

**Exposure Draft  
February 2019**

*Comments due: July 1, 2019*

*International Standard on Quality Management*

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**Proposed International Standard  
on Quality Management 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*

**IAASB**

International Auditing  
and Assurance  
Standards Board

## About the IAASB

This Exposure Draft was developed and approved by the International Auditing and Assurance Standards Board (IAASB).

The objective of the IAASB is to serve the public interest by setting high-quality auditing, assurance, and other related standards and by facilitating the convergence of international and national auditing and assurance standards, thereby enhancing the quality and consistency of practice throughout the world and strengthening public confidence in the global auditing and assurance profession.

The IAASB develops auditing and assurance standards and guidance for use by all professional accountants under a shared standard-setting process involving the Public Interest Oversight Board, which oversees the activities of the IAASB, and the IAASB Consultative Advisory Group, which provides public interest input into the development of the standards and guidance. The structures and processes that support the operations of the IAASB are facilitated by the International Federation of Accountants (IFAC).

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## REQUEST FOR COMMENTS

This Exposure Draft, proposed ISQM 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*, was developed and approved by the International Auditing and Assurance Standards Board® (IAASB®).

The proposals in this Exposure Draft may be modified in light of comments received before being issued in final form. **Comments are requested by July 1, 2019.**

Respondents are asked to submit their comments electronically through the IAASB website, using the "[Submit a Comment](#)" link. Please submit comments in both a PDF and Word file. First-time users must register to use this feature. All comments will be considered a matter of public record and will ultimately be posted on the website.

This publication may be downloaded from the IAASB website: [www.iaasb.org](http://www.iaasb.org). The approved text is published in the English language.

# EXPLANATORY MEMORANDUM

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## Section 1 Introduction

1. This memorandum provides background to, and an explanation of, the Exposure Draft of proposed International Standard on Quality Management 1 (Previously International Standard on Quality Control (ISQC) 1<sup>1</sup>), *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements* (ED-ISQM 1), which the IAASB approved for exposure in December 2018. The sections that follow describe the key issues considered by the IAASB in developing ED-ISQM 1. The proposed revisions address the most relevant public interest issues related to firms' systems of quality control, including those highlighted in the Invitation to Comment (ITC) released in December 2015, [Enhancing Audit Quality in the Public Interest: A Focus on Professional Skepticism, Quality Control and Group Audits](#).
2. ED-ISQM 1 is part of a package of proposed quality management standards on which the IAASB is seeking public comment. This memorandum supplements the overall explanatory memorandum, [The IAASB's Exposure Drafts for Quality Management at the Firm and Engagement Level](#). The overall explanatory memorandum includes background to the IAASB's three quality management Exposure Drafts, discusses the scalability of the standards and sets forth the IAASB's considerations regarding the possible effective dates of the three standards following final approval by the IAASB and approval of due process by the Public Interest Oversight Board. The overall explanatory memorandum also explains the linkages between the three quality management standards and addresses the related conforming amendments to the IAASB's International Standards on Auditing (ISAs).

## Section 2 Guide for Respondents

The IAASB welcomes comments on all matters addressed in ED-ISQM 1, but especially those identified in the Request for Comments section. Comments are most helpful when they refer to specific paragraphs, include the reasons for the comments, and make specific suggestions for any proposed changes to wording. Respondents are free to address only questions relevant to them. When a respondent agrees with the proposals in ED-ISQM 1, it will be helpful for the IAASB to be made aware of this view as support for the IAASB's proposals cannot always be inferred when not explicitly stated.

## Section 3 Significant Matters

### Section 3A – A New Approach Focused on Quality Management

3. An effective system of quality control provides the foundation for the approach to achieving consistent engagement quality, as it sets out what is needed in a firm's system of quality control to manage the quality of engagements performed by the firm. Extant ISQC 1 requires firms to establish and maintain a system of quality control and specifies the policies and procedures that firms are required to establish as part of the system of quality control.
4. In the wake of the financial crisis, many companies responded to the changing environment and emerging corporate governance risks by revisiting their business practices and relevant activities. Questions have arisen about whether extant ISQC 1 remains fit for purpose, given the evolving environment in which firms operate, the intensifying focus on quality and the increasing expectations of firms' stakeholders. Furthermore, the findings from the post-implementation review of the clarified

<sup>1</sup> ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

ISAs, inspection findings and ongoing outreach have suggested that several aspects of extant ISQC 1 could be more robust, and that additional action is needed to address the proportional application of the standard by small- and medium-sized practitioners (SMPs).

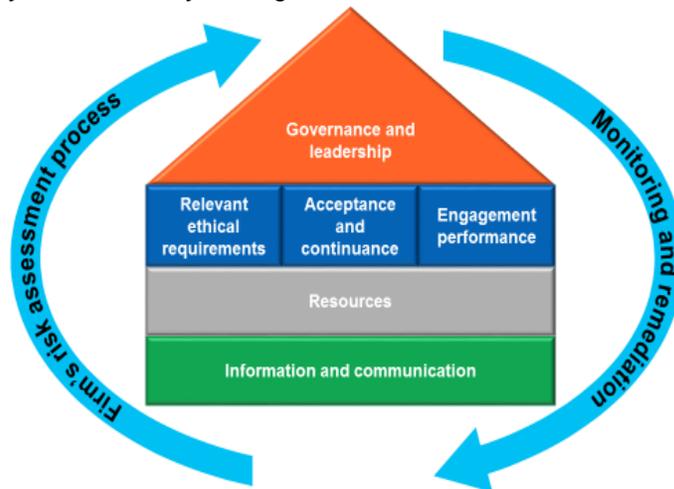
5. Recognizing these issues, the ITC highlighted several public interest issues, which included the need for proactive management of quality and keeping the standard fit for purpose. The ITC suggested that a new approach to quality control at the firm level is needed that emphasizes the responsibility of firm leadership for proactively managing quality, while at the same time being scalable to deal with differences in the size of firms and nature of the services they provide. As a result, the ITC proposed a new approach for ISQC 1, the quality management approach.
6. Respondents to the ITC supported the quality management approach because it is more risk-based and proactive, and agreed that the approach could provide benefits for firms' systems of quality control, including that it would likely enhance the ability for firms to proportionately apply the standard. However, some respondents noted that only limited information had been provided in the ITC about the new approach and cautioned that the new approach should not simply result in add-ons to the existing requirements that may result in compliance with the standard becoming unnecessarily onerous, particularly for SMPs. On the other hand, other respondents were concerned that a new approach could diminish the robustness of ISQC 1 because the approach would involve more judgment and some of the requirements of the extant standard may not be adapted to the risk-based approach appropriately.
7. The IAASB concluded that in order to substantively enhance firms' management of engagement quality and at the same time improve the scalability of the standard, ED-ISQM 1 should incorporate the new quality management approach that would be focused on proactively identifying and responding to risks to quality. This approach would include other enhancements to address key issues highlighted in the ITC to improve the robustness of firms' systems of quality management (e.g., enhanced requirements and focus on governance and leadership, monitoring and remediation, and circumstances when a firm belongs to a network).
8. The essence of the new approach is to focus firms' attention on risks that may have an impact on engagement quality. Unlike extant ISQC 1, the new approach requires a firm to customize the design, implementation and operation of its system of quality management based on the nature and circumstances of the firm and the engagements it performs. The new approach also requires the firm to transition from policies and procedures that address standalone elements, as required by extant ISQC 1, to an integrated approach that reflects upon the system as a whole.
9. The new approach, termed quality management, is expected to generate multiple benefits for firms' systems of quality management that support the consistent performance of quality engagements, including:



The new quality management approach aims to improve the scalability of ED-ISQM 1 because it requires a firm to **customize** the design, implementation and operation of its system of quality management based on the **nature and circumstances of the firm and the engagements it performs**

- (a) A system that is tailored for the nature and circumstances of the firm and the engagements it performs, thereby improving the robustness and effectiveness of activities undertaken by the firm to address engagement quality. A tailored system of quality management may also result in improved utilization of firm resources.
  - (b) Facilitating a proactive response by the firm to changing circumstances and proactively managing or mitigating risks, and promoting continual improvement and responsiveness. This new approach will also aid in keeping the standard fit for purpose and adaptable to a changing environment.
  - (c) Increased emphasis on monitoring the system as a whole and timely and effective remediation, to promote ongoing improvement and consideration of the appropriateness of the system, including whether it is effective in supporting engagement quality.
  - (d) Improved integration of the components of the system, thereby promoting an ongoing process of improvement, and consideration of the effect of decisions across the system.
10. In incorporating the new approach into the standard, the IAASB considered many other risk management and governance frameworks, such as the COSO Integrated Framework (2013).<sup>2</sup> ED-ISQM 1 has many similarities to these frameworks, where the aim is to achieve objectives or principles through managing risks to achieving those objectives. The IAASB also undertook outreach with firms that have begun to adopt risk-based approaches in their systems of quality control.
11. Given the new references to quality management, the title of the standard and other references to quality control in the requirements and application material have been changed to refer to quality management. The IAASB recognizes that many jurisdictions have law or regulation that requires firms to adopt ISQC 1 or otherwise refer to ISQC 1 in jurisdictional professional standards, and changing the title may create the need for law or regulation or jurisdictional standards to be amended. However, the IAASB notes the introduction of ED-ISQM 2, which may also create the need for amendments to law or regulation or jurisdictional standards. The IAASB is seeking views of respondents as to whether the change in title will create significant difficulties in adopting the standard at a jurisdictional level (see question 15).

*The Components of a System of Quality Management*



<sup>2</sup> Committee of Sponsoring Organizations of the Treadway Commission *Internal Control – Integrated Framework (2013)*

12. In determining the key components of the system of quality management that need to be addressed in ED-ISQM 1, the IAASB considered the organization of the other risk management and governance frameworks highlighted previously and how the elements in extant ISQC 1 should be retained. The IAASB agreed that retaining the elements of extant ISQC 1 is important as they reflect topics that continue to be relevant to a firm's system of quality management and provide a necessary link to the management of quality at the engagement level (i.e., ED-220<sup>3</sup>). The eight components of the proposed system of quality management, which are depicted in the diagram, are as follows:
- (a) Governance and leadership (adapted from "leadership responsibilities for quality within the firm" in extant ISQC 1);
  - (b) The firm's risk assessment process (new);
  - (c) Relevant ethical requirements;
  - (d) Acceptance and continuance of client relationships and specific engagements;
  - (e) Engagement performance;
  - (f) Resources (adapted from "human resources" in extant ISQC 1);
  - (g) Information and communication (new); and
  - (h) Monitoring and remediation process (adapted from "monitoring" in extant ISQC 1).
13. While ED-ISQM 1 is organized according to the eight components, firms are not required to organize their systems according to these discrete components (see paragraph A5 of ED-ISQM 1). ED-ISQM 1 only requires that a firm meet all of the requirements of the standard in designing, implementing and operating its system of quality management. For example, provided that all of the requirements of the standard are still met, a firm may have different names for the components, may combine the components or may have additional components.
14. Unlike the elements of extant ISQC 1 that appear disconnected from one another, the eight components in ED-ISQM 1 are specifically designed and described as highly integrated. For example, resources and information and communication are essential aspects that enable the operation of each of the other components of the system of quality management. The integration of the components means that the system of quality management does not operate in a linear manner. As a result, many aspects of ED-ISQM 1 would be designed, implemented and operated by the firm in an iterative manner.
15. In order to provide an overall understanding of the integrated nature of the system, the introductory paragraphs of the standard provide a summary explanation of the components (see paragraphs 8–13 of ED-ISQM 1). Additionally, the interrelationships between the components have been emphasized and explained throughout ED-ISQM 1. However, the IAASB agreed that matters that relate to more than one component should not be repeated in each component because that would result in a voluminous standard and be perceived as more prescriptive. For example, communication of independence matters is not specifically required in the relevant ethical requirements component because it is addressed by the broader requirements in the information and communication component.

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<sup>3</sup> Proposed International Standard on Auditing (ISA) 220 (Revised), *Quality Management for an Audit of Financial Statements*

**Section 3B – General Considerations**

*Objective of the Standard*

- 16. The *objective of the firm* in the context of the standard is to design, implement and operate a system of quality management.
- 17. The system of quality management is designed to achieve the following two objectives, which are similar to the objectives in extant ISQC 1:
  - (a) The firm and its personnel fulfill their responsibilities in accordance with professional standards and applicable legal and regulatory requirements, and conduct engagements in accordance with such standards and requirements; and
  - (b) Engagement reports issued by the firm or engagement partners are appropriate in the circumstances.
- 18. An effective system of quality management provides the firm with reasonable assurance regarding the achievement of the two objectives (see paragraph A3 of ED-ISQM 1). A system of quality management cannot be designed to provide absolute assurance, because of the inherent limitations of a system, for example, human error or uncertainty in judgments. The term "reasonable assurance" rather than "absolute assurance" acknowledges that limitations exist in all systems of quality management, and that uncertainties and risks may exist that cannot be predicted. Accordingly, the *objective of the system of quality management* is to provide the firm with reasonable assurance regarding the achievement of the objectives. In this context, reasonable assurance is not intended to be obtained through independent assurance that the system is effective (i.e., in the case of an assurance engagement). Instead, reasonable assurance is obtained through the operation of the system as a whole. This approach is similar to other risk management and governance frameworks.



Objective of ED-ISQM 1

*Public Interest*

- 19. In the ITC, one of the actions proposed to address the culture of the firm and responsibility and accountability of leadership for quality was to emphasize in the introduction or application material the importance of relevant public interest considerations in relation to the design of the firm’s system of quality control. Respondents to the ITC had mixed views about this proposal and indicated that there is no common interpretation or understanding of the term “public interest.”
- 20. The International Ethics Standards Board for Accountants (IESBA) *International Code of Ethics for Professional Accountants (including International Independence Standards)* (the Code) indicates that professional accountants have a responsibility to act in the public interest. The IAASB is of the view that although public interest considerations vary across engagement types, the consistent performance of quality engagements is integral to a firm’s responsibility to act in the public interest. As a result, paragraph 23(c) of ED-ISQM 1 describes the firm’s role in serving the public interest, and paragraphs 7 and A2 of the standard explain the meaning of this term and its relationship to the Code.

21. Paragraph 7 of ED-ISQM 1 also explains the connection between the public interest and the objective of the standard. However, some Board members were of the view that the firm's role to act in the public interest should be explicitly referred to in the objective of the standard. Others were of the view that without explicit criteria, a reference to acting in the public interest in the objective would result in an objective that is not capable of being consistently measured, observed or attained. The IAASB is seeking the views of respondents on whether it is clear how achieving the objective of the standard relates to the firm's public interest role (see question 5).

#### *Professional Judgment and Professional Skepticism*

##### Professional Skepticism at the Engagement Level

22. One of the most significant public interest issues highlighted in the ITC is fostering an appropriately independent and challenging skeptical mindset of the auditor. The IAASB recognizes that many aspects of the firm's system of quality management support the exercise of professional skepticism at the engagement level. For example:
- (a) The firm's culture and the tone set by leadership should promote the importance of quality, and the need to exercise professional skepticism when performing audit, review or other assurance engagements.
  - (b) Allocating appropriate resources to perform engagements may prevent impediments to professional skepticism, such as limited time, knowledge or experience.

Given the pervasive effect of the system of quality management on supporting professional skepticism at the engagement level, ED-ISQM 1 does not specifically highlight which aspects of the system support professional skepticism. However, an emphasis on professional skepticism at the engagement level has been made in the introductory section and the engagement performance component (see paragraphs 7 and 36(b) of ED-ISQM 1). Furthermore, ED-220 addresses professional skepticism in the context of managing quality at the engagement level through explaining the impediments to the exercise of professional skepticism and actions that the engagement partner may take to deal with such impediments.

##### Professional Judgment and Professional Skepticism at the Firm Level

23. Unlike extant ISQC 1, ED-ISQM 1 explicitly requires the firm to exercise professional judgment in applying the requirements of the standard. Doing so is necessary so that a firm's system of quality management is appropriately tailored to the nature and circumstances of the firm and the engagements it performs. The need to exercise professional judgment is reinforced throughout the standard and a definition of professional judgment has been introduced (see, for example, paragraphs 7, 8, 19(n) and 22 of ED-ISQM 1).
24. The IAASB considered whether the concept of professional skepticism is relevant to professional judgments made about the system, and agreed that professional skepticism is a concept that is relevant to judgments made in performing engagements. Nevertheless, the IESBA's project addressing the [role, mindset and behavioral characteristics expected of all professional accountants when performing their professional activities](#) may be relevant to professional judgments made about the system of quality management, and the IAASB will continue to coordinate with IESBA in considering the impact of that project on ED-ISQM 1.

**Section 3C – The Firm’s Risk Assessment Process**

25. As explained in Section 3A, ED-ISQM 1 includes a new approach that focuses firms’ attention on risks that may have an impact on engagement quality. ED-ISQM 1 includes a component, the firm’s risk assessment process, which comprises the process the firm is required to follow in implementing the risk-based approach to quality management. The firm’s risk assessment process is applied to the other seven components of the system of quality management, i.e., the firm is required to use this process in establishing quality objectives, identifying and assessing quality risks, and designing and implementing responses for the other seven components.
26. As explained previously in this explanatory memorandum, ED-ISQM 1 does not require that firms organize their systems according to the components. Accordingly, firms may perform the firm’s risk assessment process in a variety of ways, for example, the process may be applied to the firm as a whole for all components together, the process may be applied individually to each component, or the process may be applied to individual business units or service lines (see paragraph A48 of ED-ISQM 1).



*Establish Quality Objectives*

27. The quality objectives established by the firm consist of objectives that, when achieved by the firm, collectively provide the firm with reasonable assurance that the objectives of the system of quality management are achieved (see paragraph 19(p) of ED-ISQM 1). The relationship between the quality objectives, the objective of the system of quality management and the objective of the standard is as follows:



28. ED-ISQM 1 includes quality objectives that all firms are required to establish (see paragraphs 23, 32, 34, 36, 38, 40 and 42 of ED-ISQM 1). The quality objectives are outcome-based and how they are achieved is determined by the firm, thereby improving the scalability of the standard. The quality objectives required by the standard comprise important aspects of extant ISQC 1 that have been retained<sup>4</sup> as well as objectives that have been introduced to address key issues highlighted in the ITC or elements the IAASB considers necessary for a system of quality management.

<sup>4</sup> In developing the quality objectives, the IAASB identified that there was an inconsistent level of granularity across the requirements in extant ISQC 1. As a result, some of the requirements transposed from extant ISQC 1 are less specific in ED-ISQM 1 to ensure a consistent level of granularity across the quality objectives.

29. The IAASB is of the view that the quality objectives in ED-ISQM 1 are comprehensive and, if properly addressed by a firm, will result in the system providing reasonable assurance that its objectives have been achieved. However, the IAASB recognizes that the nature and circumstances of firms and the engagements they perform will vary, which may give rise to the need for the firm to establish additional quality objectives beyond those set out in the standard in order to achieve the objective of the standard. Accordingly, the firm is required to establish additional quality objectives beyond those required by the standard, when those objectives are necessary to achieve the objective of the standard (see paragraph 26 of ED-ISQM 1). This requirement will also aid in keeping the standard fit for purpose and adaptable to a changing environment. A description of the purpose of each component has been included in each lead-in to the requirement to establish quality objectives.<sup>5</sup>



30. The IAASB debated whether there should also be a requirement for firms to establish more granular quality objectives than those required by the standard in order to facilitate the identification and assessment of quality risks, i.e., a requirement for the firm to break down the quality objectives required by the standard into more specific quality objectives. The IAASB agreed that such a requirement would not be necessary, as 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 quality objectives. Accordingly, establishing more granular quality objectives is not required (see paragraph A49 of ED-ISQM 1).

*Identify and Assess Quality Risks*

31. A risk-based approach supports the firm in focusing its efforts and resources on areas where they are needed the most. ED-ISQM 1 recognizes that it is not reasonable or practicable for firms to identify and assess every possible risk, and to design and implement responses for every risk (see paragraph A54 of ED-ISQM 1). Accordingly, ED-ISQM 1 includes a process for identifying and assessing quality risks that includes a threshold for identifying quality risks and a requirement to assess those risks identified, such that the nature, timing and extent of the responses designed and implemented by the firm are appropriately focused on what is important for the system of quality management. The threshold for identifying quality risks is those risks for which (a) there is a reasonable possibility of the risk occurring; and (b) if the risk were to occur, it may individually or in



<sup>5</sup> For example, paragraph 38 of ED-ISQM 1 describes the resources component as “appropriately obtaining, developing, using, maintaining, allocating and assigning resources, including human resources, technological resources, and intellectual resources, in a timely manner to enable the design, implementation and operation of the system of quality management.”

combination with other quality risks, have a significant effect on the achievement of a quality objective(s).

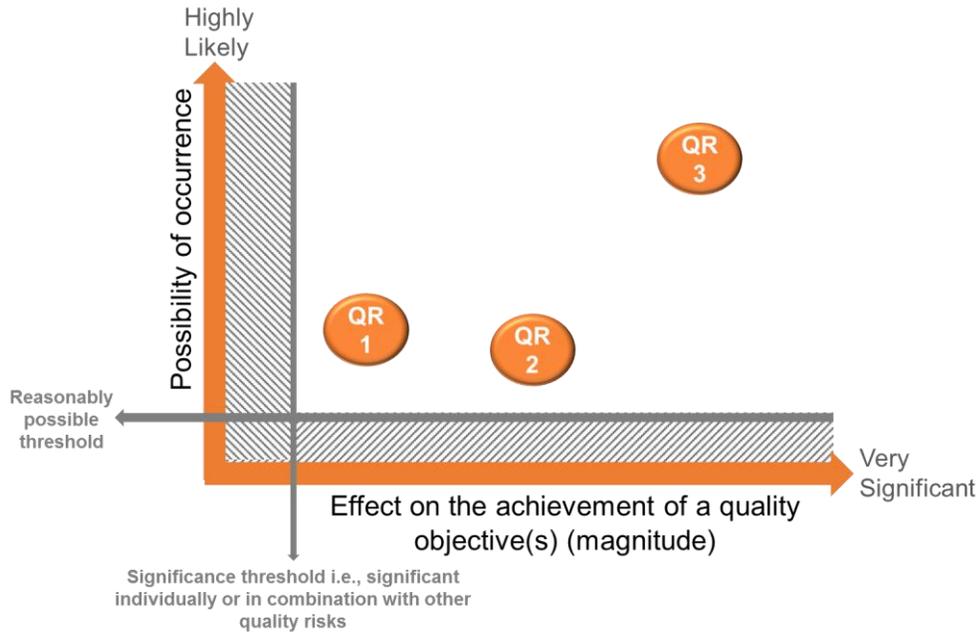
32. The IAASB is of the view that a consistent approach to identifying and assessing risks across the IAASB’s standards helps to reinforce key concepts of a risk-based approach. Accordingly, the approach for identifying and assessing quality risks in ED-ISQM 1 echoes the principles in the IAASB’s recently published Exposure Draft, ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement* (ED-315).<sup>6</sup>
33. The process in ED-ISQM 1 consists of two steps:
  - (a) Identifying the quality risks that meet the threshold described in paragraph 31, based on a preliminary consideration of the possibility of the quality risks occurring and their effect on the achievement of the quality objectives (see paragraph 28 of ED-ISQM 1); and
  - (b) Assessing the identified quality risks, which involves a more detailed consideration of the degree of the likelihood of the quality risks occurring and the significance of the effect of the identified quality risks on the achievement of the quality objectives (see paragraph 29 of ED-ISQM 1). The purpose of assessing the quality risks is to assist the firm in designing and implementing responses, because the reasons for the assessment of the quality risks affect the nature, timing and extent of the responses.

