Extracts of March 2020 IAASB Agenda Item 5 Relevant to Engagement Quality Reviewer Objectivity Considerations

Objectives of the IAASB Discussion
The objectives of this Agenda Item are to:
(a) Obtain the Board’s views about the recommendation of the ISQM 2 Task Force (the Task Force) relating to engagements subject to an engagement quality (EQ) review in accordance with paragraph 41A(e) (previously paragraph 41A(c)) of proposed ISQM 1; and
(b) Obtain the Board’s feedback on the revised draft of proposed ISQM 2.

Proposed ISQM 2: Issues and Recommendations

Introduction

Section I – Scope of Engagements Subject to an EQ Review

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

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

Task Force Discussion

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

<table>
<thead>
<tr>
<th>22E.</th>
<th>The firm shall identify and assess quality risks to provide a basis for the design and implementation of responses. In doing so, the firm shall: (Ref: Para.A24L)</th>
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<tr>
<td>(a)</td>
<td>Understand the factors that may adversely affect the achievement of its quality objectives, including: (Ref: Para. A24N)</td>
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<td>(i)</td>
<td>Those relating to the nature and circumstances of the firm:</td>
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<td></td>
<td>a. The complexity and operating characteristics of the firm;</td>
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1 Proposed International Standard on Quality Management (ISQM) 2, Engagement Quality Reviews
2 Proposed ISQM 1 (Previously International Standard on Quality Control 1), Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements

Prepared by: Hanken Talatala and Dan Montgomery (February 2020)
b. The strategic decisions, actions, and business model;
c. The characteristics and management style of leadership;
d. The resources of the firm, including the resources provided by service providers;
e. Law, regulation, professional standards and the environment in which the firm operates; and
f. In the case of a firm that belongs to a network, the characteristics of the network requirements and network services, if any.

(ii) Those relating to the nature and circumstances of the engagements performed by the firm subject to the system of quality management:
   a. The types of engagements performed by the firm and the reports to be issued; and
   b. The types of entities for which such engagements are undertaken;

(b) Consider:
   (i) Whether, and if so how, the factors could, individually or in combination with other quality risks, adversely affect the achievement of a quality objective; and (Ref: Para. A24P)
   (ii) The likelihood of the quality risks occurring, and if they were to occur the potential effect on the achievement of a quality objective(s) before consideration of any response. (Ref: Para. A24Q)

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

   • As part of a firm’s risk assessment process (FRAP) in identifying and assessing quality risks to provide a basis for the design and implementation of responses (see paragraph 22E(a) of proposed ISQM 1), the firm is required to understand factors that may adversely affect the achievement of its quality objective.

   • Those factors include factors relating to the nature and circumstances of the firm and of the engagements performed by the firm. Therefore, it becomes more challenging to explain how the category of ‘due to the nature and circumstances of the engagement or the entity’ differs from the category of engagements for which an EQ review is appropriate as a response to assessed quality risks. A firm’s decision to perform an EQ review based on the nature and circumstances of the engagement or the entity relates to the engagement performance quality objectives of the firm’s system of quality management (i.e., addressed as part of the FRAP).

   • In addition to the similarity of the wording of the separate category to the wording of the factors in the FRAP in proposed ISQM 1, some also may hold the view that a separate category that is not in response to assessed quality risks is inconsistent with the underlying principle of a firm’s system of quality management that requires the firm to apply a ‘risk-based approach’ (emphasis added), as provided in paragraphs 9A-10 of proposed ISQM 1. Consequently, requiring an EQ review in response to reasons that are not risk-based is inconsistent with, and may be viewed as undermining the principle of a risk-based approach.
in proposed ISQM 1. Extracts of paragraphs 9A-10 of proposed ISQM 1 are shown below for reference.

