailed application material, in response to feedback on the ITC, that:

- Explains why culture is so important to the firm’s system of quality management (paragraph A12 of **Agenda Item 2–B**).
- Emphasizes the role of all personnel in the firm in relation to the firm’s culture (paragraph A13 of **Agenda Item 2–B**).
- Provides examples of actions that can be undertaken by firm leadership to embed the culture (paragraph A13 of **Agenda Item 2–B**).

- (b) *The firm is organized in a manner that supports the effective design, implementation and operation of the firm's system of quality management:*

The organization of the firm encompasses:

- Establishing an internal firm structure;
- Designating authority and responsibility within the firm; and
- Maintaining and allocating sufficient and appropriate resources.

Establishing a structure within the firm and determining who in the firm is responsible for aspects of quality is critical to enabling decision-making and supporting the functioning of the system of quality management. The QCTF recognizes that certain jurisdictions prescribe the structure of the firm or the composition of the firm leadership and in many cases this has resulted in recognized improvements in firm governance. However, it is not practicable for ISQC 1 to do so, given its international application and the varying circumstances across firms and jurisdictions. Nevertheless, the QCTF is of the view that establishing the organization of the firm as a governance principle would have the effect of compelling firms to consider how to organize the firm in a manner that supports the effective design, implementation and operation of the firm's system of quality management.

- (c) *The firm has effective leadership with responsibility and accountability for quality.*

Under extant ISQC 1, firm leadership is assigned ultimate responsibility for the firm's system of quality control. Paragraph 35 to 38 below explain the QCTF's recommendations in relation to improving the requirements regarding the responsibility and accountability of firm leadership. These requirements descend from the governance principles, i.e., the governance principles establish the overall framework for the environment that is necessary to support quality, while the requirements regarding the roles and responsibilities of firm leadership support the implementation of those principles.

- (d) *The firm enhances stakeholder confidence in the public interest aspects of the firm's decision-making in relation to quality.*

The firm may have a variety of stakeholders, including the network or other network firms, audit oversight bodies and other external bodies, those charged with governance of the firm's clients or users of the firm's reports. Stakeholders' perception of the quality of engagements performed by the firm is improved when they consider that the firm supports and embeds a quality-focused culture that emphasizes the firm's public interest role. Accordingly, the QCTF is of the view that a fundamental guiding principle is that the firm should be cognizant of its stakeholder needs and take actions to build their confidence in the firm's decision-making. Furthermore, it encourages the communication with the firm's stakeholders about its commitment to quality.

31. The governance principles form the basis for the firm's decisions and how it acts in terms of the effects on quality, and therefore closely relate to the other components of ISQC 1. For example, in establishing the quality objectives, the firm considers whether the objectives are aligned with the firm's governance principles, or as part of its communication strategy, the firm considers the needs of its external stakeholders.
32. The QCTF debated how the requirement for these governance principles should be established, for example, whether the requirement should indicate that the firm shall apply these principles. The QCTF concluded that the requirement should focus on the firm establishing governance principles in relation to quality, thereby allowing the firm to consider additional principles that may be relevant in their circumstances.

33. In addition to establishing the governance principles, the QCTF noted that the firm would need to implement them through various actions in order that the outcome of the principles are achieved. Such actions would include those set out in the various proposed requirements of ISQC 1, including (i) assigning ultimate responsibility and accountability for quality to firm leadership and requiring firm leadership to take actions that address each of the principles, (ii) the firm's monitoring and remediation activities, and (iii) the responses the firm puts in place to address quality risks. In addition to these requirements, the firm may implement the governance principles through other actions that are further explained in the application material relating to governance and leadership.
34. An action that is of particular importance, and is a key element in many of the governance frameworks researched, relates to establishing a whistleblowing mechanism. Extant ISQC 1 includes this requirement, commonly known as "complaints and allegations", in the monitoring section of the standard. The QCTF debated whether it would remain appropriate for these requirements to form part of monitoring, or whether they are more suited to supporting the firm's application of the governance principles. The QCTF agreed that it would be best placed within governance given its importance to establishing the culture of the firm and to avoid the perception that complaints and allegations are only addressed through the firm's monitoring processes (paragraphs 26–27 of **Agenda Item 2–B**).

Leadership

35. As highlighted above, one of the governance principles includes having effective leadership with responsibility and accountability for quality, since firm leadership has a critical role in sustaining and continually improving quality. Firm leadership also has a responsibility to take actions to implement all of the governance principles established by the firm, for example, leadership is the key driver of the internal culture that fosters quality and establishes the professional and ethical values that support the firm's public interest role.
36. Under paragraph 18 of extant ISQC 1, the firm's chief executive officer (or equivalent), or the firm's managing board of partners (or equivalent) are required to assume ultimate responsibility for the firm's system of quality control. However, the QCTF is of the view that this requirement needs to be enhanced to further emphasize the importance of quality and to reflect firm leadership's responsibilities with respect to the governance principles. Accordingly, the QCTF proposes the following enhancements to the requirements addressing the responsibility of firm leadership (paragraph 23 of **Agenda Item 2–B**):
- (a) Extending the responsibility beyond the firm's system of quality control to being responsible for quality. Under extant ISQC 1, the focus is on firm leadership's responsibility for the firm's system of quality control. However, in the view of the QCTF, firm leadership's responsibility is broader and should focus on the ultimate objective of ISQC 1, i.e., quality.
 - (b) Introducing accountability for quality. Under extant ISQC 1, the focus is on the responsibility of firm leadership, while accountability is not mentioned. As these are different concepts, albeit interrelated, the QCTF is of the view that firm leadership should also be accountable for quality. Respondents to the ITC had also supported the suggestion to introduce accountability for quality in relation to firm leadership. This new requirement in relation to accountability for quality is supported by proposed application material that explains how accountability may be established and links accountability for quality to evaluating the effectiveness of firm leadership overall, as well as the performance of individuals within firm leadership (paragraph A28 of **Agenda Item 2–B**).

- (c) Explicitly highlighting the responsibility of firm leadership to conduct themselves in a manner that promotes the firm's culture and extends the culture throughout the firm. This aligns with the governance principle relating to the firm's culture and is consistent with the proposals in the ITC regarding firm leadership's responsibility for culture. While firm leadership needs to act in a way that embeds the culture, there are other actions that firm leadership can take to further extend the culture throughout the firm. The proposed application material explores some examples of how this can be undertaken (paragraph A13 of **Agenda Item 2–B**).
 - (d) Highlighting that firm leadership establishes a business strategy that is reflective of the firm's values and the importance of quality. The firm's business strategy defines how it will operate and accordingly is key to integrating quality within the firm. The QCTF noted the guidance in the Audit Quality Framework emphasizing the delicate balance between profitability and the need for the firm to achieve quality in all engagements, as well as paragraph A5(b) of extant ISQC 1 that discusses the assignment of management responsibilities so that commercial considerations do not override the quality of work performed. One member of the QCTF was of the view that commercial considerations have a fundamental impact on quality and therefore a requirement should specifically acknowledge the fact that commercial considerations should not override quality. However, other members of the QCTF were of the view that this could remain in application material, since commercial considerations are unlike the other leadership responsibilities as they are not associated with an action of leadership and therefore would be inconsistent. Furthermore, these members noted that balancing quality and commercial considerations would be an output of applying the governance principles and implementing the leadership actions.
 - (e) Highlighting firm leadership's role in establishing sufficient and appropriate resources. Providing the appropriate resources to support the firm's system of quality management is essential to its proper functioning, and firm leadership is in a position of power to influence the extent of the firm's resources and how they are allocated.
 - (f) Highlighting firm leadership's responsibilities in relation to the other governance principles, i.e., the organizational structure and stakeholder confidence.
37. The QCTF agreed that it needs to be clear who is responsible and accountable for the firm's system of quality management, and considered the references in extant ISQC 1 to the firm's chief executive officer (or equivalent) or, if appropriate, the firm's managing board of partners (or equivalent). The QCTF agreed that the current references are still relevant, but is of the view that further clarification is needed. In particular, in circumstances when the firm does appoint a managing board of partners, it would be inappropriate for the firm to allocate the responsibility and accountability for quality to a sole individual as may be currently implied in ISQC1. This is because other individuals on the managing board of partners are also in a position to influence the quality, culture and resources of the firm and may inappropriately do so if they are not equally responsible or accountable. Accordingly, the phrase "if appropriate" has been removed in referring to the firm's chief executive officer (or equivalent) or the firm's managing board of partners (or equivalent) and application material has been introduced to explain that in circumstances when there is a managing board of partners, that the entire managing board is responsible and accountable for quality and resources (paragraph A19 of **Agenda Item 2–B**).
38. In order to further embed the accountability of firm leadership, the QCTF is of the view that the performance of firm leadership needs to be evaluated (paragraph 25 of **Agenda Item 2–B**). The QCTF noted the performance evaluation of firm leadership is in fact a monitoring activity and debated whether it would be appropriate for this evaluation to extend to those person(s) that are

assigned operational responsibility for the firm's system of quality management. The QCTF concluded that given the importance of the role of such individual(s), it is important for them to also be evaluated. The QCTF agreed that it would be important to take appropriate action in response to the outcome of such performance evaluations and a requirement has been included to this effect. Application material that highlights who may perform the evaluation has also been included (paragraph A28 of **Agenda Item 2-B**). The QCTF will further explore application material to support aspects of such evaluations, in conjunction with the QCTF's work on engagement partner performance and rewards that will be presented to the IAASB in September 2017.

Resources

39. Under extant ISQC 1, the provisions in relation to resources focus on human resources, however there are many other types of resources that are necessary to support the firm's system of quality management and the performance of engagements, including financial resources, human resources, technology resources and intellectual resources (e.g., the firm's methodology or guides). Such resources do not only relate to resources directly utilized by engagement teams. Firms may require resources that indirectly support the performance of engagements, for example, a technical team and the resources needed to support the functioning of the technical team.
40. As a result, the QCTF is of the view that firm leadership's responsibilities related to resources discussed above should include all resources. Furthermore, the broader meaning of resources (i.e., including financial resources, human resources, technology resources and intellectual resources) is used in the QMP in relation to the prescribed quality risks and responses that are related to resources (**Agenda Item 2-C**).

Responsibility for the Firm's System of Quality Management

41. The QCTF has proposed retaining the requirement in paragraph 19 of extant ISQC 1 that addresses the experience, ability and authority of individuals who are assigned operational responsibility for the firm's system of quality management, although this has been enhanced with the addition of "accountability" of such individuals. Furthermore, the QCTF proposes the addition of application material that includes examples of how the firm may organize itself in terms of assigning operational responsibility for the system of quality management and how accountability may be established.