The IAASB acknowledges that in some instances, the two steps may be undertaken concurrently by the firm. However, the firm is not expected to assess every quality risk; the firm is only expected to assess those risks that reach the threshold criteria. The process for identifying quality risks and the further assessment is depicted as follows:



<sup>6</sup> The IAASB plans to consider the feedback from respondents on ED-315 as it relates to the concepts incorporated in ED-ISQM 1, including whether the threshold of “a reasonable possibility of occurring” is appropriate.

34. As explained above, the assessment of the identified quality risks involves a more detailed consideration of the possibility of occurrence and effect on the achievement of a quality objective(s), and may entail an analysis such as the following:



35. Unlike the quality objectives, ED-ISQM 1 does not identify quality risks that are applicable for all firms. The firm is expected to identify and assess its own quality risks for the quality objectives set forth in the standard and any additional quality objectives that the firm has established, taking into account the nature and circumstances of the firm and the engagements it performs. As a result, the quality risks identified and assessed by the firm are customized and tailored for the firm. The IAASB is of the view that specifying quality risks in the standard would result in less tailored quality risks and would likely drive a checklist-based approach to implementing the standard, contrary to the new quality management approach.

### *Design and Implement Responses*

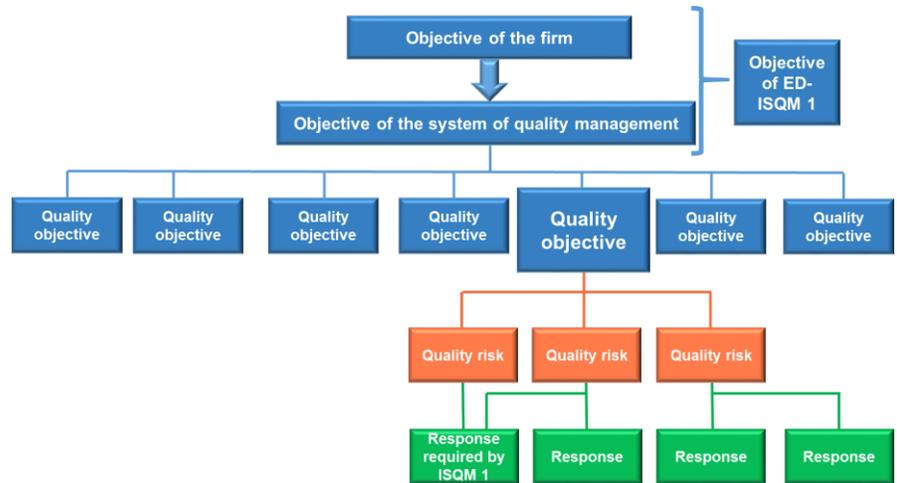
#### Definition of Responses

36. The definition of controls in ED-315 refers to policies or procedures, consistent with the COSO Integrated Framework (2013).<sup>7</sup> The IAASB is of the view that responses to quality risks are analogous to controls, and therefore the definition of responses in ED-ISQM 1 has been aligned to the definition of controls in ED-315 (see paragraph 19(t) of ED-ISQM 1). This definition recognizes that policies or procedures may include aspects of governance, for example, tone at the top and other aspects of the firm's system which are established but are not formally documented policies or procedures. The IAASB used the term responses instead of controls or policies or procedures because it emphasizes the importance of responding to the quality risks and the proactive nature of the new quality management approach.

<sup>7</sup> The COSO Integrated Framework (2013) describes control activities as the actions established by policies and procedures to help ensure management directives to mitigate risks to the achievement of objectives are carried out.

The Requirement to Design and Implement Responses

37. ED-ISQM 1 requires the firm to design and implement responses to address the quality risks, in order that the quality objectives are achieved (see paragraph 30 of ED-ISQM 1). As explained previously, the standard includes quality objectives that are comprehensive and, if properly addressed by a firm, will result in the system providing reasonable assurance that its objectives have been achieved. ED-ISQM 1 includes some responses that all firms are required to design and implement, however these responses are not comprehensive (see paragraphs 24, 25, 33, 35, 37, 41 and 43 of ED-ISQM 1). For example, the resources component does not include any required responses. As a result, the standard is explicit that the firm is required to design and implement responses to address the assessed quality risks, in addition to the responses required by the standard (see paragraphs 10(c) and A59 of ED-ISQM 1). In the view of the IAASB, this approach promotes a tailored and scalable approach to managing quality.



38. The responses in ED-ISQM 1 that all firms are required to design and implement include:

- (a) Important aspects of extant ISQC 1 that need to be retained in order to preserve the robustness of the extant standard;
- (b) New matters that have been introduced to address key issues, for example, issues highlighted in the ITC (e.g., undertaking periodic performance evaluations of firm leadership); or
- (c) Responses needed for consistency with, or linkage to, other professional standards, including relevant ethical requirements and ED-220.

Although these responses are required by the standard, the firm would tailor them taking into account the assessed quality risks that the responses address, as well as the nature and circumstances of the firm and the engagements it performs. For example, paragraph 33(d) of ED-ISQM 1 requires the firm to obtain, at least annually, a documented confirmation of compliance with independence requirements from all personnel required by relevant ethical requirements to be independent. The firm may tailor this response by adapting its frequency (e.g., obtaining the confirmation twice a year), or by adding specificity as to how the firm’s personnel will evidence the confirmation (e.g., a manual signature on a hard copy or a digital signature through an IT application).

39. The IAASB explored including more prescriptive responses in the standard, but agreed that doing so would deter firms from identifying and assessing the quality risks in a proper manner and result in firms only implementing the responses required by the standard, contrary to the new quality management approach. Furthermore, the IAASB noted that it would not be possible to comprehensively address all of the responses needed by firms in the standard, given the varying nature and circumstances of firms and the engagements they perform.

*Changes in the Nature and Circumstances of the Firm or its Engagements*

40. A key aspect of the quality management approach is continuous improvement. ED-ISQM 1 sets forth two instances when the quality objectives, quality risks or responses may need to be revised to improve the system:
- (a) As a result of information arising from the firm's monitoring activities. The revisions to the monitoring and remediation component in ED-ISQM 1 have improved the focus on ongoing, or more real-time, monitoring. In responding to identified deficiencies, which may be identified through the firm's own monitoring activities, external inspections or other information sources, paragraph 49 of ED-ISQM 1 requires the firm to determine whether the firm's quality objectives, assessed quality risks and responses remain appropriate, and modify them, as appropriate.
  - (b) As a result of changes in the nature and circumstances of the firm or its engagements. Paragraph 31 of ED-ISQM 1 requires the firm to take actions to identify these changes and modify the quality objectives, quality risks or responses, as appropriate, in response to such changes.

**Section 3D – Governance and Leadership**

41. The ITC noted that extant ISQC 1 does not specifically address firm governance, or 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. Respondents to the ITC overall supported the various suggestions to strengthen firm governance and leadership, although emphasized that any actions would need to be flexible to accommodate different jurisdictions and firm structures.
42. The IAASB is of the view that a firm's governance and leadership is of paramount importance to engagement quality, as 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. Accordingly, the governance and leadership component has been placed first in ED-ISQM 1. 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.
43. In developing the various quality objectives and responses for this component, the IAASB considered numerous global resources addressing governance and leadership in general for all entities, and those more specific to the governance of audit firms. ED-ISQM 1 has been substantially enhanced to improve the robustness of firms' governance and leadership. In particular, it addresses the expected behavior of firm leadership in setting the tone at the top, the appropriate qualifications of leadership, and holding leadership accountable through performance evaluations. The standard also now addresses the effect of the firm's strategic actions, including financial and operational decisions,<sup>8</sup> on engagement quality and the firm's public interest role, as well as firm leadership's ability to influence decisions about the firm's resources.
44. In developing the requirements, the IAASB considered who in the firm should be ultimately responsible for the system of quality management, and whether that responsibility should be extended to quality more broadly. The IAASB resolved to retain the requirement of extant ISQC 1, which assigns this role to the firm's chief executive officer (or equivalent) or, if appropriate, the firm's

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<sup>8</sup> The IAASB is of the view that commercial considerations are the same as financial and operational decisions, and preferred the latter term as it provides a more accurate description of what is meant.

managing board of partners (or equivalent) (see paragraph 24(a) of ED-ISQM 1). However, recognizing that SMPs may not have these types of roles in their leadership structures, outreach feedback suggested that an additional option should be added to acknowledge SMPs (i.e., the firm's managing partner). The IAASB further agreed that leadership cannot be responsible and accountable for quality broadly, but is responsible and accountable for the system of quality management that supports the consistent performance of quality engagements. The accountability of leadership is reinforced by the new requirement for the firm to undertake performance evaluations of those assigned leadership roles.

45. In developing ED-ISQM 1, the IAASB undertook various outreach activities across many stakeholder groups. The IAASB heard concerns that SMPs may experience practical challenges in implementing certain proposals related to governance and leadership. The IAASB is of the view that the requirements in this component are universally applicable to firms of all sizes, in particular since the quality objectives have been established as outcomes. The nature and extent of the actions taken in achieving those objectives may be more simple for an SMP. For example, paragraph A28 of ED-ISQM 1 explains that a smaller firm may be able to establish the desired culture of the firm through the direct interaction of firm leadership with other personnel, which is not always possible in the case of a larger firm. Furthermore, paragraph 21 of the standard recognizes that not all requirements are relevant in all circumstances, and paragraph A20 of ED-ISQM 1 provides examples of when the requirements might not be relevant, which includes aspects of governance and leadership in certain circumstances.

#### Operational Responsibility for Compliance with Independence Requirements

46. In the ITC the IAASB had included a proposal to specifically require a firm to identify appropriate personnel within the firm's leadership to be responsible and accountable for independence matters. This proposal was included in response to calls from certain regulatory stakeholders to the IESBA to more clearly and robustly address the issue of responsibility for independence within a firm. Although respondents to the ITC expressed mixed views about this proposal, the IAASB is of the view that independence is critical to the performance of engagements for which independence is required. Accordingly, requiring firms to assign responsibility for independence emphasizes that independence is an important consideration in a firm's system of quality management (see paragraph 24(a)(iii) of ED-ISQM 1). This new requirement operates in conjunction with many other enhanced requirements of the standard, for example, the firm may need resources to support its activities to determine compliance with independence requirements.
47. In developing ED-ISQM 1, the IAASB coordinated with the IESBA on many matters of mutual interest, including responsibility for independence. Through this engagement, the IESBA suggested that the requirement in ED-ISQM 1 should more broadly capture responsibility for relevant ethical requirements. In general, the IAASB is of the view that doing so would reduce the focus on the importance of independence. However, the IAASB is interested in respondents' views as to whether there should be an individual assigned responsibility for relevant ethical requirements, and if so, whether this should be in addition to assigning responsibility for compliance with independence requirements (see question 8(a)). The IAASB recognizes that an individual within the firm could fulfill both roles, particularly in the case of an SMP.

## Responsibility for Understanding ED-ISQM 1

48. In order to improve leadership's responsibility for the system of quality management, paragraph 20 of ED-ISQM 1 is more explicit about who is responsible for understanding ED-ISQM 1. However, through its outreach in developing the standard, the IAASB heard that while these individuals may have ultimate responsibility for the system, responsibilities for aspects of the system are delegated to other individuals within the firm who support leadership (this is particularly the case in large firms). As a result, the IAASB heard concerns that requiring those with ultimate or operational responsibility for the system to have an in-depth understanding of the standard would be impractical. Accordingly, paragraph 20 of ED-ISQM 1 has been adjusted from extant ISQC 1 and requires these individuals to have an understanding of ED-ISQM 1 that is relevant to their responsibilities.

## Section 3E – Resources

### Technological Resources

49. The IAASB recognizes that firms are increasingly using technology in performing engagements, which may be developed by the firm or obtained from the firm's network or an external service provider. Firms are also increasing their use of technology in facilitating the operation of their systems of quality management, for example, technology may be used to continually monitor the permissibility of financial investments recorded by personnel as part of the firm's independence responses.
50. As part of the modernization of the standard, the IAASB has introduced a new requirement addressing the use of technological resources, both in the performance of engagements and the operation of the system of quality management (see paragraph 38(e) of ED-ISQM 1). The requirement is principles-based because the IAASB is mindful that the types of technologies, and the extent to which they are being used, are continually evolving. It is noted that the application material includes IT-related concepts that have been explained in a manner consistent with ED- 315.<sup>9</sup>

### Intellectual Resources

51. The IAASB noted that intellectual resources are essential to enabling the performance of quality engagements, and are not addressed in extant ISQC 1. For example, in performing an audit of financial statements, engagement teams ordinarily depend on the firm's methodology to perform their work, which is based on professional standards and addresses applicable law or regulation. Accordingly, a new principles-based requirement addressing intellectual resources has been introduced in ED-ISQM 1, designed to be adaptable to the variety of intellectual resources that may be utilized within the firm (see paragraph 38(f) of ED-ISQM 1).

## Section 3F – Information and Communication

52. Extant ISQC 1 does not address the broader need for information and communication across the system and the communication of information with engagement teams, which is essential for the effective operation of the system of quality management and the performance of engagements. It also does not acknowledge the two-way nature of communication. As a result, ED-ISQM 1 includes

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<sup>9</sup> ED-315 includes new material to address how automated tools and techniques are being used in performing audits. ED-315 also includes significant clarifications and enhancements to address the auditor's understanding of an entity's IT environment, and provides greater clarity on IT-related concepts. The IAASB is mindful that the explanations and descriptions in ED-315 need to be principles-based, given that rapid changes in IT and the terms in which it is described could outdate the standard within a short period of time.

a new component, information and communication, which includes requirements for the firm to establish an information system<sup>10</sup> and emphasizes the need for effective two-way communication within the firm, as well as the responsibility of all personnel for communication (see paragraphs 40 and 41 of ED-ISQM 1). The new component also supports the firm in addressing the need for robust communication and interactions during the performance of engagements, a key public interest issue highlighted in the ITC.

53. The IAASB considered whether the requirements in the information and communication component should further specify with whom communication should take place and the type of information that should be obtained, generated and communicated. The IAASB is of the view that specifying the information and communication needs for each component would result in lengthy requirements and could inadvertently omit information or communication needs. Furthermore, such an approach would be prescriptive and contrary to the principles-based nature of the standard. Accordingly, the requirements do not include this specificity and in designing the system of quality management, the firm would need to understand the integration of the components and the information that needs to be obtained, generated or communicated to support the firm in achieving the requirements of each of the components.

#### *Communication with External Parties*

54. The ITC recognized that some firms are increasingly issuing publicly available reports that provide transparency regarding certain elements of the firm and its operations, commonly referred to as transparency reports. Accordingly, the ITC explored various actions for the IAASB to take. Respondents to the ITC were generally supportive of further actions but cautioned that any actions should not stifle developments or innovation related to transparency reporting at a jurisdictional level. However, certain respondents, mostly investors, called for the IAASB to more specifically address transparency reports in the IAASB's standards.
55. Transparency reports are required in many jurisdictions, largely for firms that perform audits of public interest entities or certain listed entities, and are commonly prepared by firms in certain other jurisdictions on a voluntary basis. However, the IAASB observed that there are still many jurisdictions where transparency reporting is not required or common practice, largely because there is a lack of demand from stakeholders in those regions for such information. Furthermore, firms that tend to prepare transparency reports perform audit engagements of public interest entities or listed entities; there is low demand for transparency reporting for smaller firms that do not perform these types of engagements.
56. The IAASB recognizes that firms communicate with external parties in a variety of ways and the communication is continually evolving. For example, firms may provide information on their website or through a publication other than a transparency report or may have a mechanism to engage directly with external parties. The IAASB is of the view that specifically requiring firms to prepare transparency reports may discourage the exchange of valuable and insightful information with external parties through alternative means that may be more appropriate or effective than a transparency report given the circumstances of the firm. The IAASB further noted that other means of communication with external parties are just as relevant and important as transparency reports.

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<sup>10</sup> Paragraphs A137 and A138 of ED-ISQM 1 explain that the information system may include the use of manual or IT elements, and in smaller firms is likely to be less sophisticated than in larger firms and involve a less complex IT environment.

57. Accordingly, the requirements in ED-ISQM 1 for communication with external parties address all forms of communication with external parties and have been developed in a manner that is adaptable to the circumstances of the firm (see paragraph 41(c) of ED-ISQM 1). The requirements aim to promote the exchange of valuable and insightful information about the firm's system of quality management with the firm's stakeholders without stifling innovation or other developments at the jurisdictional level. Although the requirements explicitly recognize transparency reports so that firms are encouraged to consider whether a transparency report is appropriate, the preparation of a transparency report is not required. However, if jurisdictional law, regulation or professional standards require the firm to prepare a transparency report, this is addressed by the requirement in paragraph 41(c)(i) of ED-ISQM 1.

### **Section 3G – Engagement Quality Reviews**

58. An engagement quality review is a firm-level response to an assessed quality risk(s) that is implemented by the engagement quality reviewer on behalf of the firm. As explained in the explanatory memorandum for ED-ISQM 2, the IAASB agreed that since the engagement quality review is a response to an assessed quality risk(s), ED-ISQM 1 should address the engagements for which an engagement quality review is to be performed. The specific criteria for an individual to be eligible to perform the engagement quality review and requirements for the performance and documentation of the review are located in ED-ISQM 2.
59. The ITC proposed several enhancements to address engagement quality reviews, given the need to keep the standard fit for purpose and enhance support for exercising professional skepticism at the engagement level. Among the proposals, the IAASB explored whether the requirements for engagements that should be subject to an engagement quality review should be strengthened by requiring an engagement quality review for audits of entities other than listed entities. The ITC considered whether it would be appropriate to require an engagement quality review to be performed for audits of public interest entities (PIEs), as this term is used in the Code. However, the IAASB recognized in the ITC the difficulty of defining the term on a global basis, given the various definitions and interpretations across different jurisdictions.
60. Respondents to the ITC supported strengthening the requirement; however, there was not extensive support for requiring the performance of an engagement quality review for audits of PIEs. Respondents who did not support this proposal noted that the lack of a universal definition of PIEs could lead to inconsistent application in practice. Further, they noted that in many jurisdictions PIEs could include very small or non-complex entities (such as small charities) and performing an engagement quality review for audits of such entities would be overly burdensome.
61. However, the IAASB recognizes the need to enhance the scope of engagements subject to an engagement quality review, because there are audits of certain entities for which engagement quality reviews would be appropriate. These entities may include, for example, some entities operating in the public sector, and financial institutions such as certain banks, insurance companies and pension funds. Accordingly, paragraph 37(e)(ii) of ED-ISQM 1 includes a new requirement for the firm's policies or procedures to require an engagement quality review for audits of financial statements of entities that the firm determines are of significant public interest. ED-ISQM 1 also provides application material that describes the characteristics of such entities, to support firms in fulfilling this requirement. "Entities that are of significant public interest" is a term that is used elsewhere in the

IAASB's standards, such as ISA 700 (Revised)<sup>11</sup> and ISA 260 (Revised),<sup>12</sup> to describe those entities that may have characteristics that give rise to similar public interest issues as listed entities. Although the IAASB has determined that this term continues to be suitable for its purposes, there may be questions as to how the term relates to "public interest entity" as defined in the Code. If respondents have views on this topic, it would be helpful for these views to be included in their responses to Question 11.

62. The IAASB is of the view that in addition to audits of listed entities or entities that the firm determines are of significant public interest, an engagement quality review may be an appropriate response to an assessed quality risk(s) for other engagements. Accordingly, paragraph 37(e)(iii)(b) of ED-ISQM 1 requires the firm to establish policies or procedures to require an engagement quality review for engagements for which the firm determines that an engagement quality review is an appropriate response, based on the reasons for the assessments given to the assessed quality risk(s). However, the IAASB recognizes that an engagement quality review is not always an appropriate response to an assessed quality risk(s) and paragraph A95 of ED-ISQM 1 explains that other types of responses may be more appropriate or effective to address the assessed quality risk(s).

### Section 3H – Monitoring and Remediation Process

63. The ITC highlighted the need for greater focus on internal and external monitoring and remediation activities as one of the key public interest issues, and an area where the extant standard is in need of modernization. The improvements proposed in the ITC for monitoring and remediation were in general supported by respondents. As a result, ED-ISQM 1 has various new and improved requirements for monitoring and remediation, in particular:
- (a) The requirements promote more proactive and effective monitoring activities and have increased the emphasis on tailoring the monitoring activities to provide a sufficient basis for the firm to evaluate the system. The IAASB is of the view that this approach may encourage firms to develop innovative monitoring techniques to further enhance quality management.
  - (b) The requirements focus on monitoring all aspects of the system. Extant ISQC 1 is largely focused on inspections of completed engagements, which only address monitoring responses that are implemented at the engagement level.
  - (c) The requirements acknowledge that there may be a variety of information sources that provide the firm with information about the operation of the system of quality management, including external inspection findings.
  - (d) The requirements have been clarified to differentiate between findings and deficiencies, so that it is clear that not all findings are deficiencies for which further action is needed.
  - (e) The firm is now required to investigate the root causes of deficiencies so that appropriate action can be taken to remediate the deficiencies effectively.
  - (f) The responsibilities of firm leadership have been enhanced, and include a requirement to determine the effectiveness of remedial actions, and an evaluation, at least annually, of whether there is reasonable assurance that the objective of the system has been achieved.

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<sup>11</sup> ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*. See also paragraphs 54–61 of the [Basis for Conclusions to Reporting on Audited Financial Statements](#).

<sup>12</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*

64. While the monitoring and remediation process has been set up in ED-ISQM 1 in a logical order, the IAASB is of the view that the monitoring and remediation process is iterative, as opposed to being purely linear. For example, the firm may adjust the nature, timing or extent of the monitoring activities based on the severity and pervasiveness of the deficiencies identified.

*Monitoring Activities, Including Inspection of Engagements*

65. The IAASB recognizes that the nature, timing and extent of the firm's monitoring activities should vary from firm to firm. Accordingly, the new requirements have been designed to emphasize factors that the firm would consider in designing its monitoring activities, rather than prescribing all of the monitoring activities that need to be performed (see paragraph 44 of ED-ISQM 1).
66. The IAASB debated the retention of the requirement in extant ISQC 1 for the firm to inspect at least one completed engagement for each engagement partner on a cyclical basis. The IAASB noted the need to retain the robustness of the extant standard in this regard but at the same time address concerns that the extant requirement is inflexible and consumes resources that could be used to perform more effective monitoring activities. The IAASB resolved to retain the requirement (see paragraph 45 of ED-ISQM 1), but has taken the following steps to improve its scalability and place emphasis on other types of monitoring activities that may be more effective:
- (a) The requirement explicitly recognizes inspections of in-progress engagements (these may also be referred to as in-process reviews). It is noted that in some cases, in-process reviews may be a monitoring activity, but in other cases they may be a response to a quality risk in another component (e.g., a quality risk related to judgments made in the performance of engagements). Whether an in-process review is a monitoring activity depends on how the firm has designed the review, including how the results of the review are considered and addressed by the firm.
  - (b) The requirement emphasizes that in determining the nature, timing and extent of the inspection of engagements, the firm takes into account various factors set out in the standard, such as changes in the system.
  - (c) Although the firm is still required to inspect one completed engagement per engagement partner on a cyclical basis, more emphasis has been given to the fact that the firm determines the length of the cycle. The application material provides examples of factors that the firm may consider in determining the length of the cycle, which includes the extent to which the firm performs other monitoring activities (e.g., inspections of in-process engagements) and the nature and circumstances of the engagements. The application material also acknowledges that the cycle may vary across engagement partners, for example, the cycle may be more frequent for engagement partners who perform audits of financial statements of listed entities.