<table>
<thead>
<tr>
<th>9A. This ISQM requires the firm to apply a risk-based approach in designing, implementing and operating the components of the system of quality management in an interconnected and coordinated manner such that the quality of engagements is proactively managed by the firm. (Ref: Para. A4A)</th>
</tr>
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<tr>
<td>10. The risk-based approach is embedded in the requirements of this ISQM through: (a) Establishing quality objectives. The quality objectives established by the firm consist of objectives in relation to the components of the system of quality management that are to be achieved by the firm. The firm is required to establish the quality objectives set out in this ISQM and any additional quality objectives beyond those specified by this ISQM that are considered necessary by the firm to achieve the objectives of the system of quality management. (b) Identifying and assessing risks to the achievement of the quality objectives (referred to in this standard as quality risks). The firm is required to identify and assess quality risks to provide a basis for designing and implementing responses. (c) Designing and implementing responses to address the assessed quality risks. The nature, timing and extent of the firm’s responses to address the assessed quality risks are based on, and responsive to, the reasons for the assessments given to the quality risks.</td>
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11. It was suggested during the December 2019 Board meeting that there may be a way to further distinguish the two categories as both being responses to quality risks, but with different considerations. Although possible to pursue this, the Task Force considers it will be challenging to clearly differentiate the two categories now that proposed ISQM 1 incorporates the concept of factors that may adversely affect the achievement of a firm’s quality objectives.

12. The Task Force also considered whether it would be possible to retain the separate category of ‘due to the nature and circumstances of the engagement or the entity’ and provide additional application material (and supplemental implementation guidance, if necessary) to explain how this category differs from the category of engagements for which the firm determines an EQ review is an appropriate response to assessed quality risks. However, for the reasons noted above, the Task Force concluded that this would be a less desirable option.

**Task Force Recommendation**

13. In view of the comments from Board members during the December 2019 meeting, the Task Force recommends that the separate category of ‘due to the nature and circumstances of the engagement or the entity’ be absorbed into the broader category of engagements for which the firm determines an EQ review is an appropriate response to assessed quality risks.

14. The Task Force does not consider that absorbing this separate category would significantly affect the number of engagements subject to EQ review since relevant aspects of the application material (i.e., factors to be considered in identifying engagements subject to an EQ review due to the nature and circumstances of the engagement or the entity) have been incorporated into the application material for the broader category of engagements subject to an EQ review as an appropriate response to assessed quality risks (now part of paragraph A153 in Agenda Item 5-A).
15. Accordingly, the Task Force has made the following proposed revisions in **Agenda Item 5-A:**

- Absorbed the separate category of ‘due to the nature and circumstances of the engagement or the entity’ into the broader category of engagements for which the firm determines that an EQ review is an appropriate response to assessed quality risks in paragraph 41A(e) of proposed ISQM 1.

- Redrafted the lead-in wording in paragraph A153I (previously paragraph A104) to provide a link to the FRAP with respect to the:
  - Factors (see paragraph 22E(a)(ii) of proposed ISQM 1) relating to the nature and circumstances of the engagements performed by the firm that may adversely affect the achievement of its quality objectives, which the firm is required to understand when identifying and assessing quality risks; and
  - Conditions and circumstances that may lead the firm to determine that an EQ review is the appropriate response in designing and implementing responses to address assessed quality risks relating to the quality objectives of engagement performance.

- Aligned paragraph A153I with the ISQM 1 Task Force’s approach of presenting the examples of such conditions and circumstances in boxes. In addition, the conditions and circumstances in paragraph A153I of proposed ISQM 1 are now further subdivided into:
  - Conditions and circumstances relating to the types and characteristics of engagements performed; and
  - Conditions and circumstances relating to the types of entities for which engagements are undertaken.

- Reworded some of the bullets in paragraph A153I to be consistent with the new presentation approach in proposed ISQM 1. However, the content of all bullet points in paragraph A104 of the December 2019 draft have been retained.

- Deleted paragraphs A105A, A105B and A106 of proposed ISQM 1. However, certain parts of the deleted paragraphs have been incorporated into paragraph A153I and the accompanying example box.

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**Matter for IAASB Consideration**

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