ISQM 1: Overview of Feedback from the Exposure Draft and Outline of Proposals to Address Certain Issues

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Overview of Respondents

[Two pie charts showing the distribution of respondents by function and region.]
New Quality Management Approach (QMA)

• MG:
  – Enhancements needed to improve proactive and preventative approach
  – Needs to be able to support enforcement

• Other respondents:
  – Positive:
    • Promotes tailored systems and a proactive, integrated and thinking approach to quality management (QM)
    • Will help firms meet challenges facing the profession
  – Concerns:
    • How ED-ISQM 1 incorporates a QMA - hybrid of a risk-based approach and prescriptive requirements
    • Length and complexity of the standard
  – Suggestions included:
    • Reducing prescriptiveness of quality objectives and responses and more explicitly addressing quality risks
    • Restructuring the standard
    • Emphasis on aligning QM with the firm's business strategy and incorporating QM into enterprise risk management
Benefits for Engagement Quality and Professional Skepticism (PS)

- **MG:**
  - Support how ED-ISQM 1 addresses PS
  - Also address PS in governance and leadership
- **Other respondents:**
  - SOQM is the foundation for consistently delivering high quality engagements
  - Governance and leadership is critical to embedding and supporting a culture of quality and a focus on professional skepticism
  - Effect of the standard and expected benefits would vary from firm to firm
  - Address PS in other areas of the standard, particularly governance and leadership
  - Concerns:
    - Benefits may be limited for SMPs
    - Prescriptiveness = checklist mindset = unlikely to improve engagement quality
    - Implementing standard will be resource intensive – possible negative effect on engagement quality
    - Cost-benefit analysis needed
    - Extent of documentation needed to demonstrate compliance with the standard
Scalability

• MG:
  – Need for larger firms to scale-up (i.e., additional to what is in the standard)
  – Length of standard and proposed additional guidance – need for a critical review and improved clarity of standard

• Other respondents:
  – Examples and guidance will be needed to demonstrate scalability – however, the need for examples and guidance indicates lack of clarity of standard
  – Concerns:
    • Prescriptiveness of the standard - not scalable, and having required responses with no quality risks indicates approach is not risk-based
    • Length and complexity
    • Threshold for identifying quality risks is too low
    • Documentation burden (“comply or explain”)
    • Standard appears written for large firms – bottom-up approach needed
    • Firms that perform non-audit services – increasing trends to perform other engagements instead of audits, wide variance in degree of public interest, ITC addressed audit issues, ED-ISQM 1 very audit focused, ED-ISQM 1 not suitable for firms performing related services engagements
Suggestions:

- Separate requirements or standards for managing quality for non-audit engagements or audits of less complex entities
- Simplify requirements and reduce repetitiveness
- Use certain explanations and diagrams from the Explanatory Memorandum
- More clearly signpost paragraphs that address scalability
- Use the same approach that is being considered in the project on ISA 315 (Revised) (i.e., the what/how/why approach)
- Place material outside of the standard
- Digitize the standard
Challenges for Implementation

• Time, resources and expertise to implement the standard
• Firm-wide impact:
  – Need for a firm-wide mindset change, and influences the culture of the firm
  – Organizational restructuring, new IT systems
  – Affects other areas of the firm, e.g., human resources and IT functions
• Professional judgment – differing interpretations and concerns about level of documentation needed
• Firm’s risk assessment process (FRAP) – identified as particularly challenging to implement
• Other areas of challenge:
  – Monitoring and remediation (M&R) - root cause analysis, identifying and evaluating findings and deficiencies and firm leadership’s annual evaluation of the system of quality management
  – Consistent application for networks – includes challenges around consistency of global standards
  – Documentation – some consider standard too burdensome, others suggesting more clarity needed about what needs to be documented
• Length and complexity of standard – difficult to read and understand
• Strong call for support materials and guidance, including clarity regarding what has changed from extant ISQC 1
Components and Structure

• Standard has a logical organization and support flexibility of the components

• Concerns and suggestions
  – FRAP should be the first component – helps provide context to standard, even though governance and leadership is very important
    • Also clarifies that FRAP applies to the other components
  – FRAP and M&R are processes in nature and should not be described as components or treated in the same way as other components – “what” is managed vs. “how” it is managed
  – FRAP should not apply to M&R
    • Requirements in M&R already prescriptive – establishing quality objectives and identifying and assessing risks causes circularity
  – Information and communication are necessary for other components to function – should be integrated into the other components
Establish Quality Objectives (QO)

• MG:
  – Clarity needed on when and how additional QO should be developed
  – Suggested requirements that support establishing more granular quality objectives to support identifying and assessing quality risks (QR)

• Other respondents:
  – Mixed views
    • QOs are comprehensive, outcome-based and give a steer to firms about the starting point
    • QOs are too prescriptive – should be more high-level and fewer
  – Suggestions included
    • Include specificity of QO in quality risks
    • Clarify circumstances when additional QO should be established
    • More explicit in the standard that additional QO are not always required
    • Change the requirement to “a consideration” of whether additional QO are necessary
Identify and Assess Quality Risks (QR)

• MG:
  – QR with remote likelihood / significant impact should be considered by firms
  – Other enhancements needed:
    • Assess changes in the external environment and a firm’s own business model, need to be dynamic
    • Take findings from regulators into account as part of identifying and assessing QR

