



CANADIAN PUBLIC ACCOUNTABILITY BOARD
CONSEIL CANADIEN SUR LA REDDITION DE COMPTES

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International Auditing and Assurance Standards Board (IAASB)
Submitted electronically

Re: Comments on the IAASB Exposure Drafts for ISQM 1, ISQM 2 and ISA 220

The Canadian Public Accountability Board (CPAB) is pleased to respond to the exposure drafts relating to the proposed International Standard on Quality Management.

CPAB is Canada's independent audit regulator responsible for overseeing firms that audit Canadian reporting issuers. Our mandate is to promote high quality, independent auditing that contributes to public confidence in the integrity of reporting issuers' financial reporting.

We were impressed by the scope and depth of the IAASB's efforts to re-examine its quality control standards. We fully agree that audit firms must do more to embed audit quality on a consistent basis, and this exposure draft significantly improves on the extant ISQC. CPAB has reviewed the exposure draft and shared comments with other regulators through the International Forum of Independent Audit Regulators (IFIAR). In addition to our submission through IFIAR, we have identified in this letter several areas which we encourage the IAASB to consider in finalizing the new standard.

Starting in 2018, CPAB embarked on a strategic initiative to assess the quality management systems at audit firms. Our objectives are aligned with the aims of the IAASB. We expect the firms to have quality systems that manage risk, emphasize strong governance and culture, and deploy highly trained professionals with skillsets tailored by industry and areas of expertise. Having the right people working on the right things at the right time, all the time is essential to delivering high quality audits, consistently. We have incorporated several findings from our work to date into this letter.

Overall Comments

CPAB oversees all firms that audit reporting issuers; we have experience in overseeing firms that vary in size and nature. We have found that the most relevant factor to consider in assessing the need for a quality management system is the nature of the engagements that a firm performs, and not the firm's size, nature or circumstances. The exposure draft provides significant latitude to firms to opt out of the requirements due to their nature and circumstances (para 5), which we believe dilutes the proposed standards. We would strongly encourage the IAASB to reconsider its approach in this area.

We believe the IAASB could further enhance the exposure draft in a few key areas, by:

- Adopting a more proactive approach to achieving quality results in the design and implementation of responses to quality risks, with greater emphasis on preventative measures;
- Adding greater specificity to how the quality management system framework is defined so that it can be tested for operating effectiveness; and
- Identifying the potential for conflict within the firm structure and including further guidance to foster skepticism and an appropriately independent mindset at different levels and locations.

We are supportive of leveraging other risk management and governance frameworks, including the COSO Integrated Framework (2013) (“COSO”).¹ We believe the IAASB could go further to align this draft with other frameworks. We have identified in our letter where it would be worthwhile for IAASB to re-examine its exposure draft to better incorporate COSO.

Proactive Leadership for Quality Management

One of the key public interest issues that was raised for this project was the desire to strengthen proactive firm leadership to support the engagement partner in providing high-quality audit opinions and prevent an audit quality deficiency from occurring. We believe more can be done to fully realize this objective.

The term “proactive” does not appear in the proposed standard itself, and only twice in the application guidance, in reference to root causes of identified deficiencies. At the root cause phase, a proactive approach is too late to address past system failures.

One of the key findings from our review of firm quality management practices was that the policies or after-the-fact detective controls that are currently in place at some firms would not have identified an audit deficiency before the audit report was released. While these ex-post responses may form a part of a functioning system of quality management, we believe audit firms should do more to prevent audit quality issues from occurring.

The required responses that are identified in the exposure draft for the components of the system of quality management are more consistent with the findings that we identified in our review; they are not proactive. While we acknowledge that they are not intended to be comprehensive, they are perhaps indicative of the sorts of actions that would be viewed as appropriate or acceptable in addressing quality risks; ongoing monitoring activities, for example, are described in the application guidance as generally routine activities, and periodic monitoring activities, such as the inspection of training records or post-engagement reviews, are after-the-fact (A156). We believe the responses could be improved if they were more specific and provided an increased emphasis on proactive measures.

