July 1, 2019

Subject: Nordic Federation of Public Accountants’ Response to the IAASB’s Exposure Draft on the Proposed International Standard on Quality Management 1 (ISQM 1)

The Nordic Federation of Public Accountants (NRF) is pleased to provide you with its comments on the Proposed International Standard on Quality Management 1, Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements.

General comments

We believe that quality management standards, based on a pro-active, risk-based approach and customized to the specific firm and its engagements will most likely contribute to higher quality engagements. The proposed process, i.e. establishing quality objectives, identifying and assessing quality risks and designing and implementing responses, seems like a logical way to address this overarching objective.

However, it is our view that these exposure drafts also show the difficulties of having one set of standards that covers the entire range from big audit firms to sole practitioners. Implementing these standards will take a huge amount of resources from all audit firms no matter their size. In contrast to the big audit firms who have already begun working with a risk-based approach, and who have these resources and in-house specialist knowledge at least on a global level, this will be an overwhelming exercise for SMPs.
We are concerned that the costs of implementing these standards for SMPs will not correspond to the expected improvements on quality engagements. Also, in order for SMPs to be able to understand and implement the standards, the professional organizations will have to provide application material, guidance and training. We would like to stress that the differences between big audit firms and SMPs with regard to access to resources and in-house knowledge, also apply to professional organizations of different sizes.

We fully understand that robust quality management standards need to capture big audit firms and complex engagements regarding public interest entities. In order to achieve this, the proposed standards have a “top down-approach” which presumes that they should be scalable to also be fit-for-purpose for SMPs and even sole practitioners. In our view the scalability, as proposed in the exposure drafts, is not helpful or clear enough. The standards are very long and complex. We would like to stress the importance that, when implementing these standards, SMPs should be confident that they have understood how to navigate in the standards and that appropriate judgments calls were made.

We are also concerned that implementing these standards will result in time-consuming documentation and that focus will shift from trying to achieve higher quality engagements to trying to meet assumed requirements from external inspections.

In our view these standards, as shown in the drafts, are not fit-for-purpose for all kinds of audit firms and all kinds of engagements that they are supposed to cover. Some challenges might be solved by training and application material outside the standards themselves. However, there is a limit on how much application material and guidance it is reasonable to produce in order to understand the standards, before it becomes obvious that further work needs to be done on the standards themselves.

In order to make the standards easier to navigate and understand, we think that the structure needs to be clarified, especially with regard to the visibility of scalability options but also including clearer guidance about when and how scalability could be applied.

We believe that the length of the standard affects its clarity, in such a way that it is difficult to maintain the big picture. With regard to the magnitude of requirements, one could question whether there really is a principles-based approach. We would suggest that the IAASB reconsiders whether all the requirements are needed or if some of them might be application material. Another way to address the length of the standards (especially ISQM 1) would be to streamline the application material, i.e. move the explanations regarding the rationale for certain requirements from the application material into a different document, for example to a Basis for Conclusion. Including explanations in the application material increases the length without achieving corresponding benefits. It rather blurs the content and, as a consequence, it is difficult to sift through the material and separate the explanations/rationales for having the requirements, from necessary application material that clarifies how the associated requirements could be implemented.
NRF

Yours sincerely,

Helene Agélii
Secretary General and CEO
Nordic Federation of Public Accountants

About NRF

NRF is a separate legal institution, founded in 1932, acting on behalf of and under the direction of the recognized audit and accounting institutes in the Nordic region (DnR in Norway, FAR in Sweden, FLE in Iceland, FSR – danske revisorer in Denmark and Suomen Tilintarkastajat ry in Finland).
APPENDIX 1 – NRF comments to IAASB’s specific questions on whether:

1) Does ED-ISQM 1 substantively enhance firms’ management of engagement quality, and at the same time improve the scalability of the standard?

In particular:

(a) Do you support the new quality management approach? If not, what specific attributes of this approach do you not support and why?

In general, we support the new approach and the overall objective to focus on the responsibilities of management. We believe that the overall length of the standard and the amount of requirements will require resources for implementation that, at least for SMPs and sole practitioners, will not correspond to the expected benefits and that there is an imminent risk that firms will lose sight of the overall objective when trying to keep up with very prescriptive and detailed requirements.

At the same time as we believe that the suggested approach makes sense, we also believe that the standard has become very complex and difficult to navigate. This is probably because of the mixture between a few outcome-oriented objectives followed by a great amount of detailed requirements, unclear scalability options and an emphasis on applying professional judgment.

We do not support having information and communication as a stand-alone objective, but rather believe that these factors should be included as a natural feature in all the other objectives.