Responsibility for Independence Matters

42. The QCTF noted the mixed views from respondents to the ITC regarding the proposals for a requirement for the firm to identify appropriate personnel within firm leadership to be responsible and accountable for independence matters.
43. The QCTF is of the view that firm leadership is ultimately responsible and accountable for independence matters. Nevertheless, firm leadership may assign operational responsibility for compliance with the independence requirements within the firm, for example, in the case of a large firm the operational responsibility may be assigned to a particular partner. In such circumstances, the QCTF agreed that the individual(s) should have sufficient and appropriate experience and authority in the firm to assume that responsibility, and that a requirement in this regard would be appropriate.
44. The QCTF further agreed that assigning responsibility for the independence process would be a firm's response to the risk of non-compliance with the firm's independence requirements. Accordingly, the requirement would be placed in the QMP section (refer to R4 in **Agenda Item**

2–C). The QCTF noted that this approach would be consistent with how assigning responsibility for the monitoring process has been addressed in paragraph 42(a) of **Agenda Item 2–B**.

Other Matters

45. The ITC proposed incorporating the concept of “public interest” into ISQC 1 and emphasizing the importance of relevant public interest considerations in relation to the design of the firm’s system of quality management. The QCTF noted respondent’s overall mixed views about explicitly referring to the public interest. Nevertheless, the QCTF is of the view that firms should be reminded of their role with respect to the public interest, and actions the firm can take to enhance their consideration of their public interest role. Accordingly, throughout the requirements and application material in this component, the QCTF has proposed several references to the firm’s public interest role where relevant.
46. The QCTF noted the extensive support from respondents to the ITC for firm leadership to be more involved in monitoring the effectiveness and appropriateness of updated policies and procedures and remedial actions. As indicated in paragraph 44, the QCTF is of the view that specific responsibilities should be included in the sections to which they relate, and accordingly this has been incorporated in monitoring and remediation (paragraph 48 of **Agenda Item 2–B**).
47. In order to demonstrate the interconnectedness of the various components and to reinforce that information and communication is essential to each component of the firm’s system of quality management, emphasis has been given to effective communication in the application material in the governance and leadership section (e.g., embedding the firm’s culture and communicating roles and responsibilities within the firm).

Matters for IAASB Consideration

4. Paragraph 13 discusses the QCTF’s recommendation to combine “organization, culture and strategy that foster quality” with governance and leadership into a single component. Does the IAASB agree with this recommendation, particularly in light of the proposed requirements and application material in relation to this section?
5. Does the IAASB agree with the QCTF’s recommendation to introduce a requirement for firms to establish governance principles in relation to quality and to implement them through various actions? If so:
 - (a) Is the IAASB of the view that the four governance principles identified by the QCTF are appropriate?
 - (b) Are there additional governance principles that should be included?
6. The IAASB is asked to share their views regarding the QCTF’s proposals in relation to firm leadership, in particular the following:
 - (a) Does the IAASB agree that the responsibilities of firm leadership should be extended beyond being responsible for the system of quality control as is currently required by ISQC 1, i.e., that firm leadership should be responsible for quality?
 - (b) Does the IAASB agree that in circumstances when the firm has appointed a managing board of partners, that the full managing board of partners is responsible and accountable for quality, as proposed in paragraph 37?
 - (c) Does the IAASB agree that there should be an assignment of operational responsibility for compliance with the independence requirements, and that such person(s) should

- possess sufficient and appropriate experience and authority in the firm to assume that responsibility?
- (d) Does the IAASB agree with the introduction of a requirement for the firm to establish periodic performance evaluations that assess the effectiveness of the person(s) that are assigned ultimate responsibility or accountability for quality and does the IAASB support this being extended to any person(s) that are assigned operational responsibility for the firm's system of quality management?
- (e) Does the IAASB agree with the specific responsibilities identified in paragraph 23(a)–23(e) of **Agenda Item 2–B** and are there additional responsibilities that have not been identified that should be considered?
- (f) Does the IAASB agree with the conclusion of the QCTF that the requirements related to “complaints and allegations” are necessary in supporting the firm's culture and accordingly should be incorporated in the component “Governance and Leadership, including Organization, Culture and Strategy”?
7. Does the IAASB support the proposal to include references to public interest throughout the requirements in relation to “Governance and Leadership, including Organization, Culture and Strategy”, in order to remind firms of their role with respect to the public interest and actions the firm can take to enhance their consideration of their public interest role?

Information and Communication

48. At the December 2016 meeting, the discussion in relation to quality control included the importance of information, communication and documentation to the firm's system of quality management. Communication includes having appropriate communication resources (e.g., information systems infrastructure) to communicate information about quality across the firm and to provide timely and relevant information to the firm's leadership regarding the operation of the firm's system of quality management. The IAASB supported the QCTF's proposal that a number of revisions could be made to ISQC 1 related to the firm's information systems and communication processes.
49. The QCTF also presented its initial proposals with respect to information and communication to the CAG in March 2017 and noted the overall support from the CAG on the proposed improvements, in particular for increased emphasis on communication with external parties. The CAG also noted the importance of transparency reporting. The QCTF is continuing to discuss the topic of transparency reporting, and plans to present its recommendations to the IAASB in September 2017.
50. In exploring possible revisions to ISQC 1 to address information and communication, the QCTF considered other frameworks and sources that address information and communication, in particular the COSO Integrated Framework and the COSO Enterprise Risk Management Framework.⁶ The QCTF noted that both COSO frameworks also acknowledge the importance of information and communication as essential components of a system of quality management.
51. As indicated in the COSO Integrated Framework, communication is the continual, iterative process of providing, sharing and obtaining necessary information. The QCTF observed that under extant ISQC 1 the focus is on the firm's communication down to personnel, and gives little acknowledgement of the iterative nature of communication and the fact that information may come from a variety of sources. Accordingly, the proposed requirements in relation to information

⁶ The COSO Enterprise Risk Management Framework, released for public exposure in June 2016.

and communication include the following to emphasize the range of parties with whom communication may need to take place, and to highlight the two-way nature of communication:

- (a) A discussion of the various parties internal and external to the firm with whom communication may take place that demonstrates how information may be disseminated (paragraph 28(a)–28(c) of **Agenda Item 2–B**). This is further explained in paragraph 52.
 - (b) A specific requirement for the firm to establish policies or procedures that facilitate the communication of information relevant to the firm’s system of quality management with the relevant parties. The two-way nature of communication is further emphasized through highlighting that such information enables *the firm and the relevant parties* to take appropriate and timely action (paragraph 28 of **Agenda item 2–B**).
52. The QCTF identified the various information sources and stakeholders with whom two-way communication may take place, for incorporation in the requirement described above. These include:
- (a) Engagement teams who may need information in order to perform their engagements and may need to provide information to the firm that is necessary for the functioning of the firm’s system of quality management.
 - (b) Personnel performing functions in relation to the operation of the firm’s system of quality management who may need information to understand their roles and responsibilities and perform these functions. Likewise, these personnel may need to feed information up to the firm.
 - (c) Firm leadership who needs information in order to fulfill their oversight responsibilities for the firm’s system of quality management. Similarly, firm leadership has a key role in communicating information down into the firm, for example, in embedding the firm’s culture.
 - (d) Parties external to the firm who may need a variety of information. Such parties may include the network, network firms, external oversight authorities, users of the firm’s reports or the firm’s clients, external service organizations, or the firm’s legal counsel. Similarly, the firm may need information from these parties.
53. In addition to the requirement that specifies the various stakeholders, the QCTF has proposed application material that explains:
- (a) The type of information that may be communicated between these stakeholders (paragraphs A38–A41 of **Agenda Item 2–B**).
 - (b) The attributes of information that need to exist in order for the firm to place reliance on the information (paragraph A36 of **Agenda Item 2–B**). These attributes are similar to those related to information quality in the COSO Integrated Framework.
 - (c) The effectiveness of communication is dependent on the consistency of the matters communicated, the timeliness of the communication and the methods adopted by the firm to communicate the information (paragraph A44 of **Agenda Item 2–B**). This application material may encourage the firm to consider how to communicate information effectively.
54. The QCTF recognized that the other components of the firm’s system of quality management may need to contain specific requirements regarding communication. For example, there are communication requirements in relation to monitoring and remediation and the firm is required to establish processes to address whistleblowing. The QCTF agreed that it would be appropriate for such requirements to remain in the components to which they relate, instead of incorporating them within the information and communication section, given that information and communication is pervasive to all of the components of the system of quality management (i.e.,

specific requirements in the overall section of communication and information may undermine the universal nature of information and communication).

55. Nevertheless, the QCTF is of the view that linking the information and communication section to the specific requirements in the components is valuable in emphasizing how information and communication applies in relation to the components. For example, paragraph A13 of **Agenda Item 2–B** (relating to “governance and leadership, including organization, culture and strategy”) references to the firm’s responsibilities related to information and communication. Similarly paragraph A52 of **Agenda Item 2–B** (relating to “establish quality objectives”) highlights that the firm may consider the continued relevance of the quality objectives or whether all relevant quality objectives have been identified as a result of information, such as the results of monitoring activities or information communicated by engagement teams related to the firm’s system of quality management.
56. Information and communication are also prevalent in the quality risks and responses that form part of the QMP. The QCTF noted that in some cases the risks would arise because of insufficient information and therefore certain quality risks and responses identified in **Agenda Item 2–C** also include matters specifically related to information and communication.
57. In addition, the firm’s monitoring activities include an evaluation of the firm’s information and communication and whether it enables and supports the proper functioning of the firm’s system of quality management, which is a proposed requirement in paragraph 39(b) of **Agenda Item 2–B**. A cross-reference to this requirement has been included in the application material in the information and communication component.

Matters for IAASB Consideration

8. The IAASB is asked to share their views regarding the proposed requirements and application material addressing information and communication, in particular:
 - (a) Does the IAASB believe that these appropriately emphasize the importance of two-way communication?
 - (b) Do the proposed requirements and application material highlight the pervasive nature of information and communication, including that it is a continual, iterative process of providing, sharing and obtaining necessary information?
 - (c) Does the IAASB agree that specific requirements related to communication should be located in the sections of ISQC 1 to which they relate?

Quality Management Process

58. At the December 2016 meeting, the IAASB noted that the QMP would be an area that would be particularly challenging for SMPs to implement and provided various suggestions on the concepts proposed by the QCTF. The QCTF remains of the view that the firm should establish quality objectives, identify and assess quality risks and design and implement responses to the quality risks, and the QCTF’s thinking on how this would be established in ISQC 1 is further explained below. In developing the requirements related to the QMP, the QCTF considered other frameworks and sources that contain similar concepts, in particular the COSO Integrated Framework and how the ISAs have addressed a risk-based approach.
59. In December 2016, the QCTF also proposed an additional component of the firm’s system of quality management, “applying the QMP.” The QCTF envisioned that this would contain the elements in extant ISQC 1, converted to quality objectives, quality risks and responses consistent with the principles of a QMA. These quality objectives, quality risks and responses derived from

the elements in extant ISQC 1 would be relevant to all firms in all circumstances (these are referred to as “the prescribed quality objectives, quality risks and responses” in this Agenda Item). Since then, the QCTF debated how the proposed new requirements to establish quality objectives, identify quality risks and responses to such risks would be practically applied to the elements and the QCTF has developed its initial proposals in this regard.