• Other respondents:
  – A threshold leads to a consistent approach, standard supports enhanced understanding of QR
  – Concerns about the threshold, i.e., “reasonably possible” and “more than remote”
  – Clarify meaning of “significant effect on the achievement of a QO”
  – Process for identifying and assessing QR overly prescriptive and does not provide flexibility - 2-step process is confusing and overengineered
  – Lack of required QR – illogical
    • Suggestions to repurpose required responses and granularity of QO or provide examples of QR
  – Clarity needed on how to document
  – General need for guidance
Design and Implement Responses

• MG:
  – Firms may be overly focused on required responses
  – Responses should be more proactive and preventative

• Other respondents:
  – Responses prescriptive = checklist mindset, limited tailoring
  – Firms may “backfill” QR to match responses – perpetuates inappropriate QR
  – Inconsistency in (or lack of) responses across components – appears some components more important than others
  – Firms should not be expected to design and implement additional responses in all circumstances, i.e., responses in the standard may be sufficient
  – Varying views on how to deal with responses
    • Application material vs. requirements
    • Repurpose as QR
    • Other suggestions to clarify requirement to design and implement additional responses
ISQM 1 TF’s Consideration of Four Significant Issues

The ISQM 1 TF has developed the following proposals to address the scalability and complexity of Proposed ISQM 1:

1. The components and structure of Proposed ISQM 1
2. How Proposed ISQM 1 should address QO, QR and responses
3. How the standard addresses the FRAP
4. The scope of firms and services covered by Proposed ISQM 1
Proposal 1: The Components and Structure of Proposed ISQM 1

• Improve Proposed ISQM 1 to differentiate between:
  – _How_ the system is managed (process) – FRAP and M&R
  – _What_ needs to be managed (criteria) – all other components

• Adjust how the FRAP relates to M&R – propose that FRAP is not applied to M&R, i.e., QO and QR not needed for the M&R component
  – However, adjust requirements in M&R to retain concept that firm may need to do more than what is required by the standard

• Reorder various aspects of Proposed ISQM 1 to simplify the standard and clarify how FRAP relates to the other components
Proposal 2: How Proposed ISQM 1 Should Address QO, QR and Responses

- Revise QO to be higher level - may result in fewer QO
- Introduce “quality risk considerations” – developed from:
  - Details from QO that will no longer be included in the QO
  - Certain responses, repurposed as “quality risk considerations”
- Reduce responses (may be duplicated in a QO, or included in a “quality risk consideration”)

Approach in ED-ISQM 1

- Required quality objectives
- Required responses

Proposed revised approach

- Higher level required quality objectives
- Quality risk considerations
- Limited required responses
Proposal 3: How the Standard Addresses the FRAP

- Simplify the FRAP:
  - Condense 2-step process of identifying and assessing QR into a single requirement (AM will acknowledge that sometimes this may be a 2-step process)
  - Refocus the requirement away from being process-driven, to outcome-based
- Address threshold for identifying and assessing QR:
  - Relocate QR threshold out of requirements, to simplify the requirements
  - Remove reference to “more than remote”, but mixed views about whether to retain “reasonably possible”
  - Introduce application material to address concept of spectrum of risk
  - Adjust element of the threshold that addresses the magnitude of effect – needs to be revised to be appropriate for the new “higher level” QO
- Revise requirement for firm to establish additional QO to reflect a bottom-up approach
Proposal 4: The Scope of Firms and Services Covered by Proposed ISQM 1

• Develop separate requirements for management of quality for related services engagements:
  – Locate in a separate standard
  – Standard would apply to all firms that perform related services engagements, i.e., firms would apply:
    • Proposed ISQM 1 to managing quality for audits, reviews and other assurance engagements
    • New standard to managing quality for related services engagements
Question 1:
Do representatives support the proposals outlined in Agenda Item C.2 to address the scalability and complexity of Proposed ISQM 1, including:

(a) Reordering the components of the standard to improve the readability of the standard, and clarifying that “the firm’s risk assessment process” and “monitoring and remediation” are processes in nature?

(b) Revising the approach to required quality objectives, quality risks and responses in the components, i.e.:
   (i) Revising the quality objectives to be higher level, which may result in fewer quality objectives;
   (ii) Introducing quality risk considerations; and
   (iii) Reducing the required responses.

(c) Simplifying the requirements addressing the identification and assessment of quality risks?

(d) Developing a separate standard dealing with quality management over related services engagements?
Question 2:
Do representatives have views about additional actions the IAASB should take to address the scalability and complexity of Proposed ISQM 1?
Support for references to the public interest in the standard with suggestions to clarify meaning.

Governance and leadership – overall support, but concerns on prescriptiveness / scalability of requirements.
- Mixed views about a requirement to assign responsibility for relevant ethical requirements and/or independence.

Technological resources - overall support for how addressed in ED-ISQM 1.

Communication with external stakeholders – mixed views.
- Concerns too prescriptive as refers too directly to transparency reports; others suggesting standard should do more in addressing external communication.

Monitoring and remediation – overall support, but concerns about scalability, level of prescriptiveness and whether will drive innovation.
- Mixed views on the requirement addressing inspection of completed engagements.
- Framework for evaluating findings and identifying deficiencies lacks clarity.
- Support for new requirement to investigate root causes.
- Many challenges identified regarding annual evaluation of SOQM, including being too onerous for SMPs.
Feedback on Other Aspects of ED-ISQM 1: Initial Impressions (continued)

• Networks - overall support for proposals
• Service providers - overall support for addressing service providers in the standard
  – Concerns about the scope of service providers and obtaining information from service providers
• Strong call for additional support materials and guidance, particularly guidance supporting first time implementation, SMPs, monitoring and remediation, root cause analysis and documentation