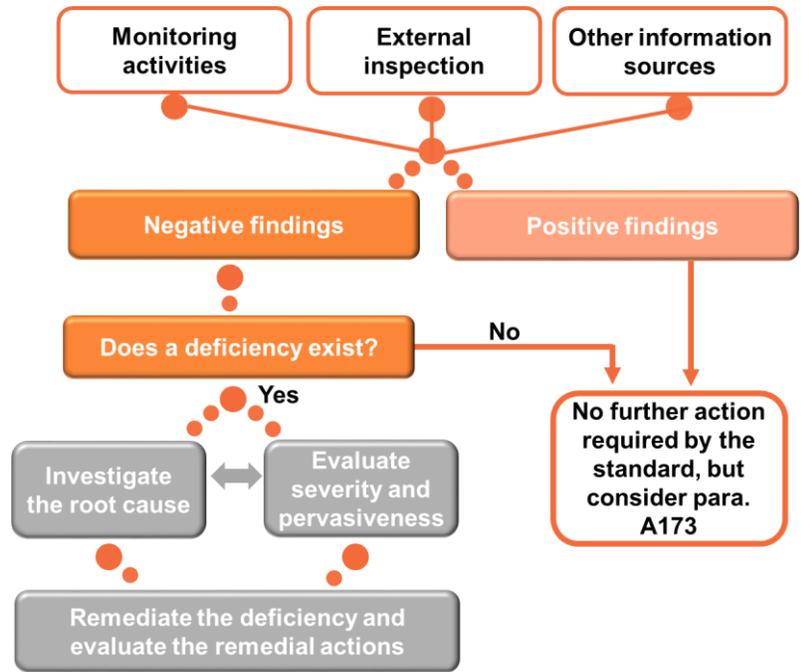
*Monitoring the Monitoring and Remediation Process*

67. The monitoring and remediation process needs to be designed appropriately and operating effectively, because without an effective monitoring and remediation process, the firm would not be able to determine whether deficiencies exist and remediate them. The IAASB is of the view that monitoring of the monitoring and remediation component may be accomplished in a variety of ways including through understanding external information (e.g., the results of external inspections may highlight deficiencies not detected by the firm's monitoring activities) or in undertaking the root cause analysis (e.g., the investigation of a deficiency may reveal further deficiencies not detected by the firm's monitoring activities) (see paragraph A177 of ED-ISQM 1). Paragraph 47 of ED-ISQM 1 requires the firm to identify deficiencies through evaluating the findings arising from monitoring

activities, results of external inspections, and other information. The identification of deficiencies may include deficiencies in the monitoring and remediation process.

*Evaluating Findings and Identifying Deficiencies*

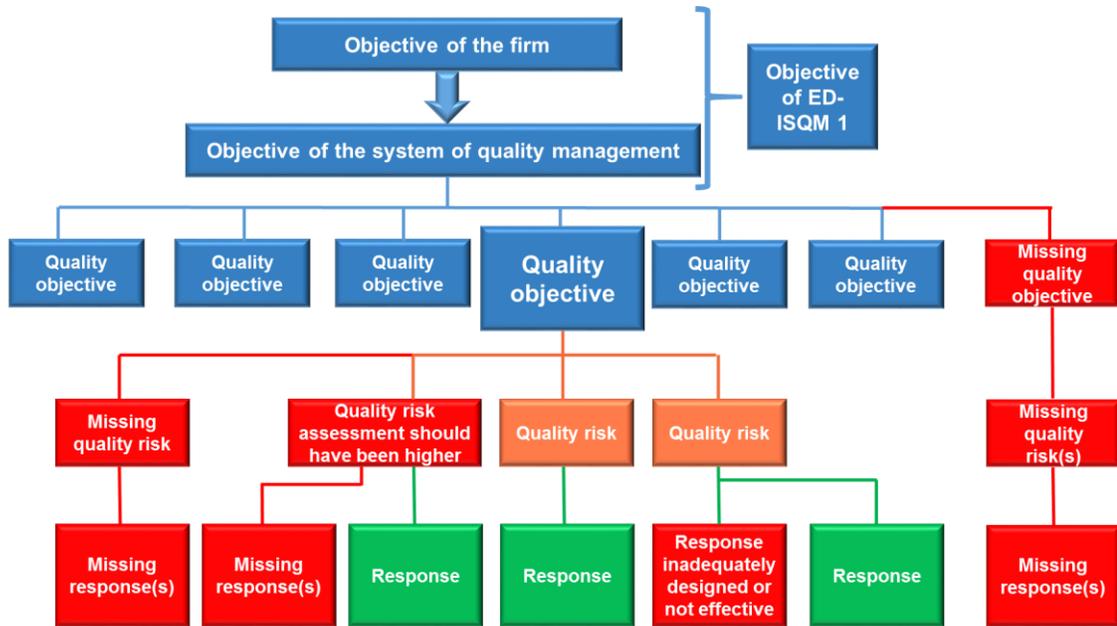
68. Findings may be positive or negative in nature, and the severity and pervasiveness of negative findings will vary. The IAASB is of the view that findings that do not rise to the level of a deficiency do not need to be subject to additional actions, such as investigating the root cause of the finding or remediating the finding. As a result, the IAASB identified the need for a clear definition of a deficiency in ED-ISQM 1<sup>13</sup> (see paragraph 19(a) of ED-ISQM 1) and a supporting framework that sets out the process for evaluating negative findings and identifying deficiencies (see paragraphs 47–48 of ED-ISQM 1). The illustration sets out the framework in ED-ISQM 1, and the application material in ED-ISQM 1 provides further guidance to support the firm in working through the framework.



69. The definition of deficiencies was developed taking into consideration how other standards and frameworks, such as ISA 265<sup>14</sup> and the COSO Integrated Framework (2013), describe deficiencies. The diagram that follows depicts examples of deficiencies that may arise in the firm’s system of quality management in red. This includes circumstances when a response that is necessary to address a quality risk has not been appropriately designed or implemented because the quality objective or quality risk was missing, or the quality risk was not appropriately assessed.

<sup>13</sup> Extant ISQC 1 requires the firm to take certain actions for deficiencies noted in the system of quality control. The term deficiencies is not defined in extant ISQC 1.

<sup>14</sup> ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*



*Root Cause Analysis*

70. Recognizing the increased demand from regulators and audit oversight bodies for firms to take action to understand the causal factors of inspection findings as a means of improving audit quality, the ITC proposed introducing a new requirement for firms to obtain an understanding of the causal factors of audit deficiencies identified by inspections and other reviews. Respondents in general supported this proposal, and therefore ED-ISQM 1 includes a new requirement for firms to investigate the root cause of deficiencies (see paragraph 48(a) of ED-ISQM 1).
71. In developing the new requirement, the IAASB debated the threshold of matters on which the root cause analysis should be performed, including whether the root cause analysis would be undertaken before determining whether a finding is a deficiency. The IAASB is of the view that determining the root cause of every finding would be onerous and consume important resources that should focus on more significant issues in the system of quality management. Therefore, the IAASB concluded that firms should be expected to determine the root cause only of identified deficiencies. However, the IAASB recognizes that in some cases the process may be iterative, i.e., in order to determine whether a finding is a deficiency, the firm may need to have some understanding of the root cause of the finding.
72. ED-ISQM 1 acknowledges that the nature and extent of the firm’s process to determine the root cause of a deficiency would vary depending on the nature and possible severity 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. In ED-ISQM 1, the requirement to determine the severity and pervasiveness of the deficiency follows the requirement to investigate the root cause of the deficiency, however investigating the root cause of the deficiency and determining the severity and pervasiveness of the deficiency is likely to be iterative.
73. The IAASB concurred with views expressed by some respondents to the ITC that determining the root cause of positive findings is valuable because it may reveal opportunities for the firm to improve the system of quality management and may assist the firm in determining the root causes of

deficiencies and how to remediate such deficiencies. Despite these benefits, the IAASB in general is of the view that ED-ISQM 1 should not require firms to determine the root cause of positive findings because the priority is for firms to remediate deficiencies, such that the objective of the standard is achieved. Furthermore, the nature of the positive findings that may enhance the system of quality management would vary and it would therefore be difficult to establish criteria in the standard for determining positive findings that should be subject to root cause analysis. The application material of ED-ISQM 1 discusses the benefits of investigating the root cause of positive findings to encourage firms to include this as part of their policies or procedures addressing the evaluation of the findings (see paragraph A178 of ED-ISQM 1). Nevertheless, the IAASB is interested in the views of respondents regarding how firms currently deal with positive findings and whether this should be more explicitly addressed in the requirements of the standard, or otherwise be more prominently highlighted (see question 12(d)(ii)).

#### *Leadership Evaluation of the System of Quality Management*

74. As explained previously, various enhancements have been made to ED-ISQM 1 to enhance the role of firm leadership as it relates to the system of quality management. Paragraph 55 of ED-ISQM 1 is a new requirement for the individual(s) assigned ultimate responsibility and accountability for the system of quality management to evaluate whether the system of quality management provides the firm with reasonable assurance that the objectives of the system have been achieved. In circumstances when it is determined that the system does not provide reasonable assurance that the objectives have been achieved, leadership is responsible for taking appropriate action. The IAASB is of the view that the new requirements reinforce the responsibility and accountability of leadership for the system of quality management. Furthermore, the requirement implicitly creates the need for the firm to collate all of the information about the system of quality management, and for leadership to evaluate this information in forming an overall view about the system.
75. The IAASB envisages that the evaluation would involve a determination of whether the system provides reasonable assurance that the objectives are achieved at the point in time the evaluation is undertaken. The IAASB debated how often the evaluation should be undertaken and agreed that undertaking the evaluation of the system at least annually would be appropriate (see paragraph 56 of ED-ISQM 1), given the requirement in extant ISQC 1 to communicate the results of the monitoring at least annually. However, the IAASB noted that in some instances the evaluation may need to be undertaken more frequently, particularly in circumstances when there is an indication that the system is not effective.

### **Section 3I – Networks and Service Providers**

#### *Networks*

76. The IAASB is of the view that in circumstances when networks share common elements related to the system of quality management (e.g., a common methodology or policies or procedures), such common elements can be instrumental in enhancing engagement quality across the firms that belong to the network. For example, in circumstances when a firm is subject to common policies or procedures established by the network, the network may hold the firm accountable for

#### **What is a network?**

Some firms operate internationally through a consortium of network firms, referred to as “a network.” Each firm that forms part of the consortium is referred to as “a network firm.”

The extent to which the network firms share common elements varies. For example, some networks may only share a brand name, while

complying with such policies or procedures. A network may also fulfill functions that the firm would otherwise have to perform, for example, the development of a methodology in accordance with international standards.

77. However, as highlighted in the ITC, concerns have been raised that firms place undue reliance on network requirements or network services (e.g., methodologies, policies or procedures, IT applications or monitoring). Accordingly, new requirements have been introduced in ED-ISQM 1 addressing network requirements or network services (see paragraphs 58–63 of ED-ISQM 1). The aim of the new requirements is to improve the robustness of the firm’s responsibilities for the network requirements or network services, so that the firm understands the network requirements or network services and the effect they have on the firm’s system of quality management. Given the varying structure of networks and the nature of the network requirements or network services, the new requirements are principles-based so that they can be adapted to a variety of circumstances. The IAASB is of the view that the new requirements emphasize that the firm is responsible for its own system of quality management, thereby addressing the issue that firms may place undue reliance on network requirements or network services.
78. The IAASB is of the view that although the new requirements are focused on the firm, they are likely to have an effect on the network. The requirements are structured such that the network would likely need to provide information to all network firms so that the firms are able to fulfill their responsibilities under ED-ISQM 1. This is expected to improve the communication and transparency between the network and network

other networks may share common methodologies or policies or procedures. In some circumstances, the network firms may be monitored by the network for compliance with the methodology or policies or procedures. The network functions (i.e., developing and maintaining the methodology or performing monitoring) may be undertaken by a standalone body established by the network to perform the various network functions.

The structure of the network may also vary. For example, within a network there may be a consortium of network firms that form a cluster within a region. Such clusters may share common policies or procedures specific to that region or there may be services used across the cluster (e.g., training).

The network firms are responsible for the engagements they perform and the reports that are issued on behalf of the network firm, i.e., the network does not perform engagements or issue engagement reports. A firm’s responsibility is established in the IAASB’s Standards,<sup>15</sup> and may be further reinforced by a jurisdictional, professional, legal or regulatory body that specifies who has the appropriate authority to perform an engagement and issue the related report.

The network itself is not responsible for the engagements undertaken by network firms or the reports issued by network firms. Furthermore, as the network is a consortium of network firms, it is not usually regulated or subject to inspection at the network level. The individual firms within the network will most likely be regulated and inspected by the regulators and audit oversight bodies within their jurisdictions or who have

<sup>15</sup> The ISAs apply to “the auditor” or “engagement partner.” ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, defines the auditor as “the person or persons conducting the audit, usually the engagement partner or other members of the engagement team, or, as applicable, the firm.” ISQC 1 defines the engagement partner as “the partner or other person in the firm who is responsible for the engagement and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.” ISQC 1 also defines the firm as “a sole practitioner, partnership or corporation or other entity of professional accountants.”

firms, and it may encourage improvements in communication across the network.

oversight of the engagements performed by the firm.

79. In developing ED-ISQM 1, the IAASB considered establishing requirements for the network instead of, or in addition to, the new requirements for the firm. The IAASB notes that the firm is responsible for the engagements it performs and the reports that are issued on behalf of the firm, and regulatory oversight occurs at the level of the firm. The network does not perform engagements and is generally not subject to regulatory inspections or overseen by oversight authorities.<sup>16</sup> Therefore, the IAASB is of the view that the firm needs to remain solely responsible for the system of quality management, i.e., requirements for networks may have the unintended effect of diluting the firm's responsibility for the system of quality management.
80. The IAASB recognizes that some stakeholders do not have an accurate understanding of the responsibilities of the network and network firms, including the relationship between networks and the network firms, and this has given rise to expectation gaps. As a result, ED-ISQM 1 includes application material to encourage firms to provide transparency about their relationships with the network and the responsibilities of the firm and the network in order to enhance stakeholders' understanding of these relationships and responsibilities (see paragraph A152 of ED-ISQM 1).

#### Network Firm Independence

81. In the IAASB's coordination with the IESBA, the IESBA questioned whether there should be more direct requirements in ED-ISQM 1 regarding compliance with independence requirements within the network. The IAASB is of the view that network firm independence is appropriately addressed in ED-ISQM 1 through the principles-based requirements addressing relevant ethical requirements.<sup>17</sup> Therefore, including more direct requirements for independence within the network would result in duplicative requirements, and the specificity of the requirement would be in contrast to other requirements in the standard. However, the IAASB is interested in respondents' views as to whether there should be more specific requirements addressing independence within the network (see question 8(b)).

#### Service Providers

82. Firms may use service providers in the system of quality management, for example, engagement software may be obtained from a service provider or the firm may use a service provider to perform engagement quality reviews. The IAASB is of the view that a service provider provides a resource, and therefore the firm needs to determine that it is appropriate to use that resource in the system of quality management. Accordingly, ED-ISQM 1 includes new requirements addressing the use of service providers in the firm's system of quality management (see paragraphs 64–65 of ED-ISQM 1). The IAASB is of the view that although the new requirements are a responsibility of the firm, they are

<sup>16</sup> Regulators are a critical element in the financial reporting supply chain and the requirements of professional standards are most effective if they are properly enforced through the legal status of standards, inspection of engagements, the investigation of allegations of failure, and when appropriate, disciplinary action being taken.

<sup>17</sup> For example, paragraph 33(a) of ED-ISQM 1 requires the firm to identify the relevant ethical requirements and determine the applicability of the relevant ethical requirements to the firm, its personnel and others, including, as applicable, the network, personnel in the network or other network firms, or service providers (this is further supported by application material that provides examples specific to networks). The firm is further required by paragraphs 33(b) and 33(c) to establish policies or procedures to address threats to compliance with relevant ethical requirements and breaches of the relevant ethical requirements, which would need to address other firms or persons within the network when there are relevant ethical requirements applicable to them.

likely to have an effect on service providers, given the need for service providers to provide information to firms to enable the fulfillment of the new requirements.

83. The IAASB noted that in some cases, a service provider may be obtained through the firm's network, for example, the network may mandate that engagement software has to be acquired from a specific service provider. In such cases, the requirements for service providers would apply to the use of those resources.

### **Section 3J – Other**

84. Many other enhancements have been made to ED-ISQM 1 that although not explicitly highlighted in this memorandum, are also intended to enhance the robustness of the standard. For example, the documentation requirements of the standard have been enhanced from extant ISQC 1, with the introduction of an overarching principles-based requirement (which has similarities to the documentation principles established in ISA 230<sup>18</sup>) and more specific requirements for matters that firms are expected to document.

### **Section 3J – Scalability**

85. The scalability of ED-ISQM 1 has been at the forefront of the IAASB's deliberations throughout the project. The ITC highlighted the need for a new approach to managing quality that is scalable to deal with differences in the size and nature of firms or the services they provide. As discussed previously, the new quality management approach drives firms to think about the nature and circumstances of the firm and the engagements it performs in designing, implementing and operating its system of quality management, and the approach is focused on achieving quality objectives that are outcome-based. While this approach is expected to generate multiple benefits for engagement quality, one of the most important benefits is a tailored system of quality management that is suitable for the nature and circumstances of the firm and the engagements it performs.
86. The IAASB recognizes that the quality management approach in ED-ISQM 1 is more complex than the approach in extant ISQC 1, and has added to the overall length of the standard. However, the IAASB is of the view that the approach in extant ISQC 1 is no longer fit for purpose and adaptable to the changing environment, given that it is more prescriptive in nature, and does not promote a scalable and tailored system of quality management that focuses on areas of risk. The IAASB acknowledges that firms will need to invest time and resources to implement the revised standard initially, however it is of the view that over time a more tailored and focused system of quality management will result in more effective use of firm resources and improvements in engagement quality.
87. Adding to the length of the standard are various new requirements that have been introduced to enhance the rigor of the standard, in particular to address key issues highlighted in the ITC (e.g., governance and leadership, monitoring and remediation, and network requirements or network services) and essential elements needed for a system of quality management (e.g., information and communication). The IAASB acknowledges that the new requirements increase the responsibilities of firms, however they address important issues that are necessary for improvements in engagement quality.

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<sup>18</sup> ISA 230, *Audit Documentation*

88. While the new quality management approach is the fundamental change introduced in the standard to address scalability, the IAASB has addressed or emphasized the scalability of ED-ISQM 1 in other ways, including:
- (a) An explicit discussion about the scalability of the standard in paragraphs 5 and 6 of ED-ISQM 1.
  - (b) A requirement to exercise professional judgment in paragraph 22 of ED-ISQM 1 and increased emphasis on professional judgment throughout the standard.
  - (c) Numerous references throughout the standard to consider the nature and circumstances of the firm and the engagements it performs.
  - (d) An explicit requirement in paragraph 21 of ED-ISQM 1 that indicates that there may be circumstances when a requirement is not relevant to the firm because of the nature and circumstances of the firm or its engagements.
  - (e) Application material that provides examples for SMPs, for example, paragraphs A28 and A42 of ED-ISQM 1.
89. The IAASB debated whether to retain the sections in extant ISQC 1 titled “Considerations Specific to Smaller Firms.” However, the IAASB is of the view that given the integrated nature of the standard, an understanding of the entire standard is needed to facilitate the implementation of a system of quality management that is tailored to the circumstances of the firm. As highlighted above, where considered useful and appropriate, the IAASB has included examples specific for SMPs. In addition, the IAASB is developing support materials to show how the standards can be applied in a scalable manner by smaller firms.

*Application Material in ED-ISQM 1*

90. Throughout the development of ED-ISQM 1, the IAASB has heard mixed views through its outreach about examples and explanations in the standard. While examples and explanations provide useful information to support implementation of the standard, they add extensive content that has resulted in an increase in the length of the standard. The IAASB is interested in respondents’ views as to the usefulness of the application material in ED-ISQM 1, in particular areas where the examples or explanations are not useful, and areas where additional examples or explanations would be helpful.

## Section 4 Request for Comments

Respondents are asked to comment on the clarity, understandability and practicality of application of the requirements and related application material of ED-ISQM 1. In this regard, comments will be most helpful if they are identified with specific aspects of ED-ISQM 1 and include the reasons for any concern about clarity, understandability and practicality of application, along with suggestions for improvement.

### Overall Questions

- 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?
  - (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?
  - (c) 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?
- 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?
- 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?

### Specific Questions

- 4) Do you support the eight components and the structure of ED-ISQM 1?
- 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?
- 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? 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?
    - ii. Is it clear that the firm is expected to establish additional quality objectives beyond those required by the standard in certain circumstances?
  - (c) Do you support the process for the identification and assessment of quality risks?

- (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?
  - 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?
- 7) Do the revisions to the standard appropriately address firm governance and the responsibilities of firm leadership? If not, what further enhancements are needed?
- 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?
  - (b) Does the standard appropriately address the responsibilities of the firm regarding the independence of other firms or persons within the network?
- 9) Has ED-ISQM 1 been appropriately modernized to address the use of technology by firms in the system of quality management?
- 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?
- 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?
- 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?
- 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?
- 14) Do you support the proposals addressing service providers?
- 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?

**PROPOSED INTERNATIONAL STANDARD ON QUALITY MANAGEMENT 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**

(Effective as of TBD)

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Appendix 1: The Components of a System of Quality Management

Proposed International Standard on Quality Management (ISQM) 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*, should be read in conjunction with the *Preface to the International Quality Management, Auditing, Review, Other Assurance, and Related Services Pronouncements*.

## Introduction

### Scope of this ISQM

1. This International Standard on Quality Management (ISQM) deals with a firm's responsibilities to design, implement and operate a system of quality management for audits or reviews of financial statements, or other assurance or related services engagements. ISQM 2<sup>19</sup> deals with the responsibility of the firm and engagement quality reviewers relating to engagement quality reviews. This ISQM is to be read in conjunction with relevant ethical requirements.
2. Other pronouncements of the International Auditing and Assurance Standards Board (IAASB) include requirements for engagement partners and other personnel regarding quality management at the engagement level. ISA 220 (Revised),<sup>20</sup> for example, deals with the specific responsibilities of the auditor regarding quality management at the engagement level for an audit of financial statements and the related responsibilities of the engagement partner. (Ref: Para. A1)
3. Law, regulation or relevant ethical requirements may establish responsibilities for the firm's management of quality beyond those described in this ISQM.
4. This ISQM applies to all firms performing audits or reviews of financial statements, or other assurance or related services engagements (i.e., if the firm performs any of these engagements, this ISQM applies).