¹Committee of Sponsoring Organizations of the Treadway Commission, Internal Control – Integrated Framework, Framework and Appendices, May 2013.

In CPAB's approach to evaluating quality processes to assess audit quality,² we outline our expectations for the audit firms we regulate. For example, leadership should be able to demonstrate that they have effective processes to:

- Dynamically manage their client portfolio to identify emerging risks within their client base.
- Objectively evaluate and approve client acceptance and continuance and identify and monitor higher risk engagements.
- Reliably forecast resources, prioritize and align them to engagement risk, and resolve projected shortfalls in a timely manner.
- Monitor resource usage against capacity constraints to identify excessive workloads.
- Realign resources in a timely manner to maintain audit quality as circumstances change.
- Monitor the progress of audits and encourage two-way communication in order to support the escalation of matters requiring their intervention.

Further to the importance of proactive quality management as a public interest issue, we recommend that the IAASB identify and emphasize more proactive responses.

Demonstrating Effective Quality Management

A few of the key terms in the exposure draft – objectives, risks, responses and deficiencies – are defined, but at a high level; the lack of specificity makes it harder to practically implement and test the system of quality management for operating effectiveness.

The key attributes of the system of quality management should be properly defined to enable the firms to design a system that is effective in responding to their risks. We explore below how more clearly defined expectations for design, implementation and operation would substantially improve on the practical applicability of the standard.

Quality objectives

Firms are required to establish quality objectives, but the attributes of quality objectives are not defined, and the quality objectives that are identified are set out in general terms. The IAASB notes that “some firms may identify high-level objectives that may be as effective in providing a basis for the identification and assessment of quality risks as firms that choose to establish more granular objectives.” (p.12) In our view, without clear guidance, firms may find it challenging to define their objectives and practically identify their related risks.

COSO notes that objectives that are suitable should be specified “so that risks to the achievement of such objectives can be identified and assessed. Specifying objectives includes the articulation of specific, measurable or observable, attainable, relevant, and time-bound objectives.” (p.6)

We recommend that the IAASB revise its draft to set out clear guidance on how these objectives should be defined and encourage the use of the concepts from COSO.

Risk Identification and Assessment

²<http://www.cpab-ccrc.ca/Documents/About/Evolution%20of%20Inspection%20Strategy.pdf>

The exposure draft defines a “reasonably possible” threshold whereby risks must be “more than remote” to be identified. Since risks with a remote likelihood need not be considered, remote risks that could have a significant impact on the business may be excluded from analysis. In our view, remote and high impact risks should be identified and carefully assessed if they have the potential to have a significant impact on the audit practice as a whole. An example could be fraud or mismanagement within an audit practice, which may be viewed as having a remote likelihood, but could have a major impact on a firm. The exclusion of a remote risk that rapidly changes to reasonably possible could lead to the failure to notice and address it in a sufficiently timely manner if it is not part of an overall risk management framework.

We recommend that the IAASB reconsider and broaden its threshold for defining quality risks. The exposure draft could also go further in identifying the need to identify and assess risks due to changes in a firm’s internal and external environment and its own business model, and in clarifying that the process for identifying and analyzing risks must be dynamic and iterative.

Responses

The IAASB has used the term responses to highlight the importance of responding to quality risks and the proactive nature of the new approach to quality management. However, the responses that are identified in the exposure draft are at a high level, and not conducive to testing for operating effectiveness.

Responses continue to be defined as policies or procedures, and a number of the required responses are consistent with the extant ISQC1; the continuation of this terminology into the new standard could lead to responses that cannot be tested as ongoing tasks and activities.