We are especially concerned with how the threshold for risk assessment should be interpreted, i.e. on risks that are “more than remote”, according to para. A55. We believe that this description is very unclear and sets the threshold too low. Also, we think that “more than remote” does not correspond with the description in the related requirement paragraph (para. 28).

We also believe that the objectives relating to the monitoring and remediation process are overshadowed by the length and details of the requirements and application material.

We are concerned about the time spent and the amount of documentation that implementing the standard will take. A212 states: “In a smaller firm, it may not be necessary to have documentation supporting matters communicated because informal communication methods may be effective. Nevertheless, the firm may determine it appropriate to document such communications in order to provide evidence that they occurred.” In order to feel safe with external inspection, the firms might feel a need to document out of a “comply or explain approach” and hence document more than is necessary.

(b) In your view, will the proposals generate benefits for engagement quality as intended, including supporting the appropriate exercise of professional skepticism at the engagement level? If not, what further actions should the IAASB take to improve the standard?
We believe that the use of both professional judgment and professional skepticism are important factors in tailoring the firm’s system of quality management. However, the combination of a vast number of very prescriptive requirements and an emphasis on using professional judgment and professional skepticism is challenging and might to some extent even be contradictory. We are concerned that the number of detailed requirements, in practice, might overshadow the use of professional judgment and professional skepticism.

Are the requirements and application material of proposed ED-ISQM 1 scalable such that they can be applied by firms of varying size, complexity and circumstances? If not, what further actions should the IAASB take to improve the scalability of the standard?

No, the way in which scalability is dealt with in the draft standard is not helpful. We are concerned that time consuming efforts will primarily be focused on understanding the standard and its scalability options, rather than on the actual implementation.

For example, para. 5 with the subheading “scalability” and the associated guidance in para. A22 and A23, only refer to the nature and circumstances of the firm, its range of engagements and its clients, i.e. they describe characteristics that could be taken into consideration when determining whether or not the firm meets the conditions in order to use scalability. We suggest that the subheading to para. 5 should reflect the content of the paragraph, e.g. conditions for scalability.

However, the main challenge with the standard is to understand in what situations and regarding what requirements scalability could be applied. We believe that this issue partly relates to the structure of the standard, especially the fact that the standard consists of a mixture of requirements, where some are scalable (and optional) and some are not.

The scalability option is addressed in para 21. It would be clarifying to gather different aspects of scalability options in a subsection connected to this paragraph, i.e. provide more guidance both in the requirement section and in the related application material. For example, we would recommend some clarification about which requirements that are not scalable. Also, we do not find the way scalability is described in para. 21 helpful; just stating that firms do not have to comply to requirements that are not relevant does not add any clarity. Neither do the examples provided in para. A20, since those examples refer to situations that, objectively, are not applicable to the firm because of its size or types of engagements. The way this is drafted, it seems like scalability (only) equals “non-applicable” situations. Since scalability also includes how different requirements could be implemented, we suggest that this should also be dealt with in this context. We also suggest that para. 21 should have its own subheading to highlight where in the standard scalability is addressed on a more general level.
2) Are there any aspects of the standard that may create challenges for implementation? If so, are there particular enhancements to the standard or support materials that would assist in addressing these challenges?

In our view it is the length of the standard, the difficulties to understand scalability options and documentation that are the biggest challenges. We refer to the above.

3) Is the application material in ED-ISQM 1 helpful in supporting a consistent understanding of the requirements? Are there areas where additional examples or explanations would be helpful or where the application material could be reduced?

It is fundamental for the implementation to understand the structure of the standard with regard to scalability. We therefore encourage the IAASB to put extra focus on clarifying how the scalability options in para. 21 are intended to be used. Any additional examples in the standard should focus on how scalability could be used rather than on examples of situations that for obvious reasons are not applicable.

Overall, we believe that the clarity of the standard would benefit by reducing its length. For example, we suggest that the application material should only include descriptions and examples of how to comply with the requirements. Explanations regarding the rationale behind having the requirements should be moved to another document, for example Basis of Conclusions.

1. Specific Questions

4) Do you support the eight components and the structure of ED-ISQM 1?

We believe that the Information and Communication component should not be a stand-alone component, but rather be an integrated part of the other components.

5) Do you support the objective of the standard, which includes the objective of the system of quality management? Furthermore, do you agree with how the standard explains the firm’s role relating to the public interest and is it clear how achieving the objective of the standard relates to the firm’s public interest role?