### Scalability

5. This ISQM requires the firm to apply a risk-based approach in the design, implementation and operation of the system of quality management, taking into account:
  - (a) The nature and circumstances of the firm, including whether it is part of a network or uses service providers; and (Ref: Para. A22)
  - (b) The nature and circumstances of the engagements performed by the firm, including the types of engagements performed by the firm and the types of entities for which such engagements are performed. (Ref: Para. A23)

Accordingly, the complexity and formality of firms' systems of quality management will vary. For example, a firm that performs different types of engagements for a wide variety of entities, including audits of financial statements of listed entities or entities that are of significant public interest, will likely need to have a more complex and more formal system of quality management than a firm that performs only reviews of financial statements or compilation engagements.

6. The nature and circumstances of the firm and its engagements may change over time. This ISQM requires the firm to identify such changes and respond appropriately.

### The Firm's System of Quality Management

7. The purpose of a system of quality management is to support the consistent performance of quality engagements, by providing the firm with reasonable assurance that the objectives of the system, stated in paragraph 18(a) and (b), are achieved. The public interest is served by the consistent performance of quality engagements. Quality engagements are achieved through planning and

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<sup>19</sup> Proposed ISQM 2, *Engagement Quality Reviews*

<sup>20</sup> Proposed International Standard on Auditing (ISA) 220 (Revised), *Quality Management for an Audit of Financial Statements*

performing engagements and reporting on them in accordance with professional standards and applicable legal and regulatory requirements. Achieving the objectives of those standards and complying with the requirements of applicable law or regulation involves exercising professional judgment and, when applicable to the type of engagement, exercising professional skepticism. (Ref: Para. A2–A4)

8. This ISQM requires professional judgment to be exercised in designing, implementing and operating the firm's system of quality management. A system of quality management is a continual and iterative process and is responsive to changes in the nature and circumstances of the firm and its engagements. It also does not operate in a linear manner. However, for the purposes of this ISQM, a system of quality management addresses the following eight components, which are highly integrated: (Ref: Para. A4–A5)
  - (a) Governance and leadership;
  - (b) The firm's risk assessment process;
  - (c) Relevant ethical requirements;
  - (d) Acceptance and continuance of client relationships and specific engagements;
  - (e) Engagement performance;
  - (f) Resources;
  - (g) Information and communication; and
  - (h) The monitoring and remediation process.

A further description of each of the eight components and their interrelationships is included in Appendix 1.

9. The firm's governance and leadership component establishes the environment in which the system of quality management operates because this component addresses the firm's culture, decision-making process, actions, organizational structure and leadership. This standard requires that the firm's leadership demonstrate a commitment to quality through their actions and behaviors and establish the expected behavior of personnel within the firm.
10. In taking a risk-based approach to quality management, the firm applies the firm's risk assessment process to the other components. The firm's risk assessment process consists of:
  - (a) Establishing quality objectives. The quality objectives established by the firm consist of objectives that, when achieved by the firm, collectively provide the firm with reasonable assurance that the objectives of the system of quality management, stated in paragraph 18(a) and (b), are achieved. The firm is required to establish the quality objectives set out in this ISQM and additional quality objectives beyond those required by this ISQM, when those objectives are necessary to achieve the objective of this ISQM.
  - (b) Identifying and assessing risks to the achievement of the firm's 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 will be based on, and responsive to, the reasons for the assessments given to the quality risks. The firm is

required to include the responses required by this ISQM, which are organized by component, in its responses to its assessed quality risks. The responses required by this ISQM are relevant to every firm's system of quality management, and are therefore applicable to all firms. However, the responses required by this ISQM alone will not be sufficient to address all of the firm's assessed quality risks for the quality objectives that are required to be established by this ISQM.

11. This ISQM includes components that address specific topics that are fundamental for the performance of audits or reviews of financial statements, or other assurance or related services engagements (i.e., relevant ethical requirements, acceptance and continuance of client relationships and specific engagements, and engagement performance). In addition, it includes components for resources and information and communication, which are necessary to enable the operation of all the other components of the system of quality management.
12. This ISQM requires the firm to evaluate the design, implementation and operation of its system of quality management through a monitoring and remediation process, which involves:
  - (a) Designing and performing monitoring activities and evaluating the findings from such activities, the results of external inspections and other relevant information to determine whether deficiencies exist in the system of quality management;
  - (b) Investigating the root cause(s) of the identified deficiencies and evaluating the severity and pervasiveness of the identified deficiencies; and
  - (c) Remediating the identified deficiencies.

The findings arising from the monitoring may also highlight positive practices that the firm uses to enhance its system of quality management. The monitoring and remediation process provides information that is the basis for the evaluation of whether the system of quality management provides reasonable assurance that the objectives stated in paragraph 18(a) and (b) have been achieved.

13. All of the components of the system of quality management operating together enable the consistent performance of quality engagements and contribute to the firm achieving the objective of this ISQM. Accordingly, other pronouncements of the IAASB, such as ISA 220 (Revised),<sup>21</sup> are premised on the basis that the firm is subject to the ISQMs or to national requirements that are at least as demanding.

### *Networks*

14. In some circumstances, the firm may belong to a network. This ISQM includes requirements for firms that operate as part of a network, in recognition that networks may establish requirements regarding the firm's system of quality management or may make services or resources available that the firm may choose to implement or use in the design, implementation and operation of its system of quality management. Network requirements or network services are further described in paragraph 58 of this ISQM. Such requirements or services may be intended to promote the consistent performance of quality engagements across the firms that operate as part of the network. Notwithstanding the firm's compliance with the network requirements or use of the network services, the firm remains responsible for its system of quality management.

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<sup>21</sup> Proposed ISA 220 (Revised), paragraph 3

### *Service Providers*

15. This ISQM also includes requirements for circumstances when the firm intends to obtain or use resources provided by a service provider in its system of quality management.

### **Authority of this ISQM**

16. This ISQM contains the objective of the firm in following this ISQM, and requirements designed to enable the firm to meet that stated objective. In addition, it contains related guidance in the form of application and other explanatory material and introductory material that provides context relevant to a proper understanding of this ISQM, and definitions. (Ref: Para. A6–A9)

### **Effective Date**

17. Systems of quality management in compliance with this ISQM are required to be established by TBD.

### **Objective**

18. The objective of the firm is to design, implement and operate a system of quality management for audits or reviews of financial statements, or other assurance or related services engagements performed by the firm, that provides the firm with reasonable assurance that:
- (a) The firm and its personnel fulfill their responsibilities in accordance with professional standards and applicable legal and regulatory requirements, and conduct engagements in accordance with such standards and requirements; and
  - (b) Engagement reports issued by the firm or engagement partners are appropriate in the circumstances.

### **Definitions**

19. In this ISQM, the following terms have the meanings attributed below:
- (a) Deficiency in the firm’s system of quality management (referred to as “deficiency” in this ISQM) – This exists when:
    - (i) A quality objective required to achieve the objective of this ISQM is not established;
    - (ii) A quality risk has not been appropriately identified or assessed, such that a response that addresses that risk has not been appropriately designed or implemented; or
    - (iii) A response to address an assessed quality risk is not properly designed, implemented or operating effectively. (Ref: Para. A10)
  - (b) Engagement documentation – The record of work performed, results obtained, and conclusions the practitioner reached (terms such as “working papers” or “work papers” are sometimes used).
  - (c) Engagement partner<sup>22</sup> – The partner or other individual, appointed by the firm, who is responsible for the engagement and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

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<sup>22</sup> “Engagement partner” and “partner” should be read as referring to their public sector equivalents where relevant.

- (d) Engagement quality review – An objective evaluation of the significant judgments made by the engagement team and the conclusions reached thereon, performed by the engagement quality reviewer and completed on or before the date of the engagement report.
- (e) Engagement quality reviewer – A partner, other individual in the firm, or an external individual appointed by the firm to perform the engagement quality review.
- (f) Engagement team – All partners and staff performing the engagement, and any other individuals who perform procedures on the engagement, including individuals engaged by the firm or a network firm. The engagement team excludes an external expert engaged by the firm or by a network firm, and also excludes individuals within the client’s internal audit function who provide direct assistance on an audit engagement when the external auditor complies with the requirements of ISA 610 (Revised 2013).<sup>23</sup>
- (g) External inspections – Inspections or investigations undertaken by an external oversight authority related to the firm’s system of quality management or engagements performed by the firm. (Ref: Para. A11)
- (h) Firm – A sole practitioner, partnership or corporation or other entity of professional accountants, or public sector equivalent. (Ref: Para. A12)
- (i) Listed entity – An entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are marketed under the regulations of a recognized stock exchange or other equivalent body.
- (j) Network firm – A firm or entity that belongs to a network.
- (k) Network<sup>24</sup> – A larger structure: (Ref: Para. A13–A14)
  - (i) That is aimed at cooperation, and
  - (ii) That is clearly aimed at profit or cost-sharing or shares common ownership, control or management, common quality management policies or procedures, common business strategy, the use of a common brand name, or a significant part of professional resources.
- (l) Partner – Any individual with authority to bind the firm with respect to the performance of a professional services engagement.
- (m) Personnel – Partners and staff.
- (n) Professional judgment – The application of relevant training, knowledge and experience, within the context of professional standards, in making informed decisions about the courses of action that are appropriate in the design, implementation and operation of the firm’s system of quality management.

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<sup>23</sup> ISA 610 (Revised 2013), *Using the Work of Internal Auditors*, establishes limits on the use of direct assistance. It also acknowledges that the external auditor may be prohibited by law or regulation from obtaining direct assistance from internal auditors. Therefore, the use of direct assistances is restricted to situations where it is permitted.

<sup>24</sup> As defined in the International Ethics Standards Board for Accountants’ *International Code of Ethics for Professional Accountants (including International Independence Standards)* (IESBA Code)

- (o) Professional standards – IAASB Engagement Standards, as defined in the IAASB’s *Preface to the International Quality Management, Auditing, Review, Other Assurance and Related Services Pronouncements*, and relevant ethical requirements.
- (p) Quality objectives – The objectives that, when achieved by the firm, collectively provide the firm with reasonable assurance that the objectives of the system of quality management are achieved.
- (q) Quality risks – Risks arising from conditions, events, circumstances, actions or inactions that may adversely affect the achievement of a quality objective(s).
- (r) Reasonable assurance – In the context of the ISQMs, a high, but not absolute, level of assurance.
- (s) Relevant ethical requirements – Principles of professional ethics and ethical requirements that are applicable to professional accountants when undertaking engagements that are audits or reviews of financial statements or other assurance or related services engagements. Relevant ethical requirements ordinarily comprise the provisions of the IESBA Code related to audits or reviews of financial statements, or other assurance or related services engagements, together with national requirements that are more restrictive. (Ref: Para. A15–A16, A67)
- (t) Response (in relation to a system of quality management) – Policies or procedures designed and implemented by the firm to address an assessed quality risk: (Ref: Para. A17–A18, A62)
  - (i) Policies are statements of what should, or should not, be done to address an assessed quality risk. Such statements may be documented, explicitly stated in communications or implied through actions and decisions.
  - (ii) Procedures are actions to implement policies.
- (u) Staff – Professionals, other than partners, including any experts the firm employs.
- (v) System of quality management – A system designed, implemented and operated by a firm to provide reasonable assurance that:
  - (i) The firm and its personnel fulfill their responsibilities in accordance with professional standards and applicable legal and regulatory requirements, and conduct engagements in accordance with such standards and requirements; and
  - (ii) Engagement reports issued by the firm or engagement partners are appropriate in the circumstances.

## Requirements

### Applying, and Complying with, Relevant Requirements

20. The individual(s) assigned ultimate responsibility and accountability, and the individual(s) assigned operational responsibility, for the firm’s system of quality management shall have an understanding of this ISQM relevant to their responsibilities, including the application and other explanatory material, to understand the objective of this ISQM and to apply its requirements properly. (Ref: Para. A19)
21. The firm shall comply with each requirement of this ISQM unless the requirement is not relevant to the firm because of the nature and circumstances of the firm or its engagements. (Ref: Para. A20)

## **System of Quality Management**

22. The firm shall design, implement and operate a system of quality management that complies with the requirements of this ISQM. The requirements are designed to enable the firm to achieve the objective stated in this ISQM. The proper application of the requirements in this ISQM is expected to provide a sufficient basis for the achievement of the objective of this standard. In applying the requirements of this ISQM, the firm shall exercise professional judgment, taking into account the nature and circumstances of the firm and its engagements, such that the objective of this ISQM is achieved. (Ref: Para. A21–A24)

## **Governance and Leadership**

23. The firm shall establish the following quality objectives that address the aspects of the firm's environment that support the design, implementation and operation of the other components of the system of quality management, including the firm's culture, decision-making process, actions, organizational structure and leadership:
- (a) The firm's culture promotes a commitment to quality, including recognizing and reinforcing the importance of professional ethics, values and attitudes throughout the firm and emphasizing the responsibility of all personnel for quality relating to the performance of engagements or activities within the system of quality management. (Ref: Para. A26–A28)
  - (b) The firm has leadership who is responsible and accountable for quality. (Ref: Para. A36)
  - (c) The firm's strategic decisions and actions, including financial and operational priorities, demonstrate a commitment to quality and to the firm's role in serving the public interest, by consistently performing quality engagements. (Ref: Para. A29–A30)
  - (d) The firm has an organizational structure with appropriate assignment of roles, responsibilities and authority that supports the firm's commitment to quality and the design, implementation and operation of the firm's system of quality management. (Ref: Para. A31–A32)
  - (e) The firm plans for its resource needs, including financial resources, and obtains, allocates or assigns resources in a manner that supports the firm's commitment to quality and enables the design, implementation and operation of the firm's system of quality management. (Ref: Para. A33–A35)
  - (f) The firm fulfills its responsibilities in accordance with law, regulation and professional standards that relate to the governance and leadership of the firm, if applicable. (Ref: Para. A25)
24. In designing and implementing responses to address the quality risks identified and assessed by the firm relating to the governance and leadership quality objectives, the firm shall include the following responses:
- (a) Assigning ultimate responsibility and accountability for the system of quality management to the firm's chief executive officer or the firm's managing partner (or equivalent) or, if appropriate, the firm's managing board of partners (or equivalent). The individual(s) to whom such responsibility and accountability is assigned shall: (Ref: Para. A36)
    - (i) Have the appropriate experience and knowledge to fulfill the assigned responsibility.
    - (ii) Demonstrate a commitment to quality through their actions and behaviors, including recognizing and reinforcing the importance of professional ethics, values and attitudes,

- and establishing the expected behavior of personnel relating to the performance of engagements and activities within the system of quality management. (Ref: Para. A26–A28)
- (iii) Establish structures, reporting lines, and appropriate authorities and responsibilities, including assigning operational responsibility for the following matters to personnel who fulfill the requirements in paragraph 25: (Ref: Para. A37–A39)
- a. The system of quality management as a whole; and
  - b. Specific aspects of the system of quality management, as appropriate to the nature and circumstances of the firm, which shall include operational responsibility for compliance with independence requirements and the monitoring and remediation process.
- (b) Establishing policies or procedures for periodic performance evaluations of the individual(s) assigned ultimate responsibility and accountability for the firm’s system of quality management, and the individual(s) assigned operational responsibility for the matters set out in paragraph 24(a)(iii), in order to hold individuals accountable for the responsibilities assigned to them. (Ref: Para. A40–A43)
- (c) Establishing policies or procedures for dealing with complaints and allegations about the commitment to quality of the firm or its personnel, including clearly defining channels within the firm that enable reporting by personnel or external parties to appropriate individual(s) without fear of reprisal and enabling the investigation and resolution of the complaints and allegations. (Ref: Para. A44–A47)
25. The personnel assigned operational responsibility for the matters set out in paragraph 24(a)(iii) shall have: (Ref: Para. A39)
- (a) The appropriate experience and knowledge and sufficient time to fulfill their assigned responsibility;
  - (b) A direct line of communication to the individual(s) assigned ultimate responsibility and accountability for the system of quality management; and
  - (c) An understanding of their assigned responsibilities and accountability for such responsibilities.

### **The Firm’s Risk Assessment Process**

26. The firm shall establish the quality objectives required by this ISQM. The firm shall also establish additional quality objectives beyond those required by this ISQM, when those objectives are necessary to achieve the objective of this ISQM. (Ref: Para. A48–A51)
27. The firm shall understand the conditions, events, circumstances, actions or inactions that may adversely affect the achievement of its quality objectives, taking into account the nature and circumstances of the firm and its engagements, to provide the basis for the identification and assessment of quality risks. (Ref: Para. A48, A52)
28. Based on the understanding obtained in paragraph 27, the firm shall identify those quality risks, before consideration of any responses, that: (Ref: Para. A48, A53–A54)
- (a) Have a reasonable possibility of occurring; and (Ref: Para. A55)

- (b) If they were to occur, may individually or in combination with other quality risks, have a significant effect on the achievement of a quality objective(s). (Ref: Para. A56–A57)
29. The firm shall assess the quality risks identified in paragraph 28 to provide a basis for the design and implementation of the related responses. (Ref: Para. A48, A58)
30. The firm shall design and implement responses to address the assessed quality risks, including the responses required by this ISQM. The design of the responses shall be based on, and responsive to, the reasons for the assessments given to the quality risks. (Ref: Para. A48, A59–A64)

#### *Changes in the Nature and Circumstances of the Firm or its Engagements*

31. The firm shall identify changes in the nature and circumstances of the firm or its engagements and modify the quality objectives, quality risks or responses, as appropriate, in response to such changes. (Ref: Para. A48, A65–A66)

#### **Relevant Ethical Requirements**

32. The firm shall establish the following quality objectives that address the fulfillment of responsibilities in accordance with relevant ethical requirements, which, as defined, include the principles of professional ethics: (Ref: Para. A67)
- (a) The firm, its personnel and others subject to relevant ethical requirements understand the relevant ethical requirements, including those related to independence.
  - (b) The firm, its personnel and others subject to relevant ethical requirements fulfill their responsibilities in relation to the relevant ethical requirements, including those related to independence.
  - (c) The firm, its personnel and others subject to relevant ethical requirements identify and appropriately respond to breaches of the relevant ethical requirements, including those related to independence, in a timely manner.
33. In designing and implementing responses to address the quality risks identified and assessed by the firm relating to the relevant ethical requirements quality objectives, the firm shall include the following responses: (Ref: Para. A68–A69 and A75)
- (a) Identifying the relevant ethical requirements and determining the applicability of the relevant ethical requirements to the firm, its personnel and others, including, as applicable, the network, network firms, personnel in the network or network firms, or service providers. (Ref: Para. A15, A70–A71)
  - (b) Establishing policies or procedures that address the identification and evaluation of threats to compliance with the relevant ethical requirements and how identified threats should be addressed. (Ref: Para. A72)
  - (c) Establishing policies or procedures that address the identification, communication, evaluation and reporting of breaches and actions to address the causes and consequences of the breaches. (Ref: Para. A73–A74)
  - (d) Obtaining, at least annually, a documented confirmation of compliance with independence requirements from all personnel required by relevant ethical requirements to be independent.

### **Acceptance and Continuance of Client Relationships and Specific Engagements**

34. The firm shall establish the following quality objectives that address the acceptance and continuance of client relationships and specific engagements that are appropriate in the circumstances: (Ref: Para. A76)
- (a) The firm obtains sufficient appropriate information about the nature and circumstances of the engagement and the integrity and ethical values of the client (including management, and, when appropriate, those charged with governance) and based on such information makes appropriate judgments about whether to accept or continue a client relationship or specific engagement. (Ref: Para. A77–A82)
  - (b) The firm makes appropriate judgments about the firm’s ability to perform the engagement in accordance with professional standards and applicable legal and regulatory requirements when determining whether to accept or continue a client relationship or specific engagement, including that the firm has: (Ref: Para. A83)
    - (i) Resources to perform the engagement; and (Ref: Para. A84)
    - (ii) Access to information to perform the engagement, or to the persons who provide such information.
  - (c) The firm’s financial and operational priorities do not lead to inappropriate judgments about whether to accept or continue a client relationship or specific engagement. (Ref: Para. A85–A86)
  - (d) The firm responds appropriately in circumstances when the firm becomes aware of information subsequent to accepting or continuing a client relationship or specific engagement that would have caused it to decline the client relationship or specific engagement had that information been known prior to accepting or continuing the client relationship or specific engagement. (Ref: Para. A87–A88)
35. In designing and implementing responses to address the quality risks identified and assessed by the firm relating to the acceptance and continuance quality objectives, the firm shall include policies or procedures that address circumstances when the firm is obligated by law or regulation to accept the client relationship or specific engagement, if applicable. (Ref: Para. A89–A90)

### **Engagement Performance**

36. The firm shall establish the following quality objectives that address the performance of quality engagements:
- (a) Personnel understand and fulfill their responsibilities in connection with the engagement, including, as applicable:
    - (i) The engagement partner’s overall responsibility for managing and achieving quality on the engagement and for being sufficiently and appropriately involved throughout the engagement; and (Ref: Para. A91)
    - (ii) The appropriate direction and supervision of the engagement team and review of the work performed. (Ref: Para. A92–A93)

- (b) Engagement teams exercise appropriate professional judgment and, when applicable to the type of engagement, professional skepticism, in planning and performing engagements such that conclusions reached are appropriate. (Ref: Para. A94–A97)
  - (c) The engagement documentation is appropriately assembled and retained.
37. In designing and implementing responses to address the quality risks identified and assessed by the firm relating to the engagement performance quality objectives, the firm shall include the following responses:
- (a) Establishing policies or procedures addressing the nature, timing and extent of the direction and supervision of engagement teams and review of their work, including that such direction, supervision and review is planned and performed on the basis that the work performed by less experienced members of the engagement team is directed, supervised and reviewed by more experienced engagement team members. (Ref: Para. A92–A93)
  - (b) Communicating to engagement teams their responsibility for planning and performing the engagement in accordance with professional standards and applicable legal and regulatory requirements.
  - (c) Establishing policies or procedures addressing consultation on difficult or contentious matters, including the engagement team’s responsibilities for consultation, the matters on which consultation is required and how the conclusions should be agreed and implemented. (Ref: Para. A95, A98–A99)
  - (d) Establishing policies or procedures addressing differences of opinion that arise within the engagement team, or between the engagement team and the engagement quality reviewer or personnel performing activities within the firm’s system of quality management, including those who provide consultation. (Ref: Para. A95, A100)
  - (e) Establishing policies or procedures addressing engagement quality reviews in accordance with ISQM 2, and that require an engagement quality review for: (Ref: Para. A101–A107)
    - (i) Audits of financial statements of listed entities;
    - (ii) Audits of financial statements of entities that the firm determines are of significant public interest; and
    - (iii) Audits or other engagements for which:
      - a. An engagement quality review is required by law or regulation; or
      - b. The firm determines that an engagement quality review is an appropriate response to assessed quality risks, based on the reasons for the assessments given to those risks.
  - (f) Establishing policies or procedures addressing assembly and retention of documentation that require:
    - (i) The engagement files to be assembled within an appropriate period of time after the engagement reports have been finalized; and (Ref: Para. A108)
    - (ii) The engagement documentation to be retained and maintained to meet the needs of the firm and to comply with law, regulation, relevant ethical requirements, or other professional standards. (Ref: Para. A109–A112)

## Resources

38. The firm shall establish the following quality objectives that address appropriately obtaining, developing, using, maintaining, allocating and assigning resources, including human resources, technological resources, and intellectual resources, in a timely manner to enable the design, implementation and operation of the system of quality management: (Ref: Para. A113–A116)
- (a) The firm hires, develops and retains personnel, including engagement partners, who have the competence and capabilities to: (Ref: Para. A117–A119)
    - (i) Consistently perform quality engagements, including knowledge or experience regarding professional standards and applicable law or regulation relevant to the engagements the firm performs; or
    - (ii) Perform activities or carry out responsibilities in relation to the operation of the firm's system of quality management.
  - (b) The firm assigns an engagement partner and other human resources to each engagement who have appropriate competence and capabilities, including being given sufficient time, to consistently perform quality engagements. (Ref: Para. A120)
  - (c) The firm assigns human resources to perform activities within the system of quality management who have appropriate competence and capabilities, including sufficient time, to perform such activities. (Ref: Para. A120)
  - (d) Personnel demonstrate a commitment to quality through their actions and behaviors, develop and maintain the appropriate competence to perform their roles, and are held accountable through timely evaluations, compensation, promotion and other incentives. (Ref: Para. A121–A123)
  - (e) The firm obtains or develops, implements and maintains appropriate technological resources to enable the operation of the firm's system of quality management and the performance of engagements. (Ref: Para. A124–A131)
  - (f) The firm obtains or develops, implements and maintains appropriate intellectual resources to enable the consistent performance of quality engagements, and such intellectual resources are consistent with professional standards and applicable legal and regulatory requirements, where applicable. (Ref: Para. A132–A133)
  - (g) Personnel appropriately use the firm's technological and intellectual resources. (Ref: Para. A134)
39. The firm shall design and implement responses to address the quality risks identified and assessed by the firm relating to the resources quality objectives.