Establish Quality Objectives

60. The overall objective of ISQC1 is set out in paragraph 16 of **Agenda Item 2–B** and the various requirements across all of the components contribute to achieving that objective. The QCTF debated whether it is necessary for the firm to establish quality objectives specific to the firm’s circumstances that support the overall objective of ISQC 1, and form the basis for the identification and assessment of quality risks.⁷ As part of this debate, the QCTF also considered how the quality objectives to be established by the firm would relate to the prescribed quality objectives.
61. The QCTF concluded that in supporting the notion that the firm’s system of quality management is tailored to the circumstances of the firm, the quality objectives would need to be relevant to the circumstances of the firm and set at an appropriate level of granularity. Furthermore, the quality objectives should facilitate the identification and assessment of quality risks, and accordingly would need to be sufficiently granular to support this. The QCTF agreed that consistency in the granularity of the quality objectives across firms would not be necessary, as some firms may identify high-level objectives that are equally as effective in providing a basis for the identification and assessment of quality risks as firms that cascade more granular quality objectives to various levels within the firm.
62. While ISQC 1 would establish prescribed quality objectives, these would not be established at a level of granularity, given the broad range of circumstances across firms and the fact that the quality objectives support the overall objective of ISQC 1. Accordingly, the expectation would be that the firm would use the prescribed quality objectives in ISQC 1 as a basis for the establishment of more relevant and granular quality objectives.
63. However, the QCTF agreed that the prescribed quality risks and responses would need to be set at a more granular level in order to capture the elements in extant ISQC 1 and to address the additional enhancements to ISQC 1 that were suggested in the ITC. The QCTF noted that the requirement for the firm to establish quality objectives would have a different approach from the requirements in relation to the firm’s identification of risks and design of responses. This would be the case because the quality objectives established by the firm would be derived from the prescribed quality objectives. Conversely, the quality risks identified by the firm would be more granular than the prescribed quality risks or additional to the prescribed quality risks, i.e., the prescribed quality risks would not identify all possible quality risks as these would need to be specific to the firm’s circumstances. The same principle would apply to the responses.
64. The QCTF has therefore proposed a requirement for the firm to establish quality objectives and for the firm to consider the relevance and granularity of the quality objectives (paragraphs 30–31 of **Agenda Item 2–B**). This is supported by application material to explain that the relevance and granularity of the quality objectives may change, for example, as a result of new information or changes in factors and circumstances (paragraph A52 of **Agenda Item 2–B**). This application material assists in emphasizing the principle of the QMA, i.e., that it is an on an ongoing and

⁷ Throughout **Agenda Item 2–B** and this Agenda Item, the term “overall objective” means the objective in paragraph 16 of **Agenda Item 2–B**, while the term “quality objectives” means the quality objectives established by the firm that support the overall objective.

continuous consideration of the circumstances of the firm and modifications may be needed from time to time, as necessary. Furthermore, the results of the firm's monitoring activities may highlight deficiencies in the firm's system of quality management and paragraph 46(b) of **Agenda Item 2–B** requires the firm to consider whether such deficiencies indicate that the quality objectives are inappropriate.

65. The requirements to establish quality objectives and consider the relevance and granularity are followed by the prescribed quality objectives, which form the basis for the quality objectives to be established by the firm (paragraph 32 of **Agenda Item 2–B**).⁸ The notion that the firm establishes more relevant and granular quality objectives based on these prescribed quality objectives is explained in the application material (paragraph A48 of **Agenda Item 2–B**). In identifying the prescribed quality objectives, the QCTF agreed that, consistent with the overall objective of the standard, the prescribed quality objectives would be related to:

- (a) The performance of engagements in accordance with professional standards and applicable legal and regulatory requirements.
- (b) The issuance of reports that are appropriate in the circumstances.

Nevertheless, the QCTF noted that it is also necessary that the firm has considered the engagement acceptance and continuance. The QCTF identified two discrete aspects in relation to the engagement acceptance and continuance:

- (a) An external aspect, i.e., the integrity, ethical values or diligence of management, and, where appropriate, those charged with governance, and their competence in relation to the subject matter of the engagement.
- (b) An internal aspect, i.e., the firm has sufficient resources to perform engagements in accordance with professional standards and applicable legal and regulatory requirements.

66. As a result, the prescribed quality objectives identified by the QCTF comprise four objectives, and the QCTF is of the view that these objectives represent the minimum appropriate level of granularity.

67. The QCTF is mindful that a firm's current system of quality control is already intended to support the achievement of the overall objective. As a result, the QCTF has recommended application material to highlight that in establishing the quality objectives for the first time, the firm may identify the quality objectives based on the firm's existing system of quality control (i.e., taking into consideration the activities that are already established by the firm and determining the intended purpose of such activities) (paragraph A53 of **Agenda Item 2–B**). This point has also been included in the application material supporting the identification and assessment of risks (paragraph A58 of **Agenda Item 2–B**). The QCTF recognizes that such application material may be better placed in guidance outside of ISQC 1 and will further consider this as part of its overall evaluation of the application material and the development of supplementary guidance.

Identify and Assess Quality Risks

68. As explained above, the prescribed quality risks that would be included in ISQC 1 would be granular in order to capture the elements in extant ISQC 1 and to address the additional enhancements to ISQC 1 that were suggested in the ITC. The prescribed quality risks would not address all possible quality risks, due to the varying circumstances across firms and therefore it would be up to the firm to identify all quality risks that are relevant to the firm. The firm may also identify quality risks that are a subset of the prescribed quality risks (i.e., more granular). A further

⁸ Paragraphs 78–86 below set out the QCTF's proposals on the prescribed quality objectives, quality risks and responses.

explanation of the QCTF's proposals regarding the prescribed quality risks is included in paragraphs 78–86 below.

69. In developing the requirements for the firm to identify and assess quality risks, the QCTF recognized that it would not be reasonable or practicable to expect the firm to identify and assess every possible quality risk. The QCTF agreed that there are some quality risks that are negligible and for which the firm would not be expected to take any further actions. Accordingly, the proposed requirement for the firm to identify and assess quality risks requires the firm to identify those risks that could *reasonably have an adverse* impact on the firm's ability to achieve its quality objectives. This is further explained in the supporting application material (paragraph A55 of **Agenda Item 2–B**).
70. Similar to how the risk identification and assessment process is established in ISA 315 (Revised),⁹ the QCTF recommends that the risk identification be enabled through understanding the factors that could create the risks, i.e., the conditions, events, circumstances, actions or inactions that, individually or combination could adversely impact the firm's ability to achieve its objectives. Paragraph A47 of **Agenda Item 2–B** includes factors that may be useful to the firm in identifying and assessing the quality risks.
71. The QCTF noted concerns from respondents to the ITC about the risk of an error or omission at the risk assessment stage of the QMP. The QCTF is of the view that this would be addressed through the firm's reassessment of its quality risks from time to time, for example, when there are new or changes to the conditions, events, circumstances, actions or inactions that give rise to the risks or when other information comes to the attention of the firm (paragraph A57 of **Agenda Item 2–B**). Furthermore, the results of the firm's monitoring activities may highlight deficiencies in the firm's system of quality management and paragraph 46(b) of **Agenda Item 2–B** requires the firm to consider whether such deficiencies indicate that the quality risks are inappropriate. As discussed in paragraph 61, in establishing the quality objectives, the firm is required to consider the granularity of the quality objectives in order that they facilitate the identification and assessment of quality risks, which may also partially prevent an error or omission at the risk assessment stage.
72. In researching other frameworks and how the risk assessment is established, the QCTF identified various factors that are useful to consider in assessing the likelihood and impact of the quality risks. The QCTF is of the view that such guidance is useful application material to support firms in assessing the quality risks and may provide some consistency in terms of how quality risks are assessed (paragraph A59 of **Agenda Item 2–B**).
73. The QCTF noted the IAASB's suggestion in December 2016 that the firm would need to establish its risk tolerance, which is linked to obtaining a reasonable level of assurance regarding the effectiveness of its system of quality management and is consistent with the principles in the COSO Integrated Framework. The QCTF debated how this concept would be applied in establishing quality objectives and identifying and assessing risks in the firm's system of quality management, and concluded that such an approach would add too much complexity to the standard. However, the QCTF is of the view that the concept of reasonable assurance in the context of a system of quality management could be better explained in ISQC 1 and this has been incorporated in the application material supporting the definition of reasonable assurance (paragraphs A5 and A6 of **Agenda Item 2–B**).

⁹ ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

Design and Implement Responses to Quality Risks

74. Similar to how the quality risks would be established in ISQC 1, the prescribed responses that would be included in ISQC 1 would be granular in order to capture the elements in extant ISQC 1 and to address the additional enhancements to ISQC 1 that were suggested in the ITC. The prescribed responses would not include all possible responses that are necessary to address quality risks, due to the varying circumstances across firms and to support the notion that the system of quality management is tailored to the firm. Therefore it would be up to the firm to design and implement responses to address all quality risks, including the prescribed quality risks. A further explanation of the QCTF's proposals regarding the prescribed responses is included in paragraphs 78–86 below.
75. Consistent with any risk-based framework, the QCTF is of the view that the nature, timing and extent of the responses to the quality risks is driven by the assessment of the quality risks, i.e., the higher the assessed risk, the more rigorous the response. The response is also affected by the factors that have caused the risk, for example, if the cause is a lack of information and communication, the response would focus on implementing procedures to support obtaining or generating and communicating the necessary information.
76. The QCTF is of the view that explaining the different characteristics of responses to risks, for example, preventative versus detective activities or manual versus automated, may prompt firms to consider the most appropriate response to address the quality risks. As a result, application material has been included to explain the different characteristics of responses for the firm to consider (paragraph A67 of **Agenda Item 2-B**).
77. As with the quality objectives and quality risks, the QCTF has introduced application material to explain the circumstances when the responses may need to be reassessed (paragraph A70 of **Agenda Item 2-B**). This is in addition to the requirement in paragraph 46(b) of **Agenda Item 2-B** that requires the firm to consider whether deficiencies identified indicate that the responses to quality risks are inappropriate.