We support the objective of the standard. However, the structure of the standard consists of objectives on different levels, and we would recommend clarifications throughout the standard about which objective the standard is referring to, for example by clarifying this in the sub-headings or by using italics in the paragraphs.

Regarding how the standard explains the firm’s role relating to the public interest, it is our general view that explanations regarding the rationale behind certain approaches and requirements would be better placed in another document than in the standard itself.

6) Do you believe that application of a risk assessment process will drive firms to establish appropriate quality objectives, quality risks and responses, such that the objective of the standard is achieved?
This is the crucial part of the process that will most likely also take a lot of time. We are concerned that it might result in a lot of documentation.

In particular:

(a) Do you agree that the firm’s risk assessment process should be applied to the other components of the system of quality management?

(b) Do you support the approach for establishing quality objectives?

   In particular:
   
   i. Are the required quality objectives appropriate?

      We agree that information and communication are key matters in a robust quality management system, but we do not support having information and communication as a required stand-alone quality objective. In our opinion information and communication is a means, an ongoing-support system, to reach the objectives and it should not be an objective in itself. Hence, information and communication should be an integrated part of the other required quality objectives.

      Also, we believe that the quality objectives are far too granular.

   ii. Is it clear that the firm is expected to establish additional quality objectives beyond those required by the standard in certain circumstances?

      It is clear that the standard requires this. However, we would encourage the IAASB to clarify scalability options for smaller firms.

(c) Do you support the process for the identification and assessment of quality risks?

   We support a risk-based approach that is tailored to the firm’s nature and circumstances.

   A crucial part of the risk assessment process is the threshold stated in para. 28, especially since all those risks should be assessed according to para. 29. Para. A55 describes this threshold as: “There is a reasonable possibility of a quality risk occurring when the likelihood of its occurrence is more than remote”. We believe that this threshold needs clarification, since “more than remote” would otherwise capture almost all imaginable risks and consequently lead to quite an amount of risk assessments and documentation. We also believe that “more than remote”, without further guidance, is much lower than “a reasonable possibility of risk”.

(d) Do you support the approach that requires the firm to design and implement responses to address the assessed quality risks?
In particular:

i. Do you believe that this approach will result in a firm designing and implementing responses that are tailored to and appropriately address the assessed quality risks?

We support the approach, but we are uncertain whether the granularity within the standard and the costs related to implementation will correspond to increased quality engagements in SMPs.

ii. Is it clear that in all circumstances the firm is expected to design and implement responses in addition to those required by the standard?

This is a logical consequence of this way of drafting, i.e. combining principles-based overall objectives with several requirements. The more detailed those requirements are, the closer you get trying to achieve an exhaustive list with the consequence that you end up with a completely rules-based standard. We are not supportive of this approach.

We also wonder if this means that there are no scalability options in this part of the process.

Para. A59 and A69 include some examples of additional responses regarding the ethical requirements, but the standard does not include similar examples with regard to the other quality objectives. Without any further guidance, this requirement is entirely based on professional judgment and lacks predictability. There is a significant risk that it will be up to the regulators and oversight bodies to decide which additional responses should be designed and implemented – and also, that these expectations will be communicated first at an external quality control.

This additional requirement to “do more” is actually related to the overarching quality objective and if the associated requirements would instead have been examples of how to comply with those overarching quality objectives, this last requirement would not have been necessary and the whole structure would make more sense. Instead of having a requirement to “do more”, an alternative approach would be to use the content in the requirements as examples in the application material.

7) Do the revisions to the standard appropriately address firm governance and the responsibilities of firm leadership? If not, what further enhancements are needed?

Yes, we believe it does address the firm’s governance and the responsibilities of firm leadership on an appropriate level. However, due to the level of details, we would suggest some clarifications of scalability options in this part.

8) With respect to matters regarding relevant ethical requirements:

(a) Should ED-ISQM 1 require firms to assign responsibility for relevant ethical requirements to an individual in the firm? If so, should the firm also be required
to assign responsibility for compliance with independence requirements to an individual?

We do not believe it is necessary to have such a general requirement even though in practice this task might be delegated to an individual. It is the firm and its leadership that has overall responsibility and accountability to comply with this standard. Having another individual responsible and accountable for compliance with the ethical requirements only contributes to uncertainty regarding how this person’s responsibility and accountability relate to the responsibility of the firm’s leadership.

(b) Does the standard appropriately address the responsibilities of the firm regarding the independence of other firms or persons within the network?

Yes, we believe so.

9) Has ED-ISQM 1 been appropriately modernized to address the use of technology by firms in the system of quality management?

Yes, we believe so.