## Information and Communication

40. The firm shall establish the following quality objectives that address obtaining, generating or using information regarding the system of quality management, and communicating information within the firm and to external parties on a timely basis to enable the design, implementation and operation of the system of quality management: (Ref: Para. A135)

- (a) The firm has an information system that supports the system of quality management by identifying, capturing, processing and maintaining relevant and reliable information, whether from internal or external sources. (Ref: Para. A136–A138)
  - (b) The firm communicates relevant and reliable information to personnel, the nature, timing and extent of which is sufficient to enable personnel to understand and carry out their responsibilities relating to the performance of engagements or activities within the system of quality management. (Ref: Para. A139)
  - (c) The firm’s culture promotes and emphasizes the responsibility of personnel to exchange information with the firm and with one another. (Ref: Para. A139)
  - (d) Personnel communicate relevant and reliable information to the firm when performing engagements or activities within the system of quality management. (Ref: Para. A139)
  - (e) The firm communicates relevant and reliable information to external parties regarding the firm’s system of quality management, as the firm determines appropriate. (Ref: Para. A142–A153)
41. In designing and implementing responses to address the quality risks identified and assessed by the firm relating to the information and communication quality objectives, the firm shall include the following responses:
- (a) Establishing policies or procedures that address the nature, timing and extent of communication and matters to be communicated by the firm with engagement teams. (Ref: Para. A140)
  - (b) Communicating the responsibility for implementing the firm’s responses to relevant personnel, including engagement teams. (Ref: Para. A141)
  - (c) Establishing policies or procedures that address the nature, timing and extent of communication and matters to be communicated with external parties, including:
    - (i) Communication to external parties in accordance with law, regulation or professional standards. (Ref: Para. A142)
    - (ii) Communication with the network. (Ref: Para. A143)
    - (iii) Communication with service providers. (Ref: Para. A144)
    - (iv) Other communication to external parties about the firm’s system of quality management, in a transparency report or otherwise, when the firm determines it appropriate to do so, taking into account: (Ref: Para. A145, A149–A153)
      - a. Whether there are external parties who may use such information to support their understanding of the quality of the engagements performed by the firm; and (Ref: Para. A146–A147)
      - b. The nature and circumstances of the firm, including the nature of the firm’s operating environment. (Ref: Para. A148)

### **Monitoring and Remediation Process**

42. The firm shall establish the following quality objectives that address the firm’s monitoring and remediation process that enable the evaluation of the design, implementation and operation of the

components of the system of quality management to determine whether the quality objectives have been achieved: (Ref: Para. A154–A155)

- (a) The firm's monitoring and remediation process provides relevant, reliable and timely information about the design, implementation and operation of the components of the system of quality management.
- (b) The firm takes appropriate actions to respond to identified deficiencies such that deficiencies are remediated on a timely basis.
- (c) The individual(s) assigned ultimate responsibility and accountability for the system of quality management evaluates whether the system of quality management provides reasonable assurance that the objectives stated in paragraph 18(a) and (b) have been achieved.

43. In designing and implementing responses to address the quality risks identified and assessed by the firm relating to the monitoring and remediation quality objectives, the firm shall include the responses in paragraphs 44–57.

#### *Designing and Performing Monitoring Activities*

44. The firm shall determine the nature, timing and extent of the monitoring activities, including the appropriate combination of ongoing and periodic monitoring activities. In designing and implementing the monitoring activities, the firm shall take into account: (Ref: Para. A156–A159)

- (a) For a response, the related assessed quality risk(s), the reasons for the assessments given to the quality risk(s) and the design of the response; (Ref: Para. A160–A161)
- (b) For monitoring activities over the firm's risk assessment process, the design of that process;
- (c) Changes in factors that have affected the firm's system of quality management or changes in the system of quality management; (Ref: Para. A162)
- (d) Previous monitoring activities and remedial actions, including whether previous monitoring activities continue to be relevant in evaluating the firm's system of quality management; and (Ref: Para. A163–A164)
- (e) Other relevant information, including concerns identified regarding the commitment to quality of the firm or its personnel and information from external inspections. (Ref: Para. A165–A167)

45. The firm's monitoring activities shall include the inspection of engagements to determine whether the responses that are required to be implemented at the engagement level have been implemented. Engagement inspections may include the inspection of in-process or completed engagements. In determining the nature, timing and extent of the inspection of engagements, the firm shall: (Ref: Para. A168–A170)

- (a) Take into account the relevant factors in paragraph 44; and
- (b) Include the inspection of at least one completed engagement for each engagement partner on a cyclical basis determined by the firm.

46. The firm shall establish policies or procedures that:

- (a) Require those performing the monitoring activities to have the competence and capabilities, including sufficient time, to perform the monitoring activities effectively; and

- (b) Address the objectivity of the individuals performing the monitoring activities. Such policies or procedures shall prohibit the engagement team members or the engagement quality reviewer of an engagement from performing any inspection of that engagement. (Ref: Para. A171)

#### *Evaluating Findings and Identifying Deficiencies*

- 47. The firm shall establish policies or procedures addressing the evaluation of the findings arising from the monitoring activities, the results of external inspections and other relevant information to determine whether deficiencies exist, including in the monitoring and remediation process. (Ref: Para. A165, A172–A177)

#### *Evaluating Identified Deficiencies*

- 48. The firm shall establish policies or procedures addressing:
  - (a) The investigation of the root cause(s) of the identified deficiencies, including that the nature, timing and extent of the procedures to be performed to investigate the root cause(s) take into account the nature of the identified deficiencies and their possible severity; and (Ref: Para. A178–A182)
  - (b) The evaluation of the severity and pervasiveness of the identified deficiencies, including the effect of the identified deficiencies, individually and in aggregate, on the system of quality management as a whole. (Ref: Para. A183)

#### *Responding to Identified Deficiencies*

- 49. The firm shall design and implement remedial actions to address identified deficiencies that are responsive to the results of the root cause analysis. In doing so, the firm shall determine whether the firm's quality objectives, assessed quality risks and responses remain appropriate and modify them, as appropriate. (Ref: Para. A184)
- 50. The individual(s) assigned operational responsibility for monitoring and remediation shall evaluate whether the remedial actions are appropriately designed to address the identified deficiencies and their related root cause(s) and determine whether they have been implemented. The individual shall also evaluate whether the remedial actions implemented to address previously identified deficiencies are effective. (Ref: Para. A163)

#### *Findings About a Particular Engagement*

- 51. In circumstances when a finding relates to an in-process or completed engagement and there is an indication that procedures required were omitted during the performance of the engagement or the report issued may be inappropriate, the firm shall: (Ref: Para. A185)
  - (a) Take appropriate action to comply with relevant professional standards and applicable legal and regulatory requirements; and
  - (b) When the report is considered to be inappropriate, consider the implications and take appropriate action, including considering whether to obtain legal advice.

#### *Ongoing Communication Related to Monitoring and Remediation*

- 52. The individual(s) assigned operational responsibility for the monitoring and remediation process shall communicate on a timely basis to the individual(s) assigned ultimate responsibility and accountability

for the system of quality management and the individual(s) assigned operational responsibility for the system of quality management: (Ref: Para. A186)

- (a) A description of the monitoring activities performed;
- (b) The identified deficiencies, including the severity and pervasiveness of such deficiencies; and
- (c) The remedial actions to address the identified deficiencies.

53. The firm shall communicate the matters described in paragraph 52 to personnel to the extent that the information is relevant to their responsibilities to enable the personnel to take prompt and appropriate action in accordance with their responsibilities. (Ref: Para. A187)

54. The firm shall communicate information about the results of the firm's monitoring and remediation process to external parties on a timely basis, in accordance with paragraph 41(c).

#### *Evaluating the System of Quality Management*

55. The individual(s) assigned ultimate responsibility and accountability for the system of quality management shall evaluate whether the system of quality management provides reasonable assurance that the objectives stated in paragraph 18(a) and (b) have been achieved. This evaluation shall take into account: (Ref: Para. A188–A189)

- (a) The severity and pervasiveness of identified deficiencies; and
- (b) The evaluation in paragraph 50 regarding whether the remedial actions are appropriately designed to address the identified deficiencies and their related root cause(s), and have been implemented.

56. The evaluation in paragraph 55 shall be undertaken at least annually, or more frequently when the identified deficiencies are of a severity and pervasiveness that indicate that the system may not be providing reasonable assurance that the objectives stated in paragraph 18(a) and (b) have been achieved.

57. If the evaluation indicates that the system of quality management does not provide reasonable assurance that the objectives stated in paragraph 18(a) and (b) have been achieved, the individual(s) assigned ultimate responsibility and accountability for the system of quality management shall:

- (a) Take prompt and appropriate action in accordance with their responsibilities; and
- (b) Communicate to: (Ref: Para. A190–A191)
  - (i) Personnel to the extent that it is relevant to their responsibilities; and
  - (ii) External parties in accordance with the firm's policies or procedures required by paragraph 41(c).

#### **Network Requirements or Network Services**

58. When the firm operates as part of a network, the firm shall understand, when applicable:

- (a) The requirements established by the network regarding the firm's system of quality management, including requirements for the firm to implement or use resources or services designed or otherwise provided by or through the network (i.e., network requirements); (Ref: Para. A192)

- (b) Any services or resources provided by the network that the firm chooses to implement or use in the design, implementation or operation of the firm's system of quality management (i.e., network services); and (Ref: Para. A193)
- (c) The firm's responsibilities for any actions that are necessary to implement the network requirements or use network services. (Ref: Para. A194)

The firm remains responsible for its system of quality management, including professional judgments made in the design, implementation and operation of the system of quality management. The firm shall not allow compliance with the network requirements or use of network services to contravene the requirements of this ISQM. (Ref: Para. A13, A195–A196)

#### *The Firm's Risk Assessment Process*

59. In complying with the requirements in paragraphs 26–30, the firm shall evaluate the effect of the network requirements or network services on the firm's system of quality management, including determining whether they need to be adapted or supplemented by the firm to be appropriate for use in its system of quality management. (Ref: Para. A197–A198)

#### *Monitoring and Remediation Process*

60. In circumstances when the network performs monitoring activities relating to the firm's system of quality management, the firm shall:
- (a) Determine the effect of the monitoring activities performed by the network on the nature, timing and extent of the firm's monitoring activities performed in accordance with paragraphs 44–45; (Ref: Para. A199)
  - (b) Determine the firm's responsibilities in relation to the monitoring activities, including any related actions by the firm; and
  - (c) As part of evaluating findings and identifying deficiencies in paragraph 47, obtain the results of the monitoring activities from the network in a timely manner. (Ref: Para. A200)
61. The firm shall, at least annually, obtain information from the network, about the overall scope and results of the monitoring activities across the network firms' systems of quality management and:
- (a) Consider the effect of such information on the nature, timing and extent of the monitoring activities that need to be undertaken by the firm; and (Ref: Para. A201–A202)
  - (b) Communicate the information to personnel to the extent that it is relevant to their responsibilities such that personnel take prompt and appropriate action in accordance with their responsibilities (including as it relates to the performance of engagements).
62. As part of evaluating findings and identifying deficiencies in paragraph 47, if the firm identifies deficiencies in the network requirements or network services, the firm shall communicate to the network relevant information about the identified deficiencies. (Ref: Para. A203)
63. As part of designing and implementing remedial actions in paragraph 49, for identified deficiencies related to the network requirements or network services the firm shall: (Ref: Para. A204)
- (a) Understand the planned remedial actions by the network;
  - (b) Understand whether the network's remedial actions are designed and implemented to address the identified deficiencies and their related root cause(s); and

- (c) Determine the supplementary remedial actions needed by the firm, if any.

### **Service Providers**

64. When the firm intends to obtain or use resources provided by a service provider in its system of quality management, the firm's responses for resources shall include: (Ref: Para. A205–A207)
- (a) Obtaining an understanding of the service provider, including determining that the reputation, competence and capabilities of the service provider are appropriate in the context of the intended use of the resource; (Ref: Para. A208)
  - (b) Establishing the nature and scope of the resources provided by the service provider, including the firm's responsibilities for any actions that are necessary in using the resources; and (Ref: Para. A209)
  - (c) Determining whether the resource is appropriate for use in the system of quality management in the context of the quality risks identified and assessed by the firm and the reasons for the assessments given to the quality risks, including when changes are made to the resources provided. (Ref: Para. A210)

Notwithstanding the firm's use of a service provider(s), the firm remains responsible for its system of quality management.

65. As part of evaluating findings and identifying deficiencies in paragraph 47, if the firm identifies deficiencies in the resources provided by the service provider, the firm shall communicate to the service provider relevant information about the identified deficiencies. The firm shall also:
- (a) Understand the planned remedial actions by the service provider and consider whether the service provider's remedial actions are designed and implemented to address the identified deficiencies and their related root cause(s);
  - (b) Determine the supplementary remedial actions needed by the firm, if any; and
  - (c) Consider whether to continue using the services provided by the service provider.

### **Documentation**

66. The firm shall prepare documentation of its system of quality management that is sufficient to: (Ref: Para. A211–A213)
- (a) Support a consistent understanding of the system of quality management by personnel, including an understanding of their roles and responsibilities with respect to the firm's system of quality management;
  - (b) Support the consistent implementation and operation of the responses; and
  - (c) Provide evidence of the design, implementation and operation of the responses, such that the firm is able to evaluate the system of quality management.
67. The firm shall prepare documentation that includes: (Ref: Para. A214)
- (a) The firm's quality objectives and assessed quality risks;
  - (b) A description of the responses and how the firm's responses address the assessed quality risks; and

- (c) Regarding the monitoring and remediation process:
  - (i) Evidence of the monitoring activities performed;
  - (ii) The evaluation of the findings from the monitoring activities, results of external inspections and other relevant information, including the identified deficiencies and their related root cause(s);
  - (iii) Remedial actions to address identified deficiencies and the evaluation of the design and implementation of such remedial actions;
  - (iv) Communications about monitoring and remediation; and
  - (v) The basis for the evaluation of whether the system of quality management provides reasonable assurance that the objectives stated in paragraph 18(a) and (b) have been achieved.
- 68. The firm shall document the matters in paragraph 67 as they relate to network requirements or network services or resources provided by service providers and:
  - (a) The evaluation of the effect of the network requirements or network services in accordance with paragraph 59 and the conclusions reached.
  - (b) The firm's basis for determining that it is appropriate to use the resources from a service provider in its system of quality management.
- 69. The firm shall establish a period of time for the retention of documentation for the system of quality management that is sufficient to permit those performing monitoring procedures to evaluate the firm's system of quality management, or for a longer period if required by law or regulation.

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## Application and Other Explanatory Material

### Scope of this ISQM (Ref: Para. 2)

- A1. Other pronouncements of the IAASB, including ISRE 2400 (Revised)<sup>25</sup> and ISAE 3000 (Revised),<sup>26</sup> also establish requirements for the engagement partner for the management of quality at the engagement level.

### The Firm's System of Quality Management (Ref: Para. 7–8)

- A2. The IESBA Code contains requirements and application material for professional accountants that enable professional accountants to meet their responsibility to act in the public interest. In the context of engagement performance as described in this ISQM, the consistent performance of quality engagements forms part of the professional accountant's responsibility to act in the public interest.
- A3. Reasonable assurance is obtained when the firm's system of quality management reduces to an acceptably low level the risk that the objectives stated in paragraph 18(a) and (b) are not achieved. Reasonable assurance is not an absolute level of assurance, because there are inherent limitations

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<sup>25</sup> International Standard on Review Engagements (ISRE) 2400 (Revised), *Engagements to Review Historical Financial Statements*

<sup>26</sup> International Standard on Assurance Engagements (ISAE) 3000 (Revised), *Assurance Engagements Other than Audits or Reviews of Historical Financial Information*

of a firm's system of quality management. Such limitations include reality that human judgment in decision making can be faulty and that breakdowns in the firm's system of quality management may occur, for example, due to human error or behavior or failures in the firm's IT applications.

- A4. The design, implementation and operation of the system of quality management involves the exercise of professional judgment, including when making decisions about:
- The appropriate organizational structure and assignment of roles, responsibilities and authority that support the firm's commitment to quality.
  - Establishing additional quality objectives beyond those required by this ISQM when those objectives are necessary to achieve the objective of this standard.
  - The identification and assessment of the quality risks.
  - The appropriate nature, timing and extent of the responses to address the assessed quality risks.
  - The resources and information and communication that are appropriate to enable the design, implementation and operation of the components of the system of quality management.
  - The evaluation of whether the system of quality management provides reasonable assurance that the objectives stated in paragraph 18(a) and (b) have been achieved.
  - The effect of the network requirements or network services on the firm's system of quality management.
- A5. The firm may use different terminology or frameworks to describe the components of its system of quality management.

**Authority of this ISQM** (Ref: Para. 16)

- A6. The objective of this ISQM provides the context in which the requirements of this ISQM are set, establishes the desired outcome of this ISQM and is intended to assist the firm in understanding what needs to be accomplished and, where necessary, the appropriate means of doing so.
- A7. The requirements of this ISQM are expressed using "shall."
- A8. Where necessary, the application and other explanatory material provides further explanation of the requirements and guidance for carrying them out. In particular, it may:
- Explain more precisely what a requirement means or is intended to cover; and
  - Include examples that illustrate how the requirements might be applied.

While such guidance does not in itself impose a requirement, it is relevant to the proper application of the requirements. The application and other explanatory material may also provide background information on matters addressed in this ISQM. Where appropriate, additional considerations specific to public sector audit organizations are included within the application and other explanatory material. These additional considerations assist in the application of the requirements in this ISQM. They do not, however, limit or reduce the responsibility of the firm to apply and comply with the requirements in this ISQM.

- A9. This ISQM includes, under the heading "Definitions," a description of the meanings attributed to certain terms for purposes of this ISQM. These definitions are provided to assist in the consistent

application and interpretation of this ISQM, and are not intended to override definitions that may be established for other purposes, whether in law, regulation or otherwise. The Glossary of Terms relating to International Standards issued by the IAASB in the *Handbook of International Quality Management, Auditing, Review, Other Assurance, and Related Services Pronouncements* published by IFAC includes the terms defined in this ISQM. The Glossary of Terms also includes descriptions of other terms found in the ISQMs to assist in common and consistent interpretation and translation.

## Definitions

### *Deficiencies* (Ref: Para. 19(a))

A10. A response to address an assessed quality risk is not:

- Properly designed when a response necessary to address an assessed quality risk is absent or a response is not properly designed in a manner that effectively addresses an assessed quality risk, such that a quality objective may not be achieved. A deficiency in the design of a response may also arise from a quality objective or assessed quality risk not being appropriately specific, given the nature and circumstances of the firm and its engagements.
- Operating effectively when a response that is properly designed does not operate as designed, which results in the related quality risk not being effectively addressed such that a quality objective may not be achieved.

### *External Inspections* (Ref: Para. 19(g))

A11. In some circumstances, an external oversight authority may undertake other types of reviews, for example, reviews of specific areas of focus that contribute to the improvement of engagement quality. Paragraph A165 describes such reviews as part of other relevant information considered by the firm in the monitoring and remediation component.

### *Firm* (Ref: Para. 19(h))

A12. The definition of “firm” in relevant ethical requirements may differ from the definition set out in this ISQM.

### *Network* (Ref: Para. 19(k), 58)

A13. Networks and the firms within the network may be structured in a variety of ways; however, in all cases networks are external to the firm. In some instances, network firms may provide services (e.g., resources) that are used by the firm in its system of quality management. There may also be circumstances when the network includes other structures or organizations that establish requirements for the firm related to its system of quality management, or provides services. For the purposes of this ISQM, any requirements established by the network regarding the firm’s system of quality management or services or resources provided by the network that the firm chooses to implement or use in its system of quality management that are obtained from the network, network firms or another structure or organization in the network are considered “network requirements or network services.”

A14. The IESBA Code provides guidance in relation to the terms “network” and “network firm.”

*Relevant Ethical Requirements* (Ref: Para. 19(s), 33(a))

- A15. The relevant ethical requirements that are applicable in the context of a system of quality management may vary, depending on the nature and circumstances of the firm and its engagements. The term “professional accountant” may be defined in relevant ethical requirements. For example, the IESBA Code defines the term “professional accountant” and further explains the scope of provisions in the IESBA Code that apply to individual professional accountants in public practice and their firms.
- A16. The IESBA Code addresses circumstances when law or regulation precludes the professional accountant from complying with certain parts of the IESBA Code. It further acknowledges that some jurisdictions might have provisions in law or regulation that differ from or go beyond those set out in the IESBA Code and that professional accountants in those jurisdictions need to be aware of those differences and comply with the more stringent provisions, unless prohibited by law or regulation.

*Response* (Ref: Para. 19(t))

- A17. Policies are implemented through the actions of personnel and other individuals whose actions are subject to the policies, or through their restraint from taking actions that would conflict with the firm’s policies.
- A18. Procedures may be mandated, through formal documentation or other communications, or may be effected by behaviors that are not mandated but are rather conditioned by the firm’s culture. Procedures may be enabled through the application of IT, for example, the firm may use an IT application to facilitate obtaining a documented confirmation of compliance with independence requirements from personnel.