Prescribed Quality Objectives, Quality Risks and Responses

78. The QCTF debated how the proposed new requirements to establish quality objectives, identify quality risks and responses to such risks would be practically applied to the elements in extant ISQC 1. **Agenda Item 2-C** includes the QCTF's proposed prescribed quality objectives, quality risks and responses, however these are for illustrative purposes in order to obtain the IAASB's views on:
 - (a) The level of granularity of the prescribed quality objectives, quality risks and responses.
 - (b) How the prescribed quality objectives, quality risks and responses interrelate, including whether the categorization into elements, consistent with extant ISQC 1, should be retained.
 - (c) Possible mechanisms for the presentation of the prescribed quality objectives, quality risks and responses in ISQC 1.

The QCTF will further explore the specific aspects of the quality objectives, quality risks and responses, including how these may need to be enhanced in response to other proposals in the ITC (e.g., engagement partner performance and rewards) and present its proposals to the IAASB in September 2017.

79. As explained above, the QCTF concluded that:
- (a) The prescribed quality objectives would be established at a high level, to support the consistency with the overall objective of ISQC 1.
 - (b) The prescribed quality risks and responses would be established at a granular level, in order to capture the elements in extant ISQC 1 and to address the additional enhancements to ISQC 1 that were suggested in the ITC. However, these prescribed quality risks and responses would be “incomplete”, due to the varying circumstances across firms and to support the notion that the system of quality management is tailored to the firm.
80. The QCTF noted that firms may incorrectly assume that the prescribed quality risks and responses in ISQC 1 are complete, and could fail to identify additional quality risks and responses that are necessary in the circumstances of the firm. The QCTF is of the view that ISQC 1 needs to clearly signal the significance and importance of firms establishing more granular quality objectives (as necessary), identifying quality risks in the context of the circumstances of the firm, and designing and implementing responses that are relevant, appropriate and address the identified risks. The introductory paragraphs of ISQC 1 highlight this and it is mentioned in application material supporting the QMP. However, the QCTF will give further consideration as to whether additional application material may be necessary to further emphasize this concept (paragraphs 6, 7, A48 and A49 of **Agenda Item 2-B**).
81. In developing the prescribed quality risks and responses, the QCTF analyzed the requirements within the elements in extant ISQC 1 in order to determine whether they relate to quality risks or responses. In undertaking this exercise, the QCTF grappled with the distinction between requirements that should be prescribed quality risks and those that are prescribed responses to the quality risks, and the QCTF further debated how granular the prescribed quality risks would need to be. The QCTF concluded that prescribed quality risks would be derived from the cause of the risk, for example, the firm may inappropriately accept an engagement but there is an underlying factor that causes the firm to do so (e.g., a lack of information). The QCTF noted that in cases where the extant requirement is a prescribed response, a correlating quality risk should be developed related to the response (i.e., it would be inappropriate for prescribed responses to exist in ISQC 1 that do not have a correlating prescribed quality risk).
82. The QCTF debated whether the categorization of the quality objectives, quality risks and responses according to the elements should be retained. This consideration arose as the QCTF noted that in some cases similar quality risks and responses exist across the various elements, for example, the prescribed quality risks and responses in relation to compliance with relevant ethical requirements apply to the elements “relevant ethical requirements”, “acceptance and continuance of client relationships and specific engagements” and “engagement performance”. Similarly, the quality risks and responses in relation to human resources apply to the elements “acceptance and continuance of client relationships and specific engagements” and “engagement performance”. In addition, the QCTF observed that categorization into elements could inadvertently discourage firms from considering quality risks and responses that may exist outside of these elements. The QCTF concluded that the categorization into elements may create an unnecessary obstacle for firms in properly identifying the quality risks and responses. Therefore the prescribed quality risks and responses have been combined into a single set of quality risks and responses (i.e., without categorization).
83. At this stage the QCTF is uncertain as to how the prescribed quality risks and responses should be placed in ISQC 1 in terms of:
- (a) Whether the quality risks and responses should be presented in a linear or tabular form.

- (b) The appropriate placement of the quality risks and responses in ISQC 1, i.e., whether they should be placed near the requirements related to identifying and assessing quality risks and designing and implementing responses, or whether they should be placed in a separate section of the standard.
84. **Agenda Item 2-C** includes both a tabular and linear form of the prescribed quality risks and responses. The tabular form more clearly demonstrates the relationship between the prescribed quality objectives, quality risks and responses than the linear form and therefore a tabular form may be more understandable in practice. Furthermore, a tabular form may also more clearly signal those prescribed quality risks that do not have related responses in ISQC 1, or the prescribed quality risks where the prescribed responses in ISQC 1 do not fully address the prescribed quality risks, thereby emphasizing the notion that the firm identifies responses that are tailored to the firm in order to address quality risks. However, such a format is not traditionally used throughout the IAASB's International Standards and if not suitable for the standard, could instead be used as an appendix to ISQC 1 or in other supplementary guidance in order to support the implementation of the standard.
85. The QCTF also debated the appropriate placement of the prescribed quality risks and responses in ISQC 1. Paragraphs 35 and 37 of **Agenda Item 2-B** have been included as placeholders for these requirements. However, the QCTF is concerned that this placement could cause confusion with the overall requirements and application material related to identifying and assessing the risks and designing and implementing responses. On the other hand, placing the quality risks and responses in a separate section, "applying the QMP," as originally proposed by the QCTF in December 2016, is disconnected from the concepts of identifying and assessing risks and designing and implementing responses and firms may therefore overlook their responsibility to establish quality objectives, identify and assess quality risks, and design and implement responses that are tailored to the circumstances of the firm.
86. The QCTF indicated in their proposals in December 2016 that in order to emphasize the scalability of ISQC 1, the responses to quality risks that are specified in ISQC 1 would refer to responses in the more general sense, rather than "policies and procedures" which is the term used in extant ISQC 1. The QCTF explained that this would provide more flexibility for firms to consider the most appropriate response to the quality risk. The QCTF further debated this differentiation and the appropriate use of the terms "responses" and "policies and procedures." The QCTF concluded that the prescribed responses (i.e., those in **Agenda Item 2-C**) should require the firm to establish policies and procedures, as there is a need to establish a consistent response to addressing quality risks in the standard. Nevertheless, the QCTF agreed that switching the term "policies *and* procedures" to "policies *or* procedures" would emphasize some flexibility for the firm, for example, that policies are not required in all instances. The QCTF further agreed that the term "responses" should be used in relation to the actions designed and implemented by the firm to address quality risks that are additional to the prescribed responses in **Agenda Item 2-C**, as these actions could comprise a variety of forms, for example, training or assigning responsibility. The QCTF has included application material to explain this differentiation, as well as the advantages of having formal documented policies and circumstances when this may be needed (paragraphs A62–A63 of **Agenda Item 2-B**).

Matters for IAASB Consideration

9. Does the IAASB agree with the proposals of the QCTF in relation to the requirements to establish objectives, identify and assess risks and design and implement responses to the risks, set out in paragraphs 30–37 of **Agenda Item 2-B**, in particular:

- (a) Does the IAASB agree with the considerations of the firm in establishing the quality objectives, i.e., (i) the alignment with the firm's governance principles, strategy, professional standards and applicable legal and regulatory requirement, (ii) whether they are relevant to the circumstances of the firm and all relevant quality objectives have been identified, and (iii) the appropriate level of granularity?
- (b) Does the IAASB agree with the approach of identifying quality risks through an understanding of the conditions, events, circumstances, actions or inactions that could give rise to those risks?
- (c) Does the IAASB agree with the threshold that has been established in identifying quality risks, i.e., those risks could reasonably have an adverse impact the firm's ability to achieve its quality objectives?
- (d) Is the IAASB of the view that the requirements clearly set out the expectations in establishing quality objectives, identifying and assessing quality risks and designing and implementing responses and would these be able to be applied in practice?
10. The IAASB is asked to share their views in relation to the prescribed quality objectives, quality risks and responses set out in **Agenda Item 2–C**, in particular:
- (a) Is the IAASB of the view that the level of granularity of the prescribed quality objectives, quality risks and responses is appropriate?
- (b) Does the IAASB support the QCTF's proposal to consolidate the prescribed quality objectives, quality risks and responses, rather than place these into the categories according to the elements in extant ISQC 1?
- (c) Does the IAASB have any suggestions regarding the presentation of the prescribed quality objectives, quality risks and responses and their placement in ISQC 1?

Monitoring and Remediation

87. In the ITC, it was noted that an effective system of quality control requires policies and procedures that provide for the regular assessment of the adequacy and effectiveness of that system, including a mechanism by which the system is evaluated and modified, as appropriate, when deficiencies are identified. It was further highlighted that the use of a QMA by the firm would create an opportunity to provide a stronger link to monitoring and remediation within the firm's system of quality control and would help to promote a focus on continuous improvements in quality. The ITC included various proposals in relation to monitoring and remediation, including the following:
- (a) Strengthen the requirements and application material for firms to respond to all feedback in relation to quality control, including feedback from external inspection findings, as well as other quality reviews that a firm might perform.
- (b) Include requirements to address actions firms should take to understand the causes of deficiencies identified by internal and external inspections and other reviews, and from other information sources.
- (c) Introduce requirements to clarify the necessary actions regarding the analysis of audit deficiencies and corrective measures.
- (d) Introduce requirements and application material addressing the monitoring by firm leadership of the effectiveness and appropriateness of remedial actions.

The QCTF observed that respondents were overall supportive of these proposals. A more detailed analysis of respondent's comments is included in the **Supplement to Agenda Item 2**.

88. Given the general support from respondents to the ITC for the proposals, the QCTF is of the view that the requirement to establish a monitoring process in paragraph 48 of extant ISQC 1 should be extended to establishing a monitoring and remediation process (paragraph 38 of **Agenda Item 2–B**).
89. The QCTF debated the purpose of the firm's monitoring and remediation process (paragraph 48 of extant ISQC 1) in determining possible revisions to ISQC 1. Under extant ISQC 1, the monitoring process is designed to provide "reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, and operating effectively". The QCTF is of the view that the monitoring process is not designed to provide the firm with reasonable assurance about the effectiveness of the procedures put in place to address the overall objective. The QCTF agreed that instead the monitoring and remediation process is designed as an evaluation of whether the firm's system of quality management is effective in providing the firm with reasonable assurance that its overall objective has been achieved. This has been captured in the revisions to ISQC 1 (paragraph 38 of **Agenda Item 2–B**).
90. In developing the requirements related to monitoring and remediation, the QCTF considered what this process would typically entail and identified the following steps:
- (a) Design monitoring activities, including the nature, scope and frequency of such activities;
 - (b) Perform internal monitoring activities;
 - (c) Assess the results of the monitoring activities and external inspections, in order to identify deficiencies in the firm's system of quality management;
 - (d) Address deficiencies identified if there is an indication that a report may be inappropriate or that procedures were omitted during the performance of an engagement;
 - (e) Determine the cause(s) of deficiencies and evaluate the effect of deficiencies;
 - (f) Implement appropriate remedial action(s);
 - (g) Monitor the effectiveness of the remedial actions and evaluate whether the remedial actions appropriately address deficiencies; and
 - (h) Communicate matters in relation to monitoring and remediation.
91. This process has been included in the application material as the QCTF is of the view that it helps to clearly set out the requirements that follow within this section of ISQC 1 (paragraph A72 of **Agenda Item 2–B**).