10) Do the requirements for communication with external parties promote the exchange of valuable and insightful information about the firm’s system of quality management with the firm’s stakeholders? In particular, will the proposals encourage firms to communicate, via a transparency report or otherwise, when it is appropriate to do so?

We believe that this requirement primarily focuses on big audit firms that have clients with a broad range of stakeholders and where there is a more apparent public interest. For smaller firms with a different type of clients which do not communicate via a transparency report, this requirement might be a challenge, since there is a lack of guidance on how to communicate this kind of information externally.

11) Do you agree with the proposals addressing the scope of engagements that should be subject to an engagement quality review? In your view, will the requirements result in the proper identification of engagements to be subject to an engagement quality review?

It is important that the standard is clear that having an engagement quality review is one, but not the only, response to address an assessed quality risk. We are concerned that the suggested, expanded scope of engagements that would require an engagement quality review is too broad.

We are especially concerned with para. 37 (e) (iii) (b) and the descriptions in A104. We believe that there are many engagements that could meet these descriptions and keeping this paragraph might drive a development where engagement quality reviews will be considered as the only acceptable response to assess quality risks. In addition to the extra costs and resources, such a development might even damage the role and value of the engagement partner, since it might give the impression that as soon as the
engagement includes a certain amount of judgment or complexity, the work of the engagement partner is not enough but an external reviewer would be necessary.

We also believe that this requirement will be the biggest challenge for SMPs and we are not convinced that the costs related to appointing external engagement quality reviewers will correspond to increased benefits.

12) In your view, will the proposals for monitoring and remediation improve the robustness of firms’ monitoring and remediation? 

In particular:

(a) Will the proposals improve firms’ monitoring of the system of quality management as a whole and promote more proactive and effective monitoring activities, including encouraging the development of innovative monitoring techniques?

(b) Do you agree with the IAASB’s conclusion to retain the requirement for the inspection of completed engagements for each engagement partner on a cyclical basis, with enhancements to improve the flexibility of the requirement and the focus on other types of reviews?

(c) Is the framework for evaluating findings and identifying deficiencies clear and do you support the definition of deficiencies?

(d) Do you agree with the new requirement for the firm to investigate the root cause of deficiencies?

In particular:

i. Is the nature, timing and extent of the procedures to investigate the root cause sufficiently flexible?

ii. Is the manner in which ED-ISQM 1 addresses positive findings, including addressing the root cause of positive findings, appropriate?

(e) Are there any challenges that may arise in fulfilling the requirement for the individual assigned ultimate responsibility and accountability for the system of quality management to evaluate at least annually whether the system of quality management provides reasonable assurance that the objectives of the system have been achieved?

The requirements and the associated application material in this part of the standard are very detailed. The scalability regarding monitoring activities is described in para. A158. However, this paragraph mainly describes under which conditions the firms could scale the responses and in what areas. It is not helpful when it comes to how scalability can be used.

Even though we acknowledge the importance of monitoring the process, we believe that the requirements are too detailed and that it will move focus from the overall objective of quality management to compliance to the requirements.

Since addressing root causes is a requirement, we would like more guidance on how scalability could be used in this area.
We suggest that the part of para. A178 that deals with investigating root causes that are not required by the standard be deleted. The requirements are more than enough as it is and having these kinds of encouragements in the application material that go beyond the requirements might open up for unintended “good practice”.

We believe that the distinction between findings and deficiencies are not sufficiently clear and that it is quite likely that firms will consider all findings as deficiencies.

We believe it will be an overwhelming task to expect one individual, especially in an SMP, to fulfill this requirement. We would also encourage the Board to reconsider whether an annual evaluation is necessary for all firms.

13) Do you support the proposals addressing networks? Will the proposals appropriately address the issue of firms placing undue reliance on network requirements or network services?

Yes, we are supportive of these proposals.

14) Do you support the proposals addressing service providers?

Yes, we are supportive of these proposals.

15) With respect to national standard setters and regulators, will the change in title to “ISQM” create significant difficulties in adopting the standard at a jurisdictional level?

For some of the Nordic jurisdictions, the change in title of the standard will have implications on the legislation. Therefore, we urge the IAASB to take this into account when deciding the time frame in which the standards will need to be implemented.

Also, the EU Audit directive from 2014 includes a lot of detailed regulations regarding the internal organization of the audit firms. These regulations are mainly based on ISQC 1 and have been implemented in the legislation/regulation within the EU member bodies. How these articles have been implemented will of course vary. We would like to flag that there might be a risk that when implementing the new quality management standards, some parts of the ISQC 1 might still need to be applied within EU jurisdictions.