In our review of firm quality management practices, we observed that descriptions of responses, which took the form of processes and controls, were too high level to enable an assessment of whether the control was appropriately designed, and effective and corrective actions taken to address audit quality issues were not described or evidenced. For example, for an unplanned change in lead engagement partner, there were no evident specific actions taken by the firm to support the new partner. Firm testing focused on whether the control had been performed rather than an assessment of the effectiveness of the control. Further, certain controls did not achieve their intended control objective or were not operating effectively. For instance, in tight time frames, progress reports and monitoring were neither sufficiently frequent nor granular enough to enable proactive intervention by leadership.

COSO defines internal control as a dynamic and iterative process, with a process consisting of ongoing tasks and activities, (p.1,3) and requiring organizations to have “persuasive evidence to show that the components and relevant principles are present and functioning” (p.29) and operating together. We view these concepts as critical and recommend that they be more clearly conveyed.

Deficiencies

The definition of deficiency is derived from the system of quality management that a firm has designed and implemented; its quality objectives, quality risks, and responses are part of the definition. The criteria for undertaking root cause analysis are accordingly embedded into the definition of a deficiency. Firms may be inherently inclined to oversimplify their objectives, risks

and responses to avoid undertaking root cause analyses for deficiencies that they view as isolated; this may inadvertently make it more challenging to systematically identify and address defects. We recommend simplifying the definition for deficiency and addressing the criteria for root cause analysis separately.

Firm Structure - Potential for Conflict

Conflicting Roles - Supervision vs Monitoring

The exposure draft does not explicitly distinguish between supervisory review activities (intended to detect and correct) and monitoring activities (to investigate root causes and remediate). This could lead to ambiguity and potential for conflict across levels and locations that compromise the integrity of the system.

In our review of firm quality management practices, we noted situations where processes and controls varied from location to location resulting in an increased risk in the overall control framework. We encountered circumstances where firms described centralized processes and controls but could not demonstrate the consistency and effectiveness of those or similar processes at a regional or office level. This may have been due in part to the lack of distinction being drawn in assigning accountabilities for supervisory review and monitoring, and the resulting challenges in delineating between the effectiveness of individuals in their different roles.

Leadership, at various levels, are likely to have dual and potentially conflicting roles for both supervisory review and dealing with system deficiencies due to unanticipated risks and conditions. The IAASB could do more to distinguish between these two roles in describing how accountability for supervisory and monitoring responses should be assigned.

Independent Engagement Quality Reviews

Engagement quality reviews are defined as “objective evaluations of the significant judgments made by the engagement team.” The definition of an engagement quality reviewer does not provide insight into the factors affecting the objectivity of the reviewer, including a number of factors that we view as critical to having a robust and objective process – their seniority and authority relative to the engagement partner, and their independence from the sales and service process. The need for the new standard to be scalable for small and medium-sized practices appears to have diluted independence considerations for engagement quality reviewers. We have commented earlier in this letter that the nature of the engagement, not the size of the firm, is a better criterion to apply to make the standard scalable. Firms that are responsible for larger, more complex audit engagements and public interest entities should be required to have independent engagement quality reviews.

Further, it is difficult for reviewers to derive significant judgments without relying on the engagement team to identify them, which inherently compromises the independence of the engagement review. We recommend that “judgments” be replaced by “risks” in the definition of engagement quality reviews to convey the need for reviewers to have a broad and sufficiently deep understanding of the engagement.

Clarifying Accountabilities - Networks and Service Providers

In addition to external monitoring, networks also provide services to local firms, and a distinction is drawn in the exposure draft between the services they provide to the firm and the services provided by an external party. The requirements to understand and assess the network's services (58, A197-198) are approached differently to those of external services providers, and we are unclear why this is the case when the nature of both are the same.

The distinctions between the definitions of an engagement team, network and service provider are also unclear and could lead to misunderstandings and challenges in identifying and assessing risks. For example, should service delivery centres supporting the engagement team be viewed as a network service, an external service provider or part of the engagement team? We recommend that these terms be further refined.

If you have any questions on this, please do not hesitate to contact me.

Yours very truly,

A handwritten signature in cursive script that reads "Carol Paradine".

Carol Paradine, CPA, CA
Chief Executive Officer