Monitoring

92. The QCTF noted that the existing requirements in paragraph 48 of ISQC 1 are generally focused on inspection of engagements, and are not necessarily clear that monitoring activities over firm-wide controls are also important. Recognizing the views of respondents, including a member of the monitoring group¹⁰, that more emphasis is needed on internal monitoring reviews of firm-wide controls, the QCTF recommends that more recognition is needed in the requirements in relation to monitoring the firm's overall system of quality management. This has been introduced through the following revisions:

¹⁰ International Forum of Independent Audit Regulators

- (a) A requirement for the firm to design and perform monitoring activities that are sufficient to provide the firm with an evaluation of the various components of the system of quality management (paragraph 39 of **Agenda Item 2–B**). This includes the identification of the components in order to remind firms that monitoring also addresses governance and firm leadership, information and communication and the QMP, including monitoring and remediation itself (i.e., the monitoring activities should also be sufficient to evaluate whether the monitoring and remediation supports the firm in achieving its overall objective).
 - (b) A requirement for the firm to determine the scope and frequency of the monitoring activities, that takes into consideration the firm’s system of quality management (paragraph 40 of **Agenda Item 2–B**).
 - (c) Application material that includes examples of other types of monitoring activities (paragraph A77 of **Agenda Item 2–B**). Including other types of engagement reviews, such as peer reviews, may also give recognition to these forms of reviews as possible monitoring activities, as noted by respondents to the ITC, in particular those representing the views of SMPs and the public sector.
93. The QCTF recognizes that the nature, timing and extent of the firm’s monitoring activities will vary from firm to firm, and therefore the requirements need to be clearly scalable. Nevertheless, there are circumstances when monitoring activities are usually undertaken, for example, in cases when the firm’s circumstances have changed, aspects of the firm’s system of quality management have changed, or the results of previous monitoring activities have identified a high number of deficiencies. Accordingly, paragraph 40 of **Agenda Item 2–B** requires the firm to determine the scope and frequency of the monitoring activities, taking into consideration these factors. This is supported by application material to explain how these factors or information may impact the scope and frequency of the monitoring activities, thereby highlighting the scalability of the requirement but at the same time ensuring the firm remains responsive to information that may indicate the need for monitoring activities to be undertaken.
94. The factors in paragraph 40 of **Agenda Item 2–B** also link to information obtained from external inspections, i.e., a possible deficiency in the firm’s system of quality management identified from external inspections may indicate the need for monitoring activities to be undertaken. This further supports the notion that the firm should respond appropriately to information from external inspections.

Inspection of Completed Engagements

95. The QCTF is of the view that the firm should determine risk-based criteria that establish which engagements should be subject to inspection, since the nature and extent of engagement inspections is dependent on what is needed by the firm to support its evaluation of its system of quality management. Accordingly, a requirement has been introduced for the firm to do so, together with application material that sets out the types of factors for the firm to consider in determining the criteria (paragraph 41 and A81 of **Agenda Item 2–B**). Such an approach is beneficial in that it encourages the firm to consider all engagements, including those that may have been subject to the cyclical inspection process. For example, there may be a circumstance when the engagement was subject to inspection as it was selected as part of the firm’s cyclical inspection of the engagement partner, but may need to be inspected in a following year as a result of certain attributes of the engagement.
96. The QCTF recognizes that the retention of a requirement to perform cyclical engagement inspections is necessary in supporting consistency across firms, however will further debate

whether this requirement should apply to all engagements as is the case in paragraph 48(a) of extant ISQC 1, or whether it should be amended to apply to audits of financial statements only.

97. The QCTF noted the views of respondents that improvement is needed in relation to engagement inspections to promote more substantive reviews of the quality of work on higher risk and judgmental areas, instead of a “tick-box” approach. The QCTF concurs with this view and has included various considerations in the application material in relation to the nature and extent of the procedures to be undertaken in performing the evaluation of completed engagements (paragraph A83 of **Agenda Item 2–B**).

Other Requirements in Extant ISQC 1

98. The QCTF noted paragraph 48(c) of extant ISQC 1 which indicates that those performing the engagement or the EQC review should not be involved in inspecting the engagement. The QCTF is of the view that those performing monitoring activities should have sufficient and appropriate experience, knowledge and capacity to perform the monitoring activity and should be sufficiently objective from the activity subject to monitoring. The QCTF notes that this would apply to all monitoring activities and not only those related to inspection of engagements and therefore have included this as a general requirement (paragraph 42(b) of **Agenda Item 2–B**). The extent of such experience, knowledge, capacity and objectivity would vary depending on the underlying activity being monitored and this is explained in the application material.
99. The QCTF has also retained the requirement for the firm to assign responsibility for the monitoring process to a partner or partners or other persons with sufficient and appropriate experience and authority in the firm to assume that responsibility. However, consistent with the assignment of responsibility in relation to independence, this requirement refers to assigning “operational responsibility” for monitoring and remediation (paragraph 42(a) of **Agenda Item 2–B**).

Remediation

100. The QCTF agreed that after performing the monitoring activities, it is necessary for the firm to assess the results in order to identify possible deficiencies. The QCTF also noted the general support from respondents for addressing the results of external inspections in ISQC 1. Accordingly, a new requirement for the firm to assess the results of its monitoring activities and external inspections has been introduced (paragraph 43 of **Agenda Item 2–B**). This is supported by a new definition explaining the meaning of “external inspections” to provide further clarity on the scope of inspections that should be subject to the firm’s consideration (paragraph 17(i) of **Agenda Item 2–B**).
101. The QCTF observed respondents’ support for introducing a causal analysis for deficiencies identified by inspections and other types of reviews. The QCTF had various debates in relation to the causal analysis and addressing the deficiencies, including:
- (a) On which deficiencies the causal analysis should be performed.
 - (b) At what point the pervasiveness of the deficiency is considered (i.e., whether it is systemic or isolated), for example, when the deficiency is identified or after performing the causal analysis.
 - (c) Whether the remedial actions are designed to address the deficiencies or the causes of the deficiencies, and how ISQC 1 would address remedial actions in relation to deficiencies for which no causal analysis has been performed
102. The QCTF concurred that once a deficiency has been identified in relation to an engagement and there is an indication that the report may be inappropriate or that procedures were omitted during

the performance of the engagement, the firm would be expected to take immediate action, irrespective of the cause of the deficiency. Accordingly, paragraph 44 of **Agenda Item 2–B** includes this requirement, which is similar to paragraph 52 of extant ISQC 1.

103. While deficiencies are typically identified from monitoring activities or external inspections, other information sources may also indicate deficiencies in the firm’s system of quality management. Accordingly, the application material notes that deficiencies may be identified from sources other than monitoring activities and provides examples (paragraph A88 of **Agenda Item 2–B**).

Causal Analysis

104. The QCTF debated which deficiencies should be subject to a causal analysis and determined that the causes of all deficiencies should be understood by the firm in order to implement appropriate remedies. The QCTF also agreed that the nature and extent of the firm’s process to determine the causes of the deficiencies would vary depending on the nature of the deficiency. For example, the causes of some deficiencies may be more obvious and immediately identifiable, whereas other deficiencies may need a more rigorous process to understand the underlying causes. As a result, a requirement for the firm to determine the causes of deficiencies has been introduced, and the nature, timing and extent of the procedures undertaken is determined by the firm based on the nature of the deficiencies (paragraph 45 of **Agenda Item 2–B**). This is supported by application material to explain that the work effort of the firm may vary according to the nature of the deficiency (paragraph A90 of **Agenda Item 2–B**).
105. As a result of this resolution, the QCTF agreed that it would be inappropriate to use terminology such as “root cause analysis” and “causal factor analysis” in these requirements. The QCTF noted that these terms are commonly used in practice and are generally implied as a rigorous process established by firms to understand the causes of deficiencies. The QCTF is of the view that it would be inappropriate for firms to apply such a rigorous process to all deficiencies identified.
106. The QCTF recognizes the importance of ensuring that the breadth and depth of the causal analysis is appropriate so that the right causes are identified. Accordingly, application material has been included that explains the purpose of the causal analysis, provides examples of causes to indicate the level of specificity, and explicitly explains that the factors need to be specific with an illustration of factors that are insufficiently specific, for example, a lack of professional skepticism (paragraphs A93–A94 of **Agenda Item 2–B**).
107. Furthermore, the QCTF has introduced application material that provides an overview of some of the procedures the firm may implement in order to undertake a causal analysis (paragraph A92 of **Agenda Item 2–B**). In developing this guidance, the QCTF referred to the recent publication by the United Kingdom Financial Reporting Council, [Audit Quality Thematic Review Root Cause Analysis A review of the six largest UK audit firms](#). The QCTF has also included guidance to emphasize the importance of establishing the competence of those performing the causal analysis.

Evaluating the Effect of Deficiencies

108. Paragraph 49 of extant ISQC 1 requires the firm to evaluate the effect of deficiencies. The QCTF is of the view that evaluating the effect of the deficiencies is important, as this affects the nature, timing and extent of the remedial actions. Accordingly, the requirements indicate that the firm is required to evaluate the effect of the deficiencies and further requires the firm to determine whether the causes are systemic, repetitive or other causes that require timely remedial action (paragraph 46 of **Agenda Item 2–B**).

109. The revised requirements also require the firm to consider the continued relevance of the firm's quality objectives, whether all quality risks have been identified and appropriately assessed and whether the responses to quality risks remain appropriate (paragraph 46(b) of **Agenda Item 2–B**). This is an important step in the QMP since it links back to the firm's assessment of its quality objectives, quality risks and responses.

Remedial Actions

110. The QCTF noted that paragraph 51 of extant ISQC 1 includes remedial actions that the firm is required to implement, for example, changes to policies and procedures, communication to those responsible for training etc. The QCTF is of the view that these requirements are too restrictive and do not provide flexibility for firms to identify the most appropriate and effective remedial actions. Accordingly, the QCTF has proposed removing the specific actions, and replacing them with a requirement that requires the firm to implement appropriate remedial actions (paragraph 47 of **Agenda Item 2–B**).
111. Consistent with the proposals in the ITC and as a result of the general support from respondents, the QCTF has proposed a new requirement for the firm, including those assigned ultimate responsibility and accountability for quality, to monitor the effectiveness of the remedial actions to address the causes and evaluate whether the remedial actions appropriately address the deficiencies identified (paragraph 48 of **Agenda Item 2–B**).