**Applying, and Complying with, Relevant Requirements** (Ref: Para. 20–21)

- A19. The individual(s) assigned ultimate responsibility and accountability for the system of quality management may also assume operational responsibility for the system of quality management, for example, in smaller firms.
- A20. Examples of when a requirement of this ISQM may not be relevant to the firm include:
- When the firm is a sole practitioner. For example, the requirements addressing the organizational structure and assigning roles, responsibilities and authority within the firm, appropriate direction, supervision and review and addressing differences of opinion may not be relevant.
  - When the firm only performs engagements that are related services engagements. For example, if the firm is not required to maintain independence for the related services engagements, the requirement to obtain a documented confirmation of compliance with independence requirements from all personnel would not be relevant.

**System of Quality Management** (Ref: Para. 22)

- A21. Paragraph 55 requires the individual(s) assigned ultimate responsibility and accountability for the system of quality management to evaluate whether the system of quality management provides reasonable assurance that the objectives stated in paragraph 18(a) and (b) have been achieved.
- A22. The nature and circumstances of the firm may include consideration of matters such as:

- The size and operating characteristics of the firm, including the geographical dispersion and the extent to which the firm concentrates or centralizes its processes or activities.
- The firm's strategic decisions and actions, including those about financial and operational matters.
- External factors, for example, law or regulation, economic stability, stakeholder expectations and social factors.
- In the case of a firm that belongs to a network, the nature of the network, how the network is organized and the nature and extent of the requirements established by the network regarding the firm's system of quality management or services or resources provided by the network that the firm chooses to implement or use in the design, implementation and operation of the firm's system of quality management.
- The extent to which the firm uses service providers in its system of quality management and the nature of such services.

A23. The nature and circumstances of the engagements performed by the firm may include consideration of matters such as:

- The types of engagements performed by the firm, for example, whether the firm performs only compilation engagements or performs a variety of engagements, including audits of financial statements.
- The types of entities for which such engagements are undertaken, for example, the industries in which the entities operate and whether the entities are owner-managed, listed or of significant public interest. An entity may be of significant public interest because it has a large number and wide range of stakeholders or due to the nature and size of its business.
- External factors, such as relevant professional standards and law or regulation.

A24. The quality of professional judgments exercised by the firm is enhanced when personnel making such judgments demonstrate an attitude that includes a questioning mind, critical assessment of information in formulating decisions, and being alert to changes in the nature and circumstances of the firm or its engagements.

#### **Governance and Leadership** (Ref: Para. 23–25)

A25. Law, regulation or other professional standards may prescribe additional matters related to the governance or leadership of the firm, for example, the firm may be required to follow an audit firm governance code that may incorporate specific governance principles and require adherence by the firm to specific provisions.

#### *Culture* (Ref: Para. 23(a), 24(a)(ii))

A26. The firm's culture is an important factor in influencing the behavior of personnel. Relevant ethical requirements ordinarily establish the principles of professional ethics, and are further addressed in the relevant ethical requirements component of this ISQM. Professional values and attitudes may include, for example:

- Professional manner, for example, timeliness, courteousness, respect, accountability, responsiveness, and dependability;

- A commitment to teamwork;
- Maintaining an open mind to new ideas or different perspectives in the professional environment;
- Pursuit of excellence;
- A commitment to continual improvement (e.g., setting expectations beyond the minimum requirements); and
- Social responsibility.

A27. A culture that promotes a commitment to quality is likely to involve clear, consistent, frequent and effective actions, including communications, at all levels within the firm, that emphasize the firm's commitment to quality. The tone at the top and the attitude towards quality, including reinforcing the importance of professional ethics, values and attitudes, are set by the individual(s) assigned ultimate responsibility and accountability for the system of quality management through their personal conduct, communication and actions. The attitude towards quality is further shaped and reinforced by other personnel who are expected to embed or demonstrate the behaviors that reflect the firm's commitment to quality.

A28. The nature and extent of the actions of the individual(s) assigned ultimate responsibility and accountability for the system of quality management in establishing the firm's culture may depend on factors such as the size, structure, geographical dispersion and complexity of the firm. For example, a smaller firm may be able to establish the desired culture through the direct interaction of firm leadership with other personnel. For a larger firm in which personnel are dispersed across many geographical locations, more formal communication may be necessary. Other actions that may be taken to establish the expected behavior of personnel include creating a code of conduct.

*Strategic Decisions and Actions* (Ref: Para. 23(c))

A29. It is important that the firm's strategic decision-making process, which may include establishing a business strategy, takes into consideration how the firm's decisions about financial and operational matters (e.g., the firm's profitability or strategic focus, such as growth of the firm's market share, industry specialization or new service offerings) affect the performance of quality engagements.

*Public Sector Considerations*

A30. In the public sector, although the firm's strategic decisions and actions may be less influenced by matters such as profitability or strategic focus areas, they are nevertheless affected by financial and operational priorities, for example, the allocation of financial resources.

*Organizational Structure* (Ref: Para. 23(d), 24(a)(iii))

A31. The organizational structure of the firm may include operating units, operational processes, divisions or geographical locations and other structures. In some instances, the firm may concentrate or centralize processes or activities in a service delivery center, for example, engagement teams may include human resources from service delivery centers who perform specific tasks that are repetitive or specialized in nature.

A32. How the firm assigns roles, responsibilities and authority within the firm may vary. For example, the leadership structure of a smaller firm may comprise a single managing partner with sole responsibility

for the oversight of the firm. Larger firms may have multiple levels of leadership, such as a chief executive officer (or equivalent) and a managing board of partners (or equivalent), and further levels that reflect the organizational structure of the firm. Some firms may also have an independent governing body that has non-executive oversight of the firm. At a jurisdictional level, law or regulation may impose certain requirements for the firm that affect the leadership and management structure or their assigned responsibilities.

*Resources* (Ref: Para. 23(e))

- A33. The quality objective in this component for resources addresses all categories of resources. The resources component includes quality objectives that address specific aspects of human resources, technological resources and intellectual resources. Financial resources are necessary for obtaining, developing, using and maintaining human resources, technological resources and intellectual resources. The quality objectives and responses in governance and leadership, such as those that address financial and operational priorities, address financial resources.
- A34. The individuals(s) assigned ultimate responsibility and accountability or operational responsibility for the system of quality management are in most cases able to influence the nature and extent of resources that the firm obtains, develops, uses and maintains, and how those resources are allocated or assigned, including the timing of when they are used. The firm's strategic decisions and actions may affect decisions about obtaining, allocating or assigning resources. Paragraph 23(c) requires that the strategic decisions and actions, including the firm's financial and operational priorities, demonstrate a commitment to quality, including not leading to inappropriate decisions about obtaining, allocating or assigning resources for the system of quality management.
- A35. Resource needs may change over time as a result of changes in the nature and circumstances of the firm (e.g., the emergence of new or advanced technology or evolution in the firm's business model) and the engagements performed by the firm. The firm's resource planning involves determining the resources currently required and forecasting the firm's future resource needs. However, given the continual changes in the nature and circumstances of the firm and its engagements, it may not be practicable for the firm to anticipate all possible resource needs or changes to the resource needs and therefore, in most cases, the firm's resource planning includes processes to deal with resource needs that cannot be anticipated as and when they arise.

*Firm Leadership Responsibility and Accountability* (Ref: Para. 23(b), 24(a))

- A36. Paragraph A32 explains the various leadership structures that may exist in a firm. Ordinarily the person with ultimate responsibility and accountability for the system of quality management is the chief executive officer (or equivalent), or the firm's managing partner (e.g., in the case of a smaller firm). However, some firm management structures may share the responsibility and accountability for the system of quality management among the firm's managing board of partners (or equivalent).

*Operational Responsibility* (Ref: Para. 24(a)(iii), 25)

- A37. The individual(s) assigned ultimate responsibility and accountability for the system of quality management is responsible and accountable for the firm achieving the objective of this ISQM. The individual(s) assigned operational responsibility for the system of quality management as a whole is responsible and accountable for the design, implementation and operation of the firm's system of quality management. In some instances, operational responsibility for the matters in paragraph

24(a)(iii) may be assigned to one individual, particularly in the case of a smaller firm. These responsibilities may also be fulfilled by the individual(s) assigned ultimate responsibility and accountability for the system of quality management.

- A38. In some instances, the individual assigned operational responsibility for the system of quality management may further assign specific roles, procedures, tasks or actions to other individuals within the firm. For example, in addition to assigning responsibility for compliance with independence requirements and the monitoring and remediation process, the individual may assign responsibility for technological resources.
- A39. In some circumstances, the firm may establish additional criteria for the eligibility of the individual(s) assigned operational responsibility for the matters set out in paragraph 24(a)(iii).

*Performance Evaluations (Ref: Para. 24(b))*

- A40. Periodic performance evaluations of individual(s) within the firm are a required response to promote the accountability of such individual(s) for their assigned responsibilities. In considering the performance of individuals, the firm may take into account:
- The results of the firm's monitoring activities for aspects of the system of quality management that relate to the responsibility of the individual. For example, the firm may set targets for the individual and measure the results of the firm's monitoring activities against those targets.
  - The actions taken by the individual(s) in response to identified deficiencies that relate to the responsibility of that individual, including the timeliness and effectiveness of such actions.
- A41. A positive performance evaluation may be rewarded through compensation, promotion and other incentives that focus on the individual's commitment to quality, and reinforce accountability. On the other hand, the firm may take corrective actions to address a negative performance evaluation that may affect the firm's achievement of its quality objectives.
- A42. Given the unique position of the individual(s) assigned ultimate responsibility and accountability for the system of quality management, the performance evaluations may be undertaken by an independent non-executive member of the firm's governing body, or a special committee overseen by the firm's governing body, or the firm may engage a service provider to perform the evaluation. In the case of smaller firms, it may not be practicable to perform performance evaluations; however, in such cases, the results of the firm's monitoring activities may provide an indication of the performance of the individual(s).

*Public Sector Considerations*

- A43. In the case of the public sector, it may not be practicable to perform a performance evaluation of the individual assigned ultimate responsibility and accountability for the system of quality management, or to take actions to address the results of the performance evaluation, given the nature of the individual's appointment. Nevertheless, performance evaluations may still be undertaken for other individuals in the firm who are assigned operational responsibility for aspects of the system of quality management.

*Complaints and Allegations (Ref: Para. 24(c))*

- A44. Establishing policies or procedures for dealing with complaints and allegations supports the firm's commitment to quality. Complaints and allegations may originate from within or outside the firm and

they may be made by personnel or external parties, such as clients or others within the firm's network. Complaints and allegations may relate to the failure to perform work in accordance with professional standards and applicable legal and regulatory requirements, or non-compliance with the firm's policies or procedures. A complaint or allegation may indicate that there is a deficiency in the firm's system of quality management, which would be other relevant information considered by the firm as part of its monitoring and remediation process, as required by paragraph 44(e).

- A45. Law, regulation or relevant ethical requirements may establish responsibilities for the firm or its personnel in circumstances when complaints or allegations arise, such as an obligation on the firm or its personnel to report the matter to an authority outside the firm. For example, sections 260 and 360 of the IESBA Code address the approach to be taken by the firm or its personnel in responding to non-compliance or suspected non-compliance with laws or regulations, which may include communications external to the firm that are addressed through the firm's policies or procedures for external communication in paragraph 41(c).
- A46. In identifying an appropriate individual(s) to whom complaints and allegations are to be communicated, the firm may consider whether the individual(s) has:
- The experience, knowledge, time and appropriate authority within the firm needed to assume the role; and
  - A direct line of communication to the individual(s) assigned ultimate responsibility and accountability for the system of quality management.

The firm may use a service provider to facilitate the reporting of complaints and allegations.

- A47. The firm may also identify an individual(s) to be responsible for supervising the investigation of complaints and allegations and may consider:
- The factors described in paragraph A46; and
  - Whether the individual(s) is not otherwise involved in the engagement to which a complaint or allegation pertains or has sufficient objectivity from the area or personnel subject to the investigation.

The individual(s) supervising an investigation may involve legal counsel as necessary. In the case of a smaller firm, it may not be practicable to identify an individual to supervise an investigation of an allegation or complaint who is not involved in the related engagement or area of the investigation. As a result, such firms may use a service provider to carry out the investigation into complaints and allegations, for example, legal counsel or a suitably qualified consultant.

#### **The Firm's Risk Assessment Process** (Ref: Para. 26–31)

- A48. The approach that the firm takes to the risk assessment process may vary according to many factors, including how the firm is structured and organized. For example, the firm's risk assessment process may be centralized (e.g., the quality objectives, quality risks and responses are established centrally for all business units, functions and service lines) or may be decentralized (e.g., the quality objectives, quality risks and responses are established at a business unit, function or service line level, with the outputs combined at the firm level). Although this ISQM is organized by components, the firm's risk assessment process may be undertaken for the system of quality management as a whole.

*Establish Quality Objectives* (Ref: Para. 26)

- A49. The quality objectives that the firm is required to establish are set out in paragraphs 23, 32, 34, 36, 38, 40 and 42. In addition, given the nature and circumstances of the firm and its engagements the firm:
- Is required to establish additional quality objectives beyond those required by this ISQM, when those objectives are necessary to achieve the objective of this ISQM.
  - May decide that more granular quality objectives than those set out in this ISQM are appropriate. Establishing more granular quality objectives may enhance the firm's identification and assessment of quality risks.
- A50. Given the iterative nature of the firm's risk assessment process, the firm may determine that additional quality objectives are necessary to achieve the objective of this ISQM at any stage in the process of establishing quality objectives, identifying and assessing quality risks and designing and implementing responses. The results of the firm's monitoring and remediation process may also highlight that additional quality objectives are necessary to achieve the objective of this ISQM, including in circumstances when it is determined that the system of quality management does not provide reasonable assurance that the objectives stated in paragraph 18(a) and (b) have been achieved.
- A51. Although the quality objectives set out in this ISQM are organized by component, an objective in one component may overlap, be related to, support or be supported by a quality objective in another component. For example, the quality objective in information and communication addressing the communication of relevant and reliable information in a timely manner to personnel supports the quality objective in the relevant ethical requirements component addressing the understanding of relevant ethical requirements by the firm, its personnel and others subject to relevant ethical requirements.

*Conditions, Events, Circumstances, Actions or Inactions That May Affect the Achievement of the Quality Objectives* (Ref: Para. 27)

- A52. In understanding the conditions, events, circumstances, actions or inactions that may affect the achievement of its quality objectives, the firm may consider what could go wrong in relation to the matters identified in paragraphs A22–A23 that could affect the achievement of such objectives. Such consideration may also assist with identifying quality risks.

*Identify and Assess Quality Risks* (Ref: Para. 28–29)

- A53. The firm exercises professional judgment in identifying and assessing quality risks. The process for identifying and assessing quality risks may involve a combination of ongoing and periodic risk identification and assessment procedures. In some circumstances, the identification and assessment of quality risks may be undertaken concurrently.
- A54. Under this ISQM, not every quality risk needs to be identified and further assessed. The firm identifies which quality risks need to be further assessed based on a preliminary consideration of the possibility of the quality risks occurring and the effect on the achievement of the quality objectives. Only those quality risks that meet both of the criteria in paragraph 28(a) and (b) need to be identified and further assessed. The further assessment of the quality risks involves a more detailed consideration of the

degree of the likelihood of the quality risks occurring and the significance of the effect of the quality risks on the achievement of the quality objectives.

- A55. There is a reasonable possibility of a quality risk occurring when the likelihood of its occurrence is more than remote.
- A56. The significance of the effect of a quality risk on the achievement of a quality objective(s) is judged in the context of the underlying conditions and events that gave rise to the quality risk, as well as the nature and circumstances of the firm and its engagements, which are further described in paragraphs A22–A23.
- A57. The firm may determine that a quality risk that has a reasonable possibility of occurring does not, on its own, have a significant effect on the achievement of a quality objective(s). However, a quality risk is required to be identified and further assessed in circumstances when the quality risk, in combination with other quality risks that have a reasonable possibility of occurring, have a significant effect on the achievement of a quality objective(s).
- A58. The assessment of identified quality risks need not comprise formal ratings or scores, and may involve taking into consideration:
- The expected frequency of the quality risk occurring.
  - The rate at which the effect of the quality risk would take place, or the amount of time that the firm has to respond to the quality risk.
  - The duration of time of the effect of the quality risk after it has occurred.

*Design and Implement Responses to Assessed Quality Risks* (Ref: Para. 19(t), 30)

- A59. The responses required by this ISQM are set out in paragraphs 24, 25, 33, 35, 37, 41 and 43 and represent responses that are relevant to every firm's system of quality management and are therefore applicable to all firms. However, the responses required by this ISQM alone will not be sufficient to address all of the firm's assessed quality risks, as explained in paragraph 10(c). Accordingly the firm is required to design and implement responses in addition to those required by this ISQM. For example, paragraph A69 identifies additional responses that may be appropriate to address quality risks for relevant ethical requirements.
- A60. The firm exercises professional judgment in designing and implementing responses to address the assessed quality risks. The nature, timing and extent of the responses are affected by the reasons for the assessment given to the assessed quality risks, which includes:
- The likelihood of the assessed quality risk occurring. For example, a more robust response may be needed for an assessed quality risk that has a higher likelihood of occurring.
  - The significance of the effect on the achievement of the quality objectives. For example, a more robust response may be needed for an assessed quality risk that has a more significant effect on the achievement of a quality objective.
  - The conditions, events, circumstances, actions or inactions that give rise to the assessed quality risks. For example, if the assessed quality risk relates specifically to engagements performed for a category of entities (e.g., audits of financial statements of listed entities), the responses may require specific actions for entities in that category, rather than all engagements performed by the firm.

- A61. The nature and circumstances of the firm and its engagements affect the reasons for the assessment given to the assessed quality risks, and the nature, timing and extent of the responses designed and implemented to address the assessed quality risks. For example, in demonstrating a commitment to quality through their actions and behaviors, as required by paragraph 24(a)(ii), leadership of a smaller firm may engage in direct and frequent interactions with personnel throughout the firm. However, in the case of a larger firm, frequent and direct interactions by leadership with all personnel may not be practicable and therefore the actions taken to demonstrate a commitment to quality may involve multiple actions, including establishing firm values in a code of conduct that all personnel are required to comply with and a series of formal communications from firm leadership that emphasize the importance of quality.
- A62. The responses designed and implemented by the firm may operate at the firm level or engagement level, or there may be a combination of responsibilities for actions to be taken at the firm and engagement level in order for a response to operate as designed. For example, the firm may appoint suitably qualified and experienced personnel to provide technical advice to engagement teams and, in doing so, may prescribe specific matters for which consultation by the engagement team is required. The engagement team may have a responsibility to identify when such matters occur and to initiate such consultation as required by the firm's policies or procedures. Communicating to engagement teams about their responsibilities for the implementation of the responses is therefore important for the functioning of the system of quality management, and is a response required by paragraph 41(b).
- A63. The need for formally documented policies or procedures may be greater for firms that have many personnel or that are geographically dispersed, in order to achieve consistency across the firm.
- A64. In some cases, the response designed and implemented by the firm may address multiple assessed quality risks across multiple components of the system of quality management. Furthermore, the responses designed and implemented to address an assessed quality risk in one component may affect the assessed quality risks and responses of another component. For example, engaging a service provider to manage all aspects of the firm's IT environment may create new quality risks for relevant ethical requirements (e.g., the service provider may have access to confidential information).

*Changes in the Nature and Circumstances of the Firm or Its Engagements (Ref: Para. 31)*

- A65. In some circumstances, changes in the nature and circumstances of the firm's engagements may affect the design, implementation and operation of the system of quality management. For example, the firm may accept an engagement to perform an audit of financial statements for an entity involved in an industry for which the firm has not previously performed audit engagements that may create new quality risks (e.g., personnel do not have the knowledge or experience relevant to the engagement).
- A66. Quality objectives, quality risks or responses may also need to be modified as a result of:
- Changes that affect specific components of the system of quality management, for example, changes in the firm's resources.
  - Information from the firm's monitoring and remediation, including identified deficiencies from monitoring activities, external inspections or other relevant information.

**Relevant Ethical Requirements** (Ref: Para. 32–33)

A67. The IESBA Code sets out the fundamental principles of ethics that establish the standard of behavior expected of a professional accountant and establishes the International Independence Standards. The fundamental principles are integrity, objectivity, professional competence and due care, confidentiality and professional behavior. The IESBA Code also specifies the approach that a professional accountant is required to apply to comply with the fundamental principles and the International Independence Standards and addresses specific topics relevant to complying with the fundamental principles. Law or regulation in a jurisdiction may also contain provisions addressing ethical requirements, including independence, for example, privacy laws affecting the confidentiality of information.

A68. In some cases, the firm may determine that it is appropriate to design and implement responses that are more specific than the provisions of relevant ethical requirements. For example, having regard to the nature and circumstances of the firm and its engagements, a firm may:

- Prohibit the acceptance of gifts and hospitality from a client, even if the value is trivial and inconsequential.
- Set rotation periods for the engagement partner and other senior personnel for all engagements performed by the firm, including other assurance or related services engagements.

A69. Other components include responses that may affect or relate to the relevant ethical requirements component. For example, the following are examples of responses for information and communication and resources that may address assessed quality risks for relevant ethical requirements:

- Communicating the independence requirements to all personnel and others subject to independence requirements, as applicable.
- Providing training for personnel on relevant ethical requirements.
- Establishing manuals and guides (i.e., intellectual resources) containing the provisions of the relevant ethical requirements and guidance on how they are applied in the circumstances of the firm and the engagements it performs.
- Assigning personnel (i.e., human resources) to manage and monitor compliance with relevant ethical requirements or to provide consultation on matters related to relevant ethical requirements.
- Establishing policies or procedures for personnel to communicate relevant information to appropriate parties within the firm or to the engagement partner related to:
  - Personal or firm situations that may create threats to independence, for example, financial interests, loans, employment relationships or personal appointments.
  - Client engagements, including non-assurance engagements. For example, this may include the scope of services, fees or information about long association.
  - Business relationships.
  - Any breaches of the relevant ethical requirements, including those related to independence.

- Establishing an information system, including through IT applications (i.e., technological resources), to monitor compliance with relevant ethical requirements, including recording and maintaining information about independence.

Furthermore, the individual in the firm assigned operational responsibility for compliance with independence requirements is ordinarily responsible for the oversight of all matters related to independence, including the policies or procedures addressing communication of breaches of independence requirements and determining that appropriate actions have been taken to address the causes and consequences of the breach.

- A70. Various provisions of the relevant ethical requirements may apply only to personnel and not the firm itself. For example, Part 2 of the IESBA Code applies to individuals who are professional accountants in public practice when performing professional activities pursuant to their relationship with the firm. The firm's system of quality management may need to address personnel's compliance with such relevant ethical requirements, for example, the firm may need to establish policies or procedures to facilitate personnel's compliance with Part 2 of the IESBA Code (e.g., policies or procedures addressing section 260 of the IESBA Code regarding non-compliance with laws and regulations).
- A71. The applicability of the relevant ethical requirements to others (i.e., the network, network firms, personnel in the network or network firms, or service providers) depends on whether those requirements contain specific provisions addressing others, and how the firm uses others in its system of quality management. For example:
- Relevant ethical requirements may include requirements for independence that apply to network firms or employees of network firms.
  - The definition of engagement team under relevant ethical requirement may include any individuals engaged by the firm who perform assurance procedures on the engagement (e.g., a service provider engaged to attend a physical inventory count at a remote location). Accordingly, any requirements of the relevant ethical requirements that apply to the engagement team may also be relevant to such individuals.
  - The principle of confidentiality may apply to a network, network firm or service provider, given that they may have access to client information obtained by the firm.
- A72. Relevant ethical requirements may contain provisions regarding the identification and evaluation of threats and how they should be addressed. For example, the IESBA Code provides a conceptual framework for this purpose and, in applying the conceptual framework, requires that the firm use the reasonable and informed third party test.
- A73. The policies or procedures addressing breaches of the relevant ethical requirements, including those related to independence, may address matters such as:
- The communication of breaches of the relevant ethical requirements to appropriate individual(s) within the firm;
  - The evaluation of the significance of a breach and its effect on compliance with relevant ethical requirements;
  - The actions to be taken to satisfactorily address the consequences of a breach, including that such actions be taken as soon as practicable;
  - Determining whether to report a breach to external parties; and

- Determining the appropriate actions to be taken in relation to the individual(s) responsible for the breach.