Communicating Matters Related to Monitoring and Remediation

112. Paragraphs 50 and 53 of extant ISQC 1 include requirements related to communication. The QCTF recommends that these be consolidated into a single requirement addressing communication with the parties identified in paragraph 28 of **Agenda Item 2–B** (paragraph 49 of **Agenda Item 2–B**). The QCTF concluded that all of these parties have some level of information needs in relation to monitoring and remediation, although these would vary depending on their roles and responsibilities. Therefore the requirement emphasizes the relevance of the information to be communicated.
113. The QCTF also debated whether the requirement to communicate on an annual basis should remain. The QCTF agreed that in some circumstances information may need to be communicated more frequently than on an annual basis in order that causes are rectified and remedial actions implemented on a timely basis. However, the QCTF is of the view that the requirement to communicate at least annually should be retained, as this would drive the firm to assess their system of quality management at least on an annual basis. Accordingly, the QCTF recommends that the requirement indicate that the information should be communicated on a timely basis or at least annually.

Matters for IAASB Consideration

11. Paragraph 14(b) discusses the QCTF's recommendation to retain monitoring and remediation as a subset of the QMP process. Does the IAASB agree with this recommendation?
12. Does the IAASB agree with the purpose of monitoring and remediation explained in paragraph 89?
13. Does the IAASB support the inclusion of external inspections in paragraph 40 and 43 of **Agenda Item 2–B**?

14. Does the IAASB consider the requirements in paragraph 40 of **Agenda Item 2–B** to be appropriate, including the factors the firm is required to consider in determining the scope and frequency of the monitoring activities?
15. Does the IAASB agree with the QCTF's recommendation in relation to engagement inspections, i.e., that the firm is required to set out criteria for the selection of completed engagements for inspection that sufficiently support the firm in its evaluation of its system of quality management?
16. Does the IAASB agree with the proposal to include a requirement relating to the experience, knowledge, capacity and objectivity of those performing the monitoring activities?
17. Does the IAASB support the proposals in relation to the causal analysis, in particular, does the IAASB agree with the conclusion of the QCTF that the causal analysis should apply to all deficiencies that are identified by the firm, and that the nature, timing and extent of the procedures undertaken by the firm to determine the cause(s) of deficiencies are determined by the firm based on the nature of the deficiencies?
18. Does the IAASB agree with including a requirement in monitoring and remediation for the firm to consider the appropriateness of the quality objectives, quality risks and responses in evaluating the effect of deficiencies identified?
19. Does the IAASB agree with the inclusion of a requirement for the firm, including those assigned ultimate responsibility and accountability for quality, to monitor the effectiveness of the remedial actions and evaluate whether they appropriately address the deficiencies identified?
20. Does the IAASB agree with the revisions to the communication in relation to monitoring and remediation, including the conclusion to retain the requirement to communicate on an annual basis?

Interconnectedness of the Components

114. The components within the system of quality management are highly interconnected. The governance principles form the framework for how the firm's decisions are made and therefore promote an environment that sustains and improves quality. The actions the firm takes to implement the governance principles may include the responses the firm designs and implements in addressing the quality risks, for example, the firm's responses in relation to compliance with relevant ethical requirements may assist the firm in embedding the firm's internal culture, in particular the professional and ethical values.
115. Information and communication is necessary in order for all of the components of the firm's system of quality management to function. There are requirements that are directly linked to information and communication, for example, in relation to monitoring and remediation. There are also numerous prescribed quality risks and responses that relate to information and communication, for example, those relating to engagement acceptance and continuance. Information also supports the firm in establishing quality objectives and identifying and assessing quality risks and in undertaking monitoring and remediation activities.
116. Establishing the quality objectives also has many relationships with the other components. For example, in establishing the quality objectives the firm's governance principles are required to be considered. Furthermore, when deficiencies in the firm's system of quality management are identified, including as a result of monitoring activities, the firm is required to consider the continued relevance of the firm's quality objectives.

117. The same requirement applies to quality risks and responses, i.e., when deficiencies in the firm's system of quality management are identified, the firm is required to consider whether the quality risks and the responses to quality risks remain appropriate.
118. In designing the monitoring activities, the firm is required to determine the scope and frequency of the monitoring activities by taking into consideration various factors that include the design and implementation of the firm's system of quality management, for example, quality risks that are assessed as higher risks may warrant increased focus in monitoring activities. Furthermore, as highlighted above, the results of the monitoring activities may also indicate deficiencies in relation to the quality objectives, quality risks and responses that require further consideration.
119. The firm's responses to quality risks may provide information that indicates deficiencies in the firm's system of quality management. For example, responses that monitor breaches of the firm's independence policies or procedures may highlight deficiencies in the firm's system of quality management.
120. The QCTF is of the view that it is important that the relationships between the various components are clear, since the components depend on the proper functioning of other components and the firm's evaluation of its system of quality management focuses on the system as a whole, rather than the individual components that make up the system. Accordingly, throughout the requirements and application material, the QCTF has explained these relationships and included various cross-references, as appropriate.

Matter for IAASB Consideration

21. The IAASB is asked to share their views regarding whether the interconnectedness of the components is clear in **Agenda Item 2–B**?

Changing Behaviors

121. In December 2016 and March 2017, both the IAASB and the CAG encouraged the QCTF to consider how the proposals would change firm behavior. The QCTF is mindful that a firm's current system of quality control is intended to support the achievement of the overall objective of ISQC 1. The QCTF further noted that behaviors are influenced by a range of factors, including factors that exist outside the system of quality management, for example, the Audit Quality framework describes some of the external factors that contribute to the improvement of audit quality.
122. The QCTF is of the view that the revisions to ISQC 1 could positively influence firm behavior and the behavior of the firm's personnel (including firm leadership and those assigned operational responsibility for the firm's system of quality management) in a variety of ways. These include the following:
 - (a) A preventative approach to managing quality. The risk-based approach that has been integrated into the revisions in ISQC 1 would result in firms anticipating the risks that could arise in order to proactively implement responses to address them. Under extant ISQC 1, the policies and procedures are standardized across firms, and therefore additional risks that are specific to the firm's circumstances may not be proactively identified, considered and addressed.
 - (b) A clear responsibility for the firm to consider the system of quality management on an ongoing basis. Across the proposed revisions, the firm is required to respond to information that may impact its system of quality management, for example, changes in the firm's circumstances and information that may indicate deficiencies in the firm's system of quality management. Under extant ISQC 1, there is no recognition of the impact of changes in the

firm's circumstances, or clear need to respond to information that may indicate deficiencies. Considering the system of quality management on an ongoing basis will require firm-wide efforts and a long term commitment to quality.

- (c) A responsibility to tailor the system of quality management for the circumstances of the firm. The revised approach to ISQC 1 is a risk-based approach for which targeted responses are designed and implemented by the firm. While the requirements in extant ISQC 1 would be retained in the form of prescribed quality risks and responses, these are being taken a step further as the firm would be required to identify additional quality risks and consider whether additional responses are needed in the circumstances.
- (d) A holistic approach to quality management. This is established through the interrelationship of the components. In extant ISQC 1 the elements are set up independently of each other and there is not a clear link as to how the outcome of a particular element impacts other aspects of the firm's system of quality control. Under the new approach, in setting up and maintaining its system of quality management, the firm would need to ensure that the components are suitably interconnected.
- (e) A responsibility on the firm to embed governance principles that support quality and the firm's public interest role and enhanced responsibility and accountability of firm leadership. The new governance principles and enhanced responsibility and accountability of firm leadership are more robust than the responsibilities of firm leadership in extant ISQC 1, thereby placing additional responsibilities on firm leadership for quality. These changes include increased focus on the firm's culture and the role of firm leadership in embedding that culture through the firm. The firm's culture directly influences the behavior of all firm personnel.
- (f) A responsibility to establish mechanisms to support information and communication. The proposed changes support a more robust approach to obtaining or generating and communicating information throughout the firm and emphasizes that communication is two-way. This is expected to change firm behaviors as information and communication will be a critical consideration in establishing and maintaining a system of quality management.
- (g) Increased recognition of external stakeholders, to improve the firm's recognition of its public interest role. This is established in both the governance principles and in the information and communication and is expected to influence firm behavior through factoring the firm's public interest role in the decisions made by the firm and in engaging with external stakeholders.
- (h) Improved understanding of the causes of deficiencies. This is established by the requirement for the firm to understand the causes of deficiencies identified, which is not a requirement in extant ISQC 1. An improved understanding of the causes of deficiencies is expected to influence firm behavior since it would assist the firm in properly addressing the causes of deficiencies.

Matter for IAASB Consideration

22. The IAASB is asked to share their views regarding how the proposals could change firm behavior, and whether there are any unintended consequences on firm behavior that may arise as a result of the proposed revisions to ISQC 1.

Separate Standard Addressing EQC Reviews

123. Given the importance and value placed on the role of the EQC review by stakeholders, particularly investors and regulators, the ITC requested views from respondents regarding whether a separate EQC review standard would be appropriate to give further prominence to, and emphasize the importance of, the EQC review. Respondents to the ITC had mixed views regarding whether a separate standard should be developed for EQC reviews.
124. The QCTF presented the views of respondents to the IAASB at the September 2016 IAASB meeting, and the IAASB agreed with the QCTF's view that the necessity for a separate standard would only be clear once the QCTF has considered all of the issues relating to EQC reviews, in particular the complexity and volume of the enhanced proposals and how these integrate within the firm's system of quality management.
125. Subsequent to the discussion with the IAASB in September 2016, the QCTF has presented the proposed requirements and application material relating to EQC reviews to the IAASB in both December 2016 and March 2017. In order to further develop the exposure draft of ISQC 1, the QCTF is of the view that it would be beneficial at this time to determine whether the requirements relating to the EQC review should be incorporated into a separate standard.
126. Both extant ISQC 1 and ISA 220¹¹ include requirements and application material discussing the EQC reviewer's responsibilities with respect to the performance of the EQC review (including what the review should include, the eligibility of the EQC reviewer and the documentation requirements) and such requirements are repetitive across the two standards. ISQC 1 contains requirements regarding which engagements are subject to an EQC review and paragraph 19 of ISA 220 contains requirements addressing the responsibility of the engagement partner in relation to the EQC review.
127. If a separate standard were to be developed, i.e., a new ISQC, the QCTF envisions that the requirements would be established in a manner similar to how the communication of key audit matters are established in ISA 700 (Revised)¹² and ISA 701:¹³
- (a) A requirement would remain in ISQC 1 under the responses to quality risks for the firm to establish policies or procedures that require an EQC review to be performed for audits of financial statements of listed entities, where required by law or regulation and other engagements according to the firm's risk-based criteria (for example, see R13 in **Agenda Item 2–C**). This would be supported by application material that addresses which engagements fall within the scope of an EQC review.
 - (b) All other requirements related to EQC reviews would be placed in a new ISQC, i.e., the requirements related to how the EQC review should be performed, the eligibility of the EQC reviewer and the documentation of the EQC review.
128. However, if a separate standard was not developed, the QCTF envisions that all of the requirements in relation to the EQC review would remain in ISQC 1, however the location of such requirements would need to be further considered, given they would be of a different nature than the other prescribed responses proposed by the QCTF.
129. Under both options, the requirements in ISA 220 in relation to an EQC review would be those related to the responsibility of the engagement partner (similar to those contained in paragraph 19 of extant ISA 220) and the engagement partner's responsibility to implement firm level policies

¹¹ ISA 220, *Quality Control for an Audit of Financial Statements*

¹² ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*

¹³ ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

or procedures at an engagement level. The requirements in paragraph 20 and 21 of extant ISA 220 would not remain.

130. The QCTF considered the various benefits and challenges of developing a separate standard or retaining the requirements in ISQC 1. The performance of an EQC review is a required response in the circumstances when the engagement meets the prescribed criteria and is addressed through requirements that prescribe the nature and extent of the EQC review and the eligibility and selection of the EQC reviewer. Therefore, the nature of these requirements are more robust in comparison to how the other required responses of ISQC 1 have been developed (i.e., the other responses often require the firm to develop policies or procedures but do not prescribe specific requirements to be contained within those policies or procedures). Further, the QCTF is of the view that the level of prescription in relation to the requirements addressing EQC reviews is inconsistent with the underlying concepts of a QMA that have been embedded in the revisions to ISQC 1. Furthermore, locating the material in a separate standard would allow for greater elaboration of the requirements and application material.
131. The QCTF also considered whether placing the requirements in a separate standard would help emphasize the scalability of ISQC 1. The QCTF concluded that this would assist with emphasizing the scalability of ISQC 1 as it may support the concept that the firm identifies the most appropriate responses to address quality risks (i.e., if the EQC review is not required to be performed or does not meet the firm's risk-based criteria, other responses may be appropriate). The QCTF is also of the view that the scalability of ISQC 1 would be clearer as the new ISQC would apply only when firms are required or choose to perform an EQC review (i.e., similar to how the communication of key audit matters is addressed in ISA 700 (Revised) and ISA 701).
132. The QCTF noted the challenges set out in the ITC regarding the development of a separate standard, in particular that this approach could result in duplication or that linkages between the EQC review and the overall system of quality management could be lost. However, the QCTF determined that a separate standard would not result in duplication or a missing linkage, given that the requirement for the performance of an EQC review would remain in ISQC 1, with the details of how this is undertaken being located in the new ISQC.
133. However, the QCTF observed that locating the requirements in a separate standard could be perceived as giving undue prominence to an EQC review in relation to other important factors in quality management, in particular the role of the engagement partner.

Matters for IAASB Consideration

23. Does the IAASB support the development of a separate standard for EQC reviews?

Next steps

134. As highlighted throughout this paper, the QCTF continues to deliberate the other discrete topics that form part of a firm's system of quality management. The table below highlights the various topics that have been discussed with the IAASB since the issuance of the ITC, including those set out in this Agenda Item, and the additional topics that have yet to be considered by the QCTF and presented to the IAASB. Following the June 2017 discussion, the QCTF will consider the next topics to be deliberated and presented to the IAASB in September 2017 and those that will be discussed at a later time.
135. The QCTF will continue to coordinate with the ISA 220 Task Force at both a Staff and Task force level, including on matters of mutual interest such as networks and client engagement acceptance and continuance. The QCTF recognizes that the changes to ISQC 1 may also impact the IAASB's

International Standards other than the ISAs, and these will need to be further considered in terms of whether conforming amendments or other changes are needed.

136. The QCTF observed that the various changes to the International Ethics Standards Board for Accountants (IESBA) *Code of Ethics for Professional Accountants* (the Code) may impact ISQC 1 and these will need to be considered in drafting the quality risks and responses. Conversely, the proposed changes to ISQC 1 may have an impact on various aspects of the IESBA Code. Accordingly, the QCTF intends on coordinating with the IESBA Staff on matters of mutual interest as the revisions to ISQC 1 are further developed.

Topic	Discussions with the IAASB since the issuance of the ITC	Further discussions
Components of ISQC 1	December 2016 and June 2017	No further discussions are likely necessary
Governance and leadership, including organization, culture and strategy	June 2017	Further discussions in response to the IAASB's input from June 2017
Information and communication	June 2017	Further discussions in response to the IAASB's input from June 2017
Documentation		To be presented to the IAASB later in 2017
Transparency reporting		To be presented to the IAASB in September 2017
QMP	June 2017	Further discussions in response to the IAASB's input from June 2017
Prescribed quality objectives, quality risks and responses	June 2017	Further discussions needed on the quality objectives, quality risks and responses and how these will be presented in ISQC 1, to be presented to the IAASB later in 2017
EQC reviews	September 2016, December 2016, March 2017 Separate standard: June 2017	Further discussions in response to the IAASB's input from March 2017 and June 2017
Engagement partner performance and rewards, and engagement partner		To be presented to the IAASB in September 2017

Topic	Discussions with the IAASB since the issuance of the ITC	Further discussions
competency and human resources		
Monitoring and remediation	June 2017	Further discussions in response to the IAASB's input from June 2017 Consideration of outstanding issue on engagement inspections to be presented to IAASB later in 2017
Networks	June 2017 (Agenda Item 4–A)	How this will specifically be addressed in ISQC 1 will be presented to the IAASB later in 2017
Consideration of the effect of changes to the IESBA Code		To be presented to the IAASB later in 2017
Impact on IAASB's International Standards (excluding the ISAs)		To be presented to the IAASB in early 2018

Minutes from the December 2016 IAASB Meeting

Quality Control – ISQC 1

Ms. French provided an overview of the Quality Control Working Group's (QCWG) recommendations on the possible approach to revising ISQC 1 to incorporate quality management, as presented in **Agenda Item 6-A**. Ms. French provided feedback from the SMP Committee, highlighting its support for the proposals and the components and their agreement that the proposals would keep the standards robust. She noted, however, their concerns that the proposals could be an add-on to the existing requirements of ISQC 1 and the SMP Committee's encouragement to ensure the standards are scalable. She added that the SMP Committee encouraged the IAASB to keep the standards clear and simple, to think about the appropriate placement of the examples and to consider how the incorporation of quality management would operate in networks of firms.

The Board was supportive of the overall direction proposed by the QCWG, but emphasized the importance of the change management related to this project, including considering what the proposals are expected to achieve, how the proposals would change behaviors and the impact on audit firms, as well as how regulators inspect audit firms. The Board encouraged the QCWG to improve the linkage of ISQC 1 to the Audit Quality Framework, and to consider the applicability of the proposals to other services as the standard is developed.

COMPONENTS OF QUALITY MANAGEMENT

The Board was supportive of the proposed components of quality management and how these were depicted in the diagram to reflect how they inter-relate. The Board provided the following suggestions:

- Governance and leadership are important to the effective functioning of the firm's quality management, however "governance and leadership" are elements that exist outside of the firm's quality management and should be articulated in terms of the role they play in the firm's quality management.
- "Organization, culture and strategy that foster quality" should be presented as a separate component from "governance and leadership", as this is a fundamental element of quality management that could be understated if it were subsumed as part of "governance and leadership". Furthermore, the link between "governance and leadership" and "organization, culture and strategy that foster quality" needs to be clear, as well as any relationship between firm culture and ethical considerations.
- Given the fundamental nature of "monitoring and remediation", it may warrant more prominence than how it is depicted or implied in **Agenda Item 6-A**.
- "Information, communication and documentation" are not foundational components for effective quality management, but are rather important measures needed to support effective quality management. Furthermore, documentation is conceptually a subset of information and communication and accordingly should not be incorporated in the heading.
- The difference between "quality management" and the "QMP" needs to be clarified, as well as what is considered to be components of quality management and elements of applying the QMP. Clarification of other terminology was also recommended and there were some suggestions to align the terminology with that used in the COSO Integrated Framework.

ROBUSTNESS OF ISQC 1

The Board was of the view that more specific details of how the proposals would be developed is necessary to support the understanding of whether the robustness of ISQC 1 would be retained. The Board also recommended that the requirements be established in terms of levels, through establishing outcomes-based or principles-based requirements at an overall level, providing flexibility in terms of their implementation, with a further layer of more specific requirements.

SCALABILITY OF ISQC 1

The Board agreed with the QCWG's suggestions on how to incorporate scalability in ISQC 1, and provided the following additional comments and questions:

- What is meant by “scalability” and “proportionality” needs to be clarified in order to facilitate the development of the requirements.
- How the concepts of quality management would apply in the circumstance of networks of firms is important to being able to demonstrate scalability.
- Being clear about at what level the “QMP” would be applied within the firm, including whether it applies to all services, would be necessary to establishing the scalability of ISQC 1.
- The use of terminology is important, for example, “informal” has connotations that the firm does not need to have very rigorous quality management and would be better contextualized as “simple.”

QUALITY MANAGEMENT PROCESS

The Board noted that this would be an area that would be particularly challenging for SMPs to implement. The Board also had various suggestions relating to the proposals in respect of the requirements for the QMP:

- With respect to the assessment of the risks to quality, the Board cautioned that this should not be confused with performing the assessment of risks of material misstatement as contemplated in ISA 315 (Revised), and the assessment should be based on an understanding of the engagements performed by the firm.
- Consistent with the COSO Integrated Framework, the firm would need to establish its risk tolerance, linked to obtaining a reasonable level of assurance regarding the effectiveness of its quality management.
- There should be recognition in ISQC 1 that responses to quality risks may be established by the firm but are implemented at an engagement level.
- It was suggested that “re-evaluating the QMP” should not be a discrete element, and that this would be part of monitoring and remediation and the assessment by firm leadership of the effectiveness of the firm's quality management.

APPLYING THE QUALITY MANAGEMENT PROCESS

The Board did not agree with the use of the phrase “at a minimum” to indicate that the objectives and responses are the minimum required in addition to the firm's own evaluation of its quality objectives and responses, as it was perceived that this could create unintended consequences. The Board encouraged the QCWG to establish well-defined objectives that clarify what is considered to be quality. The Board recommended that the identification and assessment of risks to quality also needs to be included in order to support the requirement being scalable and proportional and that the term

“responses” be considered in the context of other control frameworks and the terminology in the ISAs. The Board cautioned that the existing requirements of ISQC 1 would need to be carefully considered as they are updated and transposed.

PIOB OBSERVER REMARKS

Prof. Van Hulle highlighted the importance to the public interest of establishing requirements that support consistent audit quality across firms globally.