A74. Relevant ethical requirements may specify how the firm is required to respond to a breach. The IESBA Code sets out requirements for the firm in the event of a breach of the IESBA Code and includes specific requirements addressing breaches of the International Independence Standards, which includes requirements for communication with external parties.

*Public Sector Considerations*

A75. Statutory measures may provide safeguards for the independence of public sector auditors. However, threats to independence may still exist regardless of any statutory measures designed to protect the firm's independence that will require an appropriate response by the organization.

**Acceptance and Continuance of Client Relationships and Specific Engagements** (Ref: Para. 34–35)

A76. Other components include responses that may affect or relate to the acceptance and continuance of client relationships and specific engagements component. For example:

- The information necessary to support the firm's decisions about the acceptance and continuance of client relationships and specific engagements is identified, captured, processed and maintained through the information and communication component, and may include intellectual resources such as databases of client information or access to external information databases.
- The firm may use technological resources in the form of IT applications to facilitate the approval of client relationships or specific engagements at appropriate levels within the firm.
- Governance and leadership addresses the responsibility of the firm with respect to appropriate resource planning and obtaining, allocating or assigning resources.

*The Nature and Circumstances of the Engagement and the Integrity and Ethical Values of the Client* (Ref: Para. 34(a))

A77. The information obtained about the nature and circumstances of the engagement may include:

- The industry of the entity for which the engagement is being undertaken and relevant regulatory factors;
- The nature of the entity, for example, its operations, organizational structure, ownership and governance, its business model and how it is financed; and
- The nature of the underlying subject matter and the criteria to be applied in the preparation of the subject matter information, for example, in the case of integrated reporting, the underlying subject matter may include social, environmental and health and safety information and the criteria may be performance measures established by a recognized body of experts.

A78. In some circumstances the firm may establish policies or procedures that specify, or prohibit, the types of engagements that may be performed by the firm, for example, the firm may prohibit the performance of assurance engagements over a certain subject matter. The policies or procedures may also prohibit the performance of engagements for certain types of entities, for example, the firm may prohibit the performance of engagements in certain industries.

- A79. The information obtained to support the firm's judgments about the integrity and ethical values of the client may include the identity and business reputation of the client's principal owners, key management, and those charged with its governance. The nature and extent of information obtained may depend on factors such as:
- The nature of the entity for which the engagement is being performed, including the complexity of its ownership and management structure.
  - The nature of the client's operations, including its business practices.
  - Information concerning the attitude of the client's principal owners, key management and those charged with its governance towards such matters as aggressive interpretation of accounting standards and the internal control environment.
  - Whether the client is aggressively concerned with maintaining the firm's fees as low as possible.
  - Indications of a client-imposed limitation in the scope of work.
  - Indications that the client might be involved in money laundering or other criminal activities.
  - The reasons for the proposed appointment of the firm and non-reappointment of the previous firm.
  - The identity and business reputation of related parties.
- A80. The firm may obtain the information from a variety of internal and external sources, for example:
- In the case of an existing client, consideration of matters that have arisen during the current or previous engagements, if applicable, or inquiry of other personnel who have performed other engagements for the client.
  - In the case of a new client, inquiry of existing or previous providers of professional accountancy services to the client, in accordance with relevant ethical requirements.
  - Discussions with other third parties, such as bankers, legal counsel and industry peers.
  - Background searches of relevant databases (which may be intellectual resources). In some cases, the firm may use a service provider to perform the background search.
- A81. Information that is obtained during the firm's acceptance and continuance process about the nature and circumstances of the engagement and the integrity and ethical values of the client's management, and, when appropriate, those charged with governance is in most cases relevant to the engagement team when planning and performing the engagement. Professional standards may specifically require the engagement team to obtain or consider such information. For example, ISA 220 (Revised)<sup>27</sup> requires the engagement partner to take into account information obtained in the acceptance and continuance process in planning and performing the audit engagement in accordance with the ISAs and complying with the requirements of ISA 220 (Revised).
- A82. Professional standards or legal and regulatory requirements may include specific provisions that need to be addressed before accepting or continuing a client relationship or specific engagement and may also require the firm to make inquiries of an existing or predecessor firm when accepting an

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<sup>27</sup> Proposed ISA 220 (Revised), paragraph 21

engagement. For example, when there has been a change of auditors, ISA 300<sup>28</sup> requires the auditor, prior to starting an initial audit, to communicate with the predecessor auditor in compliance with relevant ethical requirements. The IESBA Code also includes requirements for the consideration of conflicts of interests in accepting or continuing a client relationship or specific engagement and communication with the existing or predecessor firm when accepting an engagement that is an audit or review of financial statements.

*The Firm's Ability to Perform Engagements (Ref: Para. 34(b))*

A83. The consideration of whether the firm is able to perform engagements in accordance with professional standards and applicable legal and regulatory requirements includes determining that the firm, its personnel and others are able fulfill their responsibilities in relation to the relevant ethical requirements.

A84. The judgments about whether the firm has the resources to perform the engagement may involve reviewing the specific circumstances of the engagement and considering whether the firm has the resources to perform the engagement within the reporting deadline, including whether there are:

- Human resources with the appropriate competence and capabilities, including sufficient time, to perform the engagement. This includes:
  - Personnel to direct and supervise the engagement and take overall responsibility; and
  - Human resources with knowledge of the relevant industry or the underlying subject matter or criteria to be applied in the preparation of the subject matter information and experience with relevant regulatory or reporting requirements.
- Experts that are available, if needed.
- Engagement quality reviewers who meet the eligibility requirements in ISQM 2, if applicable.
- Technological resources, for example, IT applications that enable the engagement team to perform procedures on the entity's data.
- Intellectual resources, for example, a methodology, industry or subject matter-specific guides, or access to information sources.

*The Firm's Financial and Operational Priorities (Ref: Para. 34(c))*

A85. Financial priorities may focus on the profitability of the firm, and fees obtained for the performance of engagements have an effect on the firm's financial resources. Operational priorities may include strategic focus areas, such as growth of the firm's market share, industry specialization or new service offerings. There may be circumstances when the firm is satisfied with the fee quoted for an engagement but, notwithstanding the firm's operational and financial priorities, it is not appropriate for the firm to accept or continue the engagement or client relationship (e.g., when the client lacks appropriate integrity and ethical values).

A86. There may be other circumstances when the fee quoted for an engagement is not sufficient given the nature and circumstances of the engagement, and it may diminish the firm's ability to perform the engagement in accordance with professional standards and applicable legal and regulatory requirements. The IESBA Code addresses fees and other types of remuneration, including

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<sup>28</sup> ISA 300, *Planning an Audit of Financial Statements*, paragraph 13(b)

circumstances that may create a threat to compliance with the fundamental principle of professional competence and due care if the fee quoted for an engagement is too low.

*Information That Becomes Known Subsequent to Accepting or Continuing a Client Relationship or Specific Engagement* (Ref: Para. 34(d))

A87. Information that becomes known subsequent to accepting or continuing a client relationship or specific engagement may:

- Have existed at the time of the firm's decision to accept or continue the client relationship or specific engagement and the firm was not aware of such information; or
- Relate to new information that has arisen since the decision to accept or continue the client relationship or specific engagement.

The information may come to the attention of the firm in a variety of ways, including through the engagement partner or engagement team. For example, ISA 220 (Revised)<sup>29</sup> requires the engagement partner to communicate information to the firm that the engagement partner obtains that may have caused the firm to decline the audit engagement had that information been known by the firm prior to accepting or continuing the client relationship or specific engagement.

A88. The firm's response to address circumstances when information becomes known subsequent to accepting or continuing a client relationship or specific engagement that may have affected the firm's decision to accept or continue a client relationship or specific engagement may include policies or procedures that set out the actions to be taken, including:

- Undertaking appropriate consultation within the firm or with legal counsel.
- Considering whether there is a professional, legal or regulatory requirement for the firm to continue the engagement.
- Discussing with the appropriate level of the client's management and with those charged with governance or the engaging party the appropriate action that the firm might take based on the relevant facts and circumstances, and when it is determined that withdrawal is an appropriate action, informing them of this decision and the reasons for the withdrawal.
- If the firm withdraws from the engagement, considering whether there is a professional, legal or regulatory requirement for the firm to report the withdrawal from the engagement, or from both the engagement and the client relationship, together with the reasons for the withdrawal, to regulatory authorities.
- If the firm does not withdraw from the engagement, considering the effect of the information on the performance of the engagement and the additional actions to be taken by the firm or the engagement partner in managing quality at the engagement level (e.g., assigning more experienced personnel to the engagement, requiring an engagement quality review or increasing the extent and frequency of the engagement partner's direction and supervision of engagement team members and review of their work).

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<sup>29</sup> Proposed ISA 220 (Revised), paragraph 22

*Circumstances When the Firm is Obligated to Accept or Continue a Client Relationship or Specific Engagement* (Ref: Para. 35)

- A89. There may be circumstances when the firm is obligated to accept or continue a client relationship or specific engagement. For example, jurisdictional law or regulation may impose an obligation on the firm to accept or continue a client engagement, or in the case of the public sector, the firm may be appointed through statutory provisions. In such circumstances, when the firm becomes aware of information that would otherwise have caused the firm to decline or discontinue the engagement, the firm may design and implement additional responses to address the assessed quality risk(s) arising from the performance of such engagements. For example, the firm may assign more experienced personnel to the engagement or may require that an engagement quality review be performed in respect of the engagement. There may also be actions at the engagement level to manage quality when performing such engagements, for example, increasing the extent and frequency of the engagement partner's direction and supervision of engagement team members and review of their work.
- A90. In some circumstances, a threat to the firm's integrity may arise as a result of being associated with the subject matter of the engagement. Relevant ethical requirements may include requirements addressing circumstances when the firm becomes associated with information that is false or misleading. For example, the IESBA Code contains requirements addressing circumstances when the professional accountant becomes associated with information that contains a materially false or misleading statement, contains statements that have been provided recklessly or omits or obscures required information where such omission or obscurity would be misleading.

**Engagement Performance** (Ref: Para. 36–37)

- A91. ISA 220 (Revised)<sup>30</sup> requires the engagement partner to take overall responsibility for managing and achieving quality on the audit engagement.

*Direction, Supervision and Review* (Ref: Para. 36(a)(ii), 37(a))

- A92. The firm's policies or procedures addressing engagement supervision may include responsibilities for:
- Tracking the progress of the engagement;
  - Considering the competence and capabilities of individual members of the engagement team, whether they have sufficient time to carry out their work, whether they understand their instructions and whether the work is being carried out in accordance with the planned approach to the engagement;
  - Addressing matters arising during the engagement, considering their significance and modifying the planned approach appropriately; and
  - Identifying matters for consultation or consideration by more experienced engagement team members during the engagement.
- A93. The policies or procedures addressing the review of the work of engagement teams may address matters such as the reviewer's consideration of whether:

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<sup>30</sup> Proposed ISA 220 (Revised), paragraph 11

- The work has been performed in accordance with professional standards and applicable legal and regulatory requirements;
- Significant matters have been raised for further consideration;
- Appropriate consultations have been undertaken and the resulting conclusions have been documented and implemented;
- There is a need to revise the nature, timing and extent of work performed;
- The work performed supports the conclusions reached and is appropriately documented;
- The evidence obtained for an assurance engagement is sufficient and appropriate to support the report; and
- The objectives of the engagement procedures have been achieved.

*Judgments and Conclusions* (Ref: Para. 36(b))

- A94. The system of quality management creates an environment that supports engagement teams in making informed decisions about the courses of action that are appropriate given the nature and circumstances of the engagement. For example, the responses designed and implemented by the firm to establish a culture that promotes a commitment to quality or the responses addressing the hiring, development, retention and assignment of personnel with the competence and capabilities to perform engagements are important in supporting the engagement team in exercising appropriate professional judgment and, when applicable to the type of engagement, professional skepticism.
- A95. The firm's policies or procedures for consultation and differences of opinion and the performance of engagement quality reviews may also address assessed quality risks related to exercising appropriate professional judgment and, when applicable to the type of engagement, professional skepticism in planning and performing engagements. The firm may also design and implement other types of responses, including other forms of engagement reviews that are not engagement quality reviews. For example, for audits of financial statements, the firm's responses may include reviews of the engagement team's procedures on significant risks or reviews of certain matters by individuals within the firm who have specialized technical expertise. In some cases, these other types of engagement reviews may be undertaken in addition to an engagement quality review.
- A96. Professional skepticism supports the quality of judgments made on the engagement and, through these judgments, the overall effectiveness of the engagement team in performing the engagement. Other pronouncements of the IAASB may address the exercise of professional judgment or professional skepticism at the engagement level. For example, ISA 220 (Revised)<sup>31</sup> explains the impediments to the exercise of professional skepticism at the engagement level and actions that the engagement partner may take to deal with such impediments.
- A97. In performing related services engagements, a practitioner is not required to gather evidence to express an opinion or conclusion on the information. However, the practitioner may form conclusions related to the performance of the engagement, for example, in a compilation engagement the practitioner may conclude that the compiled financial information is misleading and be required to take the appropriate actions set out in ISRS 4410 (Revised).<sup>32</sup>

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<sup>31</sup> Proposed ISA 220 (Revised), paragraphs A27–A29

<sup>32</sup> International Standard on Related Services (ISRS) 4410 (Revised), *Compilation Engagements*, paragraphs 34–36

*Consultation* (Ref: Para. 37(c))

- A98. Consultation typically involves a discussion at the appropriate professional level, with individuals within or outside the firm who have specialized expertise, on difficult or contentious matters. While the firm establishes policies or procedures regarding the matters on which consultation is required, the engagement team may identify other matters that require consultation.
- A99. In considering its resource needs, the firm may consider the resources needed to enable consultation, for example, appropriate access to intellectual resources to facilitate research and personnel with the competence and capabilities to provide consultations. In some instances, such as a smaller firm, human resources to support consultation may only be available externally, for example, other firms, professional and regulatory bodies, or commercial organizations that provide such services. In such cases, paragraphs 64–65 apply.

*Differences of Opinion* (Ref: Para. 37(d))

- A100. The policies or procedures addressing differences of opinion may be established in a manner that encourages identification of differences of opinion at an early stage. Procedures to resolve such differences may include consulting with another practitioner or firm, or a professional or regulatory body.

*Engagements Subject to an Engagement Quality Review* (Ref: Para. 37(e))

- A101. The categories of engagements for which an engagement quality review is required are not mutually exclusive. For example, many listed entities may be considered to be of significant public interest based on the characteristics described in paragraph A102. In addition, law or regulation may require engagement quality reviews to be performed for certain types of entities (e.g., entities with public accountability as defined in certain jurisdictions), or may include different criteria or characteristics that firms may use in determining whether an entity is of significant public interest.
- A102. In determining whether an entity is of significant public interest, the firm may take into account, for example, whether the entity has a large number and wide range of stakeholders, and the nature and size of the business. The firm also may consider the relative significance of factors such as these in the context of the jurisdiction or region in which the entity operates. Entities that the firm determines to be of significant public interest may include entities such as financial institutions (e.g. certain banks, insurance companies, and pension funds), and other entities such as certain not-for-profit organizations.
- A103. Law or regulation may require an engagement quality review to be performed, for example, for audit engagements for entities that:
- Are characterized as public interest entities;
  - Operate in the public sector or which are recipients of government funding;
  - Operate in certain industries (e.g., financial institutions such as banks, insurance companies and pension funds);
  - Meet a specified asset threshold; or
  - Are under the management of a court or judicial process (e.g., liquidation).

A104. Audits or other engagements for which the firm may determine that an engagement quality review is an appropriate response to assessed quality risks may include, for example, engagements:

- That involve a high level of complexity or judgment, such as:
  - An audit of financial statements for an entity operating in an industry that typically has accounting estimates with a high degree of estimation uncertainty (e.g., certain large financial institutions or mining entities), or for which uncertainties exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.
  - An assurance engagement that requires specialized skills and knowledge in measuring or evaluating the underlying subject matter against the applicable criteria (e.g., a greenhouse gas statement in which there are significant uncertainties associated with the quantities reported therein).
- Where issues have been encountered on the engagement, for example, audit engagements with recurring internal or external inspection findings, unremediated deficiencies in internal control, or a material restatement of comparative information in the financial statements.
- For entities in emerging industries or that involve emerging technologies, or for which the firm has no previous experience.
- For which unusual circumstances are identified during the firm's acceptance and continuance of client relationships and specific engagements (e.g., a new client that had a disagreement with its previous auditor or assurance practitioner).
- That involve reporting on financial or non-financial information that is expected to be included in a regulatory filing, or that may involve a higher degree of judgment, such as pro forma financial information to be included in a prospectus.
- For entities for which concerns were expressed in communications from securities or prudential regulators.

A105. In some cases, there may be no engagements for which an engagement quality review is required to be performed (e.g., when a firm does not perform audits of listed entities or entities of significant public interest and other responses to assessed quality risks are determined by the firm to be appropriate).

#### Considerations Specific to Public Sector Audit Organizations

A106. Public sector entities may be of significant public interest due to their size and complexity, the range of their stakeholders and the nature of the services they provide. Factors to consider in determining whether a public sector entity is of significant public interest may include whether the entity is a national, regional or local government, or whether an opinion is being expressed on the entire entity or only certain units. Other factors to consider may include whether the entity is a corporation that is state owned or in which the state has a controlling stake or a stake with significant influence. Larger public sector entities may be determined to be of significant public interest due to their social or economic influence on the community or region in which the entity operates.

A107. The firm may determine that an engagement quality review is an appropriate response to a quality risk for engagements in the public sector for which law or regulation establishes additional reporting requirements (e.g., a separate report on instances of non-compliance with law or regulation to the

legislature or other governing body or communicating such instances in the auditor's report on the financial statements).

*Engagement Documentation* (Ref: Para. 37(f))

A108. Law or regulation may prescribe the time limits by which the assembly of final engagement files for specific types of engagements is to be completed. Where no such time limits are prescribed in law or regulation, the firm ordinarily establishes an appropriate time limit. In the case of an audit of financial statements, for example, such a time limit would ordinarily not be more than 60 days after the date of the auditor's report.

A109. The retention and maintenance of engagement documentation includes managing the safe custody, integrity, accessibility or retrievability of the underlying data. The retention and maintenance of engagement documentation may involve the use of IT applications. The integrity of engagement documentation may be compromised if it is altered, supplemented or deleted without the appropriate authorization to do so, or if it is permanently lost or damaged. The firm's responses may therefore include actions to prevent unauthorized access and create audit trails that indicate access and changes to engagement documentation.

A110. Relevant ethical requirements generally include provisions relating to confidentiality of client information, unless specific client authority has been given to disclose information, or there is a legal or professional duty or right to disclose the information. Specific law or regulation may impose additional obligations on personnel to maintain client confidentiality, particularly where data of a personal nature is concerned. Accordingly, the firm's responses for relevant ethical requirements may include responses for the retention and maintenance of engagement documentation. The firm's responses to address the confidentiality of client information may need to address all possible locations of client information, including engagement documentation, emails, firm servers or hard copy.

A111. Law or regulation may prescribe the retention period for engagement documentation, or there may be generally accepted retention periods. If the retention periods are not prescribed in law or regulation, the firm may, in determining an appropriate retention period, consider the nature of the engagements performed by the firm and the firm's circumstances, for example, whether the engagement documentation is needed to provide a record of matters of continuing significance to future engagements. In the case of audits of financial statements, the retention period would ordinarily be no shorter than five years from the date of the auditor's report, or, if later, the date of the auditor's report on the group financial statements, when applicable.

A112. Unless otherwise specified by law or regulation, engagement documentation is the property of the firm. The firm may, at its discretion, make portions of, or extracts from, engagement documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the firm or its personnel.

**Resources** (Ref: Para. 38–39)

A113. Resources for the purposes of the resources component include:

- Human resources.
- Technological resources, for example, IT applications.
- Intellectual resources, for example, written policies or procedures, a methodology or guides.

Financial resources are also relevant to the system of quality management because they are necessary for obtaining, developing and maintaining the firm's human resources, technological resources and intellectual resources. The governance and leadership component addresses appropriate resource planning for all resources. Given the nature of financial resources, the quality objectives and responses in governance and leadership, such as those that address financial and operational priorities, address financial resources. This component addresses specific aspects of human resources, technological resources and intellectual resources.

A114. Resources are pervasive to all components of the system of quality management and therefore the firm's responses for resources will address assessed quality risks specific to resources, as well as assessed quality risks for other components. Such responses may be designed and implemented individually for each component, or they may be designed and implemented for all components holistically.

A115. Resources may be internal to the firm, or may be obtained externally from a network, network firm or service provider. In such circumstances, in addition to complying with the requirements for resources set out in this component, the firm is also required to comply with paragraphs 58–63 addressing network requirements or network services or paragraphs 64–65 addressing the use of resources from a service provider.

A116. Other components include responses that may affect or relate to the resources component. For example, the information necessary to facilitate the appropriate assignment of personnel or the evaluation of personnel is identified, captured, processed and maintained through the information and communication component.

*Human Resources* (Ref: Para. 38(a)–38(d))

A117. Competence is the ability of the individual to perform a role to a defined standard and goes beyond knowledge of principles, standards, concepts, facts, and procedures; it is the integration and application of technical competence, professional skills, and professional ethics, values and attitudes. Competence can be developed through a variety of methods, including professional education, continuing professional development, training, work experience or coaching of less experienced engagement team members by more experienced engagement team members.

A118. Professional standards, law or regulation may establish requirements addressing competence and capabilities. For example, law or regulation of a jurisdiction may establish requirements for the professional licensing of engagement partners, including requirements regarding their professional education and continuing professional development.

A119. The firm's responses that relate to the hiring, development and retention of personnel may include:

- Recruitment strategies that focus on selecting individuals who have the ability to develop the competence necessary to consistently perform quality engagements or activities in relation to the operation of the system of quality management.
- Training programs, which may form part of the firm's intellectual resources, to develop personnel's competence to enable them to perform their roles and responsibilities.
- Policies addressing the continuing professional development of personnel, including personnel's responsibility to maintain an appropriate level of continuing professional development, and training resources and other assistance provided by the firm.

- Evaluation mechanisms that establish competency areas and other performance measures, and facilitate the evaluation of personnel at appropriate intervals.
- Compensation, promotion and other incentives, appropriate to the nature and circumstances of the firm, for all personnel, including engagement partners, the individuals assigned ultimate responsibility and accountability for the firm's system of quality management, and the individual(s) assigned operational responsibility the firm's system of quality management or other aspects of the system of quality management.

A120. Human resources assigned to engagements or other roles may include personnel in a service delivery center, human resources engaged by the firm (i.e., a service provider) or human resources from a network or network firm.

A121. Timely evaluations and feedback help support and promote the continual development of the competence of personnel. Less formal methods of evaluation and feedback may be used, for example, in the case of smaller firms with fewer personnel.

A122. Evaluations of personnel may be used by the firm in determining the compensation, promotion, or other incentives. In some circumstances, simple or informal incentives that are not based on monetary rewards may be appropriate.

A123. The firm may take action for personnel who demonstrate actions or behaviors that negatively affect quality, including failing to demonstrate a commitment to quality, develop and maintain the competence to perform their role or implement the firm's responses as designed (e.g., an individual breaches the firm's policies or procedures related to independence). The consequences or actions taken by the firm may depend on the severity of the failure and the frequency of occurrence and may include, for example:

- Training or other professional development;
- Considering the effect of the matter on the evaluation, compensation, promotion or other incentives of the individual(s); or
- Taking disciplinary action against the individual(s), if appropriate, depending on the severity of the failure and the frequency of occurrence.

*Technological Resources* (Ref: Para. 38(e))

A124. Technological resources, which are typically IT applications, form part of the firm's IT environment. The firm's IT environment also includes the supporting IT infrastructure and the IT processes and human resources involved in those processes that the firm uses in the operation of its system of quality management:

- An IT application is a program or a set of programs that is designed to perform a specific function directly for the user or, in some cases, for another application program.
- The IT infrastructure is comprised of the network, operating systems, and databases and their related hardware and software.
- The IT processes are the firm's processes to manage access to the IT environment, manage program changes or changes to the IT environment and manage IT operations, which includes monitoring the IT environment.

A125. An IT application, IT infrastructure or IT process may serve multiple purposes within the firm and some of the purposes may be unrelated to the system of quality management. Only IT applications, IT infrastructure or IT processes that support the firm's system of quality management are relevant for the purposes of this ISQM.

A126. In some cases, the network may require the firm to use an IT application, the firm may choose to use an IT application provided by the network, or the firm may purchase an IT application from a service provider. The firm may also use the network or a service provider to manage certain aspects of the IT processes.

A127. Paragraph 40(a) addresses the firm's responsibility to establish an information system that supports the system of quality management, which may include the use of IT elements and records in the form of digital information. The firm may also use certain IT applications to enable the operation of various aspects of its system of quality management, for example, IT applications used to monitor compliance with relevant ethical requirements and record and maintain information about independence. Other IT applications may be implemented by the firm for use by engagement teams in performing engagements, for example, the firm may mandate the use of an IT application that facilitates the documentation of work performed or the firm may offer an IT application to perform analyses of the client's information that engagement teams may choose to use.

A128. The IT environment for a larger firm may be comprised of customized or integrated IT applications, with dedicated human resources to manage the IT infrastructure and IT processes. The IT environment for smaller firms may comprise IT applications that are commercial software, and the IT processes may involve authorizing access to the IT applications and processing updates to the IT applications.

A129. The use of IT applications or other aspects in the IT environment may give rise to quality risks, for example:

- Inappropriate reliance on IT applications that are inaccurately processing data, processing inaccurate data, or both.
- Unauthorized access to data that may result in breaches in confidentiality of information contained in the data, destruction of data or improper changes to data.
- Potential loss of data or inability to access data or IT applications as required.
- Unauthorized changes to IT applications or other aspects of the IT environment.
- Failure to make necessary changes to IT applications or other aspects of the IT environment.

The nature and significance of these quality risks may vary based on whether, and the extent to which, the firm relies on IT, including automated controls, to enable the design, implementation and operation of the system of quality management. General IT controls may be part of the responses designed and implemented by the firm to address quality risks identified and assessed by the firm.

A130. When implementing an IT application, particularly a customized IT application that has been developed specifically for the firm, it is necessary for the firm to determine that the IT application operates appropriately. This determination may involve consideration of whether:

- The data inputs are appropriate and confidentiality of the data is preserved.
- The IT application operates as designed and achieves the purpose for which it is intended.

- The outputs of the IT application achieve the purpose for which they will be used.
- It is clear how users are required to interact with and use the IT application and users have appropriate support.
- The general IT controls necessary to support the IT application's continued operation as designed are appropriate.

The firm may specifically prohibit the use of IT applications or features of IT applications, until such time that it has been determined that they operate appropriately and have been approved for use by the firm.

A131. Engagement teams may need training on how to use the IT applications appropriately. Furthermore, for certain IT applications, specialized skills may be needed to utilize the IT application effectively and the firm may need to specify procedures that set out how the engagement team operates the IT application. For example, in some instances the firm's IT application for the performance of engagements may require that the engagement team complete certain information about the client and the circumstances of the engagement in order to generate an appropriate engagement file template for the circumstances of the engagement.

*Intellectual Resources (Ref: Para. 38(f))*

A132. Intellectual resources include the information the firm uses to promote consistency in the performance of engagements, for example, written policies or procedures, a methodology, industry or subject matter-specific guides, accounting guides, standardized documentation or access to information sources (e.g., subscriptions to websites that provide in-depth information about entities or other information that is typically used in the performance of engagements).

A133. The intellectual resources may be made available to personnel through technological resources, for example, the firm's audit methodology may be embedded in the audit IT application that facilitates the planning and performance of the engagement. The firm may also need human resources to develop, implement and maintain its intellectual resources. Intellectual resources may also be dependent on relevant and reliable information that is identified, captured, processed and maintained through the firm's information and communication component.

*Personnel's Use of Technological and Intellectual Resources (Ref: Para. 38(g))*

A134. The firm may establish policies or procedures regarding the use of the firm's technological and intellectual resources. Such policies or procedures may:

- Require the use of certain IT applications or intellectual resources in performing engagements, for example, engagement teams may be required to use the firm's methodology when performing the engagement. They may also be required to use IT applications that facilitate the performance of the engagement and the archival of the engagement file.
- Specify the qualifications or experience of personnel that are needed to use the IT application, for example, the firm may specify the qualifications or expertise needed to use an IT application for the performance of automated techniques and to interpret the results.
- Set out how the technological or intellectual resources are to be used.

## **Information and Communication** (Ref: Para. 40–41)

A135. Obtaining, generating or communicating information is generally an ongoing process that involves all personnel and encompasses the dissemination of information within the firm and externally. Information and communication is pervasive to all components of the system of quality management and therefore the firm's responses for information and communication address assessed quality risks specific to information and communication, as well as assessed quality risks for the other components. Such responses may be designed and implemented individually for each component, or for all components holistically. Paragraphs A51, A69, A76 and A116 explain and provide examples of how the information and communication component supports the design, implementation and operation of the other components of the system of quality management.

### *The Firm's Information System* (Ref: Para. 40(a))

A136. Reliable information includes information that is accurate, complete, timely and valid to enable the proper functioning of the firm's system of quality management and to support decisions regarding the system of quality management.

A137. The information system in smaller firms is likely to be less sophisticated than in larger firms and involve a less complex IT environment.

A138. The information system may include the use of manual or IT elements, which affect the manner in which information is identified, captured, processed, maintained and communicated. The procedures to identify, capture, process, maintain and communicate information may be enforced through IT applications, and in some cases may be embedded within the firm's responses for other components. For example, the firm's responses for monitoring and remediation may define how information from the results of the firm's monitoring activities is captured, processed, maintained and communicated. In addition, digital records may replace or supplement physical records. For example, the firm may use an IT application to obtain a documented confirmation of compliance with independence requirements from personnel.

### *Communication Within the Firm* (Ref: Para. 40(b)–(d), 41(a)–(b))

A139. The firm and its personnel share relevant information to enable the proper functioning of the firm's system of quality management. For example:

- The firm communicates information to engagement teams, such as information that is obtained during the firm's acceptance and continuance process that is relevant to engagement teams in planning and performing engagements.
- Engagement teams communicate information to the firm, for example, information about:
  - The client obtained during the performance of an engagement that may have caused the firm to decline the client relationship or specific engagement had that information been known prior to accepting or continuing the client relationship or specific engagement.
  - The operation of the firm's responses to assessed quality risks (e.g., concerns about the firm's processes for assigning personnel to engagements).

In some cases, the information communicated by the engagement team may indicate a deficiency in the firm's system of quality management.

- Personnel performing activities within the firm's system of quality management share information. For example, the individual(s) assigned operational responsibility for compliance with independence requirements may communicate to the person with ultimate responsibility for the system of quality management changes in the independence requirements and how the firm's policies or procedures have been updated in response to such changes.

Two-way communication may also be among the various parties, for example, engagement teams may communicate information directly to the personnel performing activities within the firm's system of quality management.

A140. Matters communicated by the firm to engagement teams or other personnel performing activities within the firm's system of quality management may include changes to the system of quality management, to the extent that the changes are relevant to their responsibilities and enables the personnel to take prompt and appropriate action in accordance with their responsibilities.

A141. Responsibility for operating the responses designed and implemented by the firm may be assigned to:

- The engagement team, as described in paragraph A62;
- Personnel performing activities within the firm's system of quality management (e.g., assigning responsibility for the performance of an engagement quality review to an engagement quality reviewer); or
- A combination of the engagement team and personnel performing activities within the firm's system of quality management.

The firm may also use human resources external to the firm to assist in operating the responses.

*Communication with External Parties* (Ref: Para. 40(e), 41(c))

Communication Required by Law or Regulation (Ref: Para. 41(c)(i))

A142. Law, regulation or professional standards may require the firm to communicate information to external parties. For example:

- In circumstances when the firm becomes aware of non-compliance with laws and regulations by a client, relevant ethical requirements may require the firm to report the non-compliance with laws and regulations to an appropriate authority outside the client entity, or to consider whether such reporting is an appropriate action in the circumstances.
- Law, regulation or professional standards may require the firm to publish a transparency report and may specify the nature of the information that is required to be included in the transparency report.

Communication with the Network (Ref: Para. 41(c)(ii))

A143. When the firm belongs to a network, frequent communication with the network supports the network in establishing network requirements and providing network services that promote the consistent performance of quality engagements. Furthermore, the network's communication of relevant information supports the firm in the design, implementation and operation of its system of quality management. Such communication may include matters related to independence, for example, in

circumstances when relevant ethical requirements include requirements for independence that apply to network firms or employees of network firms.

Communication with Service Providers (Ref: Para. 41(c)(iii))

A144. When the firm uses a service provider, the service provider's communication of relevant information to the firm that affects the firm's system of quality management supports the firm in the design, implementation and operation of its system of quality management.

Communication to External Parties About the Firm's System of Quality Management (Ref: Para. 41(c)(iv))

A145. The firm's ability to maintain stakeholder confidence in the quality of its engagements may be enhanced through effective two-way communication between the firm and its stakeholders. For example, stakeholders' perception of the quality of engagements performed by the firm may be improved when the firm is transparent about the activities that it has undertaken to address quality, and the effectiveness of those activities.

External parties who may use information about the firm's system of quality management (Ref: Para. 41(c)(iv)(a))

A146. External parties may include management or those charged with governance of the firm's clients, the firm's network or network firms, external oversight authorities, other firms who use the work of the firm in the performance of engagements (e.g., in relation to a group audit) or service providers. External parties may also include users of the firm's engagement reports, for example, current shareholders and credit providers of the entities for whom the firm performs engagements.

A147. The firm exercises professional judgment when taking into account whether there are external parties who may use information about the firm's system of quality management. Whether there are such external parties may depend on the nature of the engagements the firm performs and the types of entities for which such engagements are performed. For example, for a firm that performs audits of financial statements of listed entities or entities that may be of significant public interest described in paragraph A23, external parties such as shareholders of such entities may use a transparency report or similar publication to inform their understanding of the quality of engagements performed by the firm. On the other hand, for a firm that only performs compilation engagements, external parties who may use information about the firm's system of quality management may be limited, and they may obtain such information through discussions and direct interaction with the firm.

Nature and circumstances of the firm (Ref: Para. 41(c)(iv)(b))

A148. Factors that may affect the firm's operating environment include the nature and circumstances of the financial markets in which the firm operates and the understanding and interest that external parties have expressed about the engagements undertaken by the firm, and the firm's processes in performing the engagements.

Nature, timing, extent and content of communications to external parties about the system of quality management (Ref: Para. 41(c)(iv))

A149. The form of communication to external parties may include a publication such as a transparency report or audit quality report, webpage, targeted communication to specific stakeholders (e.g.,

information about the results of the firm's monitoring and remediation process), or direct conversations with the external party.

A150. The information that is communicated to external parties about the firm's system of quality management may depend on a variety of factors, including the form of the communication, the nature and circumstances of the firm and the external parties with whom the communication is being undertaken. For example, the communication may contain information about:

- The nature and circumstances of the firm, such as the organizational structure and operating environment and whether it is part of a network.
- The firm's governance and leadership, such as its culture and commitment to quality and information about the individuals responsible for the leadership of the firm.
- Factors that contribute to quality engagements, for example, such information may be presented in the form of engagement quality indicators with appropriate narrative to explain the indicators.
- The results of the firm's monitoring activities and external inspections, and how the firm has remediated identified deficiencies or is otherwise responding to them.
- The evaluation undertaken in accordance with paragraph 55 of whether the system of quality management provides reasonable assurance that the objectives stated in paragraph 18(a) and (b) have been achieved, including the basis for the judgments made in undertaking the evaluation.
- How the firm has responded to emerging developments and changes in the circumstances of the firm or its engagements, including how the system of quality management has been adapted to respond to such changes.

A151. Information that is communicated to external parties about the firm's system of quality management that has the following attributes contributes to an enhanced understanding of the quality of the engagements performed by the firm:

- The information is specific to the circumstances of the firm and is prepared and presented in a timely manner. Relating the matters in the firm's communication directly to the specific circumstances of the firm may help to minimize the potential that such information becomes overly standardized and less useful over time.
- The information is presented in a clear and understandable manner that is neither misleading nor would inappropriately influence the users of the communication (e.g. the information is appropriately balanced towards positive and negative aspects of the matter being communicated).
- The information is accurate and complete in all material respects and does not contain information that is misleading.
- The information takes into consideration the information needs of the users for whom it is intended. In considering the information needs of the users, the firm may consider matters such as the level of detail that users would find meaningful and whether users have access to relevant information through other sources, for example, information located on the firm's website.

A152. In circumstances when the firm is part of a network, it may be useful to provide information about the relationship between the firm and the network in certain external communications, such as a transparency report. Such information helps facilitate an understanding of the responsibilities of the firm and the network, and clarifies how the network requirements or network services promote the consistent performance of quality engagements across the network firms. Such information may include:

- The nature of the relationship between the firm and the network and the overall structure of the network.
- Requirements established by the network for the firm or network services that are used by the firm in its system of quality management.
- Information about the overall scope and results of network monitoring activities across the network firms that the network has provided to the firm in accordance with paragraph 61, if applicable.

In some circumstances, the network may provide external communication about the above matters, for example, in the form of a network transparency report, which may support the firm in communicating the information.

A153. In some cases, law or regulation may preclude the firm from communicating information related to its system of quality management externally. For example, certain information may be subject to privacy or secrecy laws or regulations or the firm may be precluded from communicating certain information because of the duty of confidentiality under law, regulation or relevant ethical requirements.

#### **Monitoring and Remediation Process** (Ref: Para. 42–57)

A154. In addition to enabling the firm's evaluation of the system of quality management, the monitoring and remediation process facilitates the improvement of engagement quality and the system of quality management.

A155. Professional judgment is exercised in making various decisions within the monitoring and remediation process, including decisions about:

- The nature, timing and extent of the monitoring activities, including the scope of inspection of engagements.
- The evaluation of the findings from the monitoring activities, results of external inspections and other relevant information to determine whether deficiencies exist.
- How to respond to the findings from the monitoring activities, results of external inspections and other relevant information.
- The evaluation of the severity and pervasiveness of the identified deficiencies.
- Whether the system of quality management provides reasonable assurance that the objectives stated in paragraph 18(a) and (b) have been achieved.

#### *Designing and Performing Monitoring Activities* (Ref: Para. 44–46)

A156. The firm's monitoring activities may comprise ongoing monitoring activities, periodic monitoring activities or a combination of both. Ongoing monitoring activities are generally routine activities, built

into the firm's processes and performed on a real-time basis, reacting to changing conditions, for example:

- An IT application that continually monitors the permissibility of financial investments recorded by personnel as part of the firm's independence responses.
- Inspection of in-process engagements that are focused on specific aspects of completed work.

Periodic monitoring activities are conducted at certain intervals by the firm, for example, inspection of training records to determine that personnel have attended training in accordance with the firm's policies or procedures or inspection of completed engagements. In most cases, ongoing monitoring activities identify deficiencies in the system of quality management in a timelier manner.

A157. The purpose of a monitoring activity is to monitor the responses in the system of quality management. The system of quality management may include responses that are similar in nature to a monitoring activity but have a different purpose (e.g., responses that are designed to detect failures or shortcomings in the system of quality management so that they can prevent an assessed quality risk from occurring). For example, in some circumstances, an in-process review of engagement documentation may be designed as a monitoring activity as part of paragraph 45, in which case the findings from that review are subject to the requirements in paragraph 47. In other circumstances, an in-process review may be designed as a response to address an assessed quality risks in the engagement performance component or other components. Determining the purpose of the response is necessary in determining its design and implementation, and where it fits within the system of quality management (i.e., whether it is a response in monitoring and remediation or a response in another component).

A158. The nature, timing and extent of the monitoring activities may be affected by factors such as:

- The size, structure and organization of the firm.
- The involvement of the network in monitoring activities.
- The resources that the firm intends to use to enable monitoring activities, for example, the use of IT applications in addition to human resources.
- The design of the response subject to monitoring. For example, the response may comprise in-process reviews of engagement documentation of selected engagements by personnel who are not members of the engagement team. The extent of the review of the engagement documentation, the nature of the matters considered in the review, and how the results of the review are collated may affect the nature, scope and frequency of the monitoring activities over the in-process review.

A159. When performing monitoring activities, the firm may determine that changes to the nature, timing and extent of the monitoring activities are needed. For example, the firm may identify findings that indicate the need for more extensive monitoring activities.

The Design of the Response and the Assessed Quality Risks (Ref: Para. 44(a))

A160. The nature, timing and extent of the firm's monitoring activities may be more robust for areas of the system of quality management where the assessed quality risks are greater and the related responses are more extensive or rigorous. For example, the firm may perform more extensive monitoring activities over compliance with independence requirements for audits of financial statements than for other types of engagements.

A161. The reasons for the assessments given to the assessed quality risks may include characteristics associated with certain engagements, for example:

- Engagements performed in respect of certain entities (e.g., a listed entity or entity that may be of significant public interest).
- Engagements where the firm or engagement partner are inexperienced, for example, a new industry, a new service offering or new engagement partner.
- Engagements that have been subject to external inspection and which had negative findings, or engagements where the findings of previous monitoring activities resulted in identified deficiencies.
- Engagements where the firm's engagement acceptance and continuance procedures indicated that matters may exist that may increase the engagement risk.

Changes in Factors That Have Affected the System of Quality Management or Changes in the System of Quality Management (Ref: Para. 44(c))

A162. Changes in factors that have affected the firm's system of quality management include changes in the nature and circumstances of the firm and its engagements (e.g., a new service offered by the firm or changes in the firm's environment). Changes in the system of quality management include:

- Changes to address an identified deficiency in the system of quality management.
- Changes to the responses, for example, because they have become obsolete over time or more effective responses are designed and implemented, such as the use of IT applications to replace manual processes.

When changes occur, previous monitoring activities undertaken by the firm may no longer provide the firm with information to support the evaluation of the system of quality management and, therefore, the firm's monitoring activities may include monitoring of those areas of change.

Previous Monitoring Activities (Ref: Para. 44(d), 50)

A163. The findings from the firm's previous monitoring activities may indicate areas of focus for the monitoring activities, for example, monitoring activities may need to continue to be undertaken in certain areas where there is a history of deficiencies. Furthermore, the monitoring activities may need to evaluate the effectiveness of the remedial actions that have been implemented to address deficiencies previously identified.

A164. Although areas of the system of quality management may not have changed, previous monitoring activities undertaken by the firm may no longer provide the firm with information to support the evaluation of areas that have not changed, for example, because of the time that has elapsed since the monitoring activities were undertaken.

Other Relevant Information (Ref: Para. 44(e), 47)

A165. Examples of sources of other relevant information may include:

- Information communicated by the network in accordance with paragraphs 60(c) and 61 about the firm's system of quality management, including the network requirements or network services that the firm has included in its system of quality management.

- Information communicated by a service provider about the resources the firm uses in its system of quality management.
- Concerns about the commitment to quality of the firm or its personnel, communicated in accordance with paragraph 24(c).
- The results of industry-wide reviews undertaken by an external oversight authority of focus areas related to systems of quality management or the performance of engagements.
- Other reviews undertaken by an external oversight authority, for example, informal reviews undertaken by an external oversight authority to assess a firm's preparation for the implementation of a new professional standard, or reviews of specific areas of focus that contribute to the improvement of engagement quality.
- Information from regulatory actions and litigation against the firm or other firms in the jurisdiction that may highlight areas for the firm to consider.
- A material restatement of financial statements, an engagement report that required reissuance or litigation against the firm.

A166. The results of external inspections or other relevant information may indicate findings or deficiencies in previous monitoring activities undertaken by the firm, which may affect the firm's consideration of whether the nature, scope and frequency of previous monitoring activities were appropriate.

A167. External inspections are not a substitute for the firm's internal monitoring activities. Nevertheless, the results of external inspections may inform the nature, timing and extent of the monitoring activities.

#### Engagement Inspections (Ref: Para. 45)

A168. The relevant factors in paragraph 44 affect the extent and frequency of selection of in-process or completed engagements or engagement partners for inspection. Other factors that may also affect the extent and frequency of selection of in-process or completed engagements or engagement partners for inspection include:

- The nature, timing and extent of other monitoring activities undertaken by the firm at the engagement level.
- The varying nature of the engagements performed by the firm.
- The size of the firm, including the number and geographic location of offices and the nature and complexity of the firm's practice and organization.

A169. The firm may establish different cyclical periods for inspecting engagement partners according to the categories of engagements they perform, for example, the firm may determine that the cyclical period for an engagement partner performing audits of financial statements is every three years, whereas a longer period may be appropriate for engagement partners performing only compilation engagements. The cycle of the inspection may be based on time (i.e., every three years as illustrated) or another factor, such as the number of engagements performed. The cyclical period may also be affected by the nature, timing and extent of inspection of in-process engagements and the results thereof.

A170. The purpose of an inspection of an in-process or completed engagement depends on how the inspection has been designed by the firm. Ordinarily, the inspection of an in-process or completed engagement includes determining that responses designed to be implemented at the engagement

level have been implemented, for example, the firm may determine whether engagement teams have applied the firm's methodology appropriately.

#### Individuals Performing the Monitoring Activities (Ref: Para. 46)

A171. As described in paragraph A65, objectivity is a fundamental principle of the IESBA Code, and the provisions of relevant ethical requirements are relevant in designing the policies or procedures addressing the objectivity of the individuals performing the