WAY FORWARD

The QCWG will consider the Board's comments in further developing the revisions to ISQC 1, as well as considering what outreach will be necessary in 2017 in order to establish how the proposals may impact firms and regulators. The QCWG will present their further recommendations to the Board at its March 2017 meeting, in particular in relation to monitoring and remediation, governance and leadership and information, communication and documentation.

Extract of Minutes from the March 2017 CAG Meeting

Ms. French introduced the topic and explained how a QMA would be translated into the various components comprising the firm's system of quality management. She further indicated how the structure of ISQC 1 would be revised to accommodate these components and explained how the existing elements of ISQC 1 would be adapted to reflect the principles of quality management. Ms. French provided insight as to how the QCTF envisions the robustness of the requirements of ISQC 1 would be retained, while at the same enhancing the scalability of the standard.

The Representatives were generally supportive of the direction proposed by the QCTF in relation to how a QMA would be incorporated in ISQC 1 and the proposed components. The Representatives commented further as follows:

- Mr. Iinuma and Mr. James were of the view that more clarity is needed on how these proposals would be operationalized, including scalability. Mr. James was also unclear as to whether a QMA is “built-in” to ISQC 1 or whether it would be an “add-on” to ISQC 1. Ms. French agreed that it is difficult to understand the proposals until such time as all of the requirements are presented together and noted that this would be the focus of the QCTF in the next few months.
- Mr. Baumann suggested clearly articulating the problems with the extant standard and evaluating how the QMA would solve these problems, for example, if there are consistently high levels of deficiencies in the audits performed, how would improvements to the firm's system of quality control translate into improvements in the quality of audits. Mr. Iinuma was of the view that examples of where firms have applied a QMA in practice would be helpful and also questioned how a QMA would change firms' behaviors. Ms. French agreed that as the standard is developed, it will be critical to keep in mind the original intention of the changes. She added that practical examples will be critical to proving the concept of a QMA, including demonstrating the scalability of ISQC 1 and how firms of different sizes would apply the requirements.
- Ms. Pettersson agreed with Mr. Bauman's comments and questioned whether a QMA would promote and support a more preventative and continuous approach to quality management, i.e., that quality is achieved in the engagement throughout the process, rather than quality being addressed through detection at the end or after the completion of the engagement. Prof. Schilder agreed and noted that achieving quality the first time around is the fundamental goal. Ms. French noted that the foundations of the QMA are based on a preventative, proactive

approach to quality management, rather than a detective approach, and highlighted that the revisions to ISA 220 would also incorporate this principle.

- Messrs. Perera and Lang were supportive of the proposals relating to scalability. However, Ms. Molyneux cautioned that overly emphasizing scalability could result in firms not implementing policies and procedures, or other responses, necessary to comply with ISQC 1 and that adequately address the firm's responsibility for quality. Similarly, Mr. Yoshii noted that in practice entities may appoint firms without appropriate resources and skills because the audit fees are lower for such firms. Mr. James was of the view that while flexibility is positive, the standard also needs to enable consistent application in practice and be enforceable. Ms. French explained that maintaining the robustness of the standard is critical to the revisions, and that there would be certain objectives, risks and responses which all firms would be expected to apply that are based on the current elements of ISQC 1.
- Mr. Fortin was supportive of the "foundational components" as important aspects that underpin the firm's system of quality management. He also suggested reconsidering the term "applying the QMP", since "applying" a process is illogical and may not be sufficiently clear that this component includes requirements. Ms. French agreed that the terminology used needs to be sufficiently clear that this component incorporates requirements, and accordingly indicated that the QCTF would reconsider the terminology.
- Mr. van der Ende expressed his support for maintaining the robustness of the standard and noted that the components of governance and leadership and information and communication are very important. He explained that in the Netherlands firms are required to establish a "public interest committee" comprising external senior representatives, and that this function has resulted in a positive effect on firms through the committee's independent challenge of the firm's leadership and actions they take. Ms. French thanked Mr. van der Ende for the insightful information.
- Ms. Pettersson emphasized the importance of incorporating inspection findings into ISQC 1 in order to improve quality management.

GOVERNANCE AND LEADERSHIP, INCLUDING ORGANIZATION, CULTURE AND STRATEGY

Ms. French explained how governance principles would be introduced in to ISQC 1 and the QCTF's initial thinking regarding possible enhancements to the requirements addressing leadership's responsibilities. She added that these provisions would also address the organization, culture and strategy of the firm. Ms. French noted that the QCTF is considering including references to the firm's public interest role in the requirements and application material, where relevant, to remind firms of their responsibilities.

The Representatives were generally supportive of the QCTF's proposals in relation to governance and leadership and commented further as follows:

- Ms. Molyneux was particularly supportive of the component of "governance and leadership" and suggested that merely calling this component "governance" would encompass all of the aspects including leadership, culture, strategy and organization. Ms. French noted that the QCTF had extensively debated the terminology of the components and would consider this suggestion while ensuring the terminology is clear and understandable.
- Mr. Fortin and Ms. Molyneux noted that each individual within the firm is responsible for their work. Nevertheless, they, in addition to Mr. James and Mr. Rockwell agreed that there needs to be ultimate responsibility and accountability for quality at the highest level within the firm.

Ms. Molyneux suggested that the proposals relating to firm leadership's accountability for quality needs additional emphasis.

- Mr. Iinuma and Ms. Molyneux highlighted the importance of the governance principles being principles-based in order that smaller firms are able to apply the governance principles in practice. Ms. Robert and Ms. Lang expressed their support regarding the new QMA approach, but expressed concern that there may be difficulties for small- and medium sized practices in applying governance principles. Mr. Iinuma made reference to the Japanese audit firm governance code which is principles-based and noted that how the firms are governed would vary from firm to firm. Ms. French explained that the QCTF is considering how to develop the governance principles in a manner that would facilitate application by all firms, but at the same time ensure the requirements are not too broad that they are not sufficiently robust and achieve their intended purpose.
- Mr. James challenged the proposals of the QCTF related to the firm identifying appropriate personnel within firm leadership to be responsible and accountable for independence matters. He noted that Agenda Item H.1 suggested that firm leadership would be responsible for quality, yet it was implied that it is not possible to assign responsibility for independence to a single person. Mr. James suggested that the same principle should be applied to assigning responsibility for independence as was applied to assigning responsibility for quality to firm leadership. Ms. French explained that the QCTF was of the view that independence is subsumed as part of quality and noted that the QCTF is debating the extent to which ISQC 1 should require specific allocation of responsibility for certain matters, such as independence. Mr. James added that while he agrees that independence is a subset of quality, independence is a matter that is sufficiently important that it warrants separate identification.
- Mr. Fortin agreed that governance is an important underpinning component. However, he was concerned that the types of principles identified in Agenda Item H.1 are incomplete or limited, for example, it doesn't include a concept similar to the "public interest committee" that is required in the Netherlands and he questioned how transparency would be addressed in these principles. Ms. French explained that the QCTF had undertaken extensive research of various governance codes and other publications related to governance in developing the proposals and further explained that the topic of transparency reporting would be discussed by the QCTF and with the Board in the near future.
- Mr. Rockwell noted his support for including references to public interest in the requirements and application material.
- Mr. Yoshii noted that a culture that promotes professional skepticism at engagement level is established through the governance of the firm.

INFORMATION AND COMMUNICATION

Ms. French explained why information and communication are important to the functioning of the firm's system of quality management and further noted that the QCTF is considering how to reflect the iterative nature of information and the importance of two-way communication in the requirements. She noted that the QCTF had not yet deliberated "documentation", as further understanding is needed on how the rest of ISQC 1 would be developed.

The Representatives commented as follows:

- Mr. Yoshii noted that communication with parties external to the firm is very important. Ms. French agreed and noted that the QCTF was evaluating how to emphasize the importance of external communication in ISQC 1.

- Ms. Molyneux explained the importance of the firm communicating externally regarding the firm's governance and how it manages quality, and noted that only providing internal communication of these matters is too limited. Ms. Molyneux and Ms. Robert were of the view that such information is important to those charged with governance in appointing the audit firm and understanding their approaches to quality. Mr. James noted the International Organization of Securities Commissions report on *Transparency of Firms that Audit Public Companies*, and highlighted that firms tend to use transparency reports as a tool for marketing purposes, with inadequate information about the firm's system of quality management and how quality is being addressed and monitored. Mr. James further noted that the requirements related to transparency reports across jurisdictions are basic and therefore suggested that the IAASB has the opportunity to raise the bar by introducing requirements that promote high quality transparency reports. Ms. Molyneux agreed and added that governance is about striving to exceed the minimum requirements. Ms. French indicated that the QCTF is still considering the topic of transparency reporting and that they would consider what type of information is appropriate in developing the requirements. She added that ISQC 1 would most likely address circumstances when the firm is required to prepare a transparency report and would include the type of information that should be communicated in such circumstances.
- Mr. Baumann explained that in some jurisdictions, such as the United Kingdom, firms are required to conclude in the transparency report on the effectiveness of their system of quality control. However, he noted that often firms may conclude in the transparency report that the firm's system of quality control is effective, yet the results of external inspections reflect a different outcome. He added that companies are expected to go through a rigorous process in order to be able to conclude on the effectiveness of their internal control (e.g., in the United States) and therefore questioned whether firms should also be expected to go through a similar process in concluding on the effectiveness of their system of quality control. Mr. Fortin noted that the European Union has the same regulation as the United Kingdom.
- Mr Dalkin noted that many firms strive to undertake quality work and follow the requirements of the standards, and cautioned that adding additional requirements may disproportionately burden such firms because there are other firms that do not intend on complying with the standards. Mr. Koktvedgaard noted that through his role in relation to disciplinary hearings, firms have either failed to read the standard or have no desire to comply with the standard. Mr. Koktvedgaard was therefore supportive of less, but more precise, requirements.
- Mr. Yoshii highlighted that in Japan the quality of the transparency reports is very poor and that investors struggle to understand the information presented. Accordingly, he was supportive of the IAASB addressing this topic.
- Ms. Robert referred to the legislation within the European Union regarding the transparency report and to the Accountancy Europe publication about audit quality indicators.
- Ms. Lang indicated that the development of the requirements related to documentation would be critical to the scalability of ISQC 1.

QUALITY MANAGEMENT PROCESS

Ms. French explained how the requirements related to the QMP would be developed.

Ms. Lang noted that the Representatives were overall supportive of the direction proposed. The Representatives commented further as follows:

- Mr. Rockwell supported the concept of establishing a threshold for the risks for which no further response or consideration is needed by the firm, although was agnostic about how such a threshold should be established.
- Ms. Molyneaux indicated that those charged with governance of the entity may be interested about the quality objectives, the key performance indicators on the quality objectives, and encouraged transparency about the threshold for the risks for which no further response or consideration is needed by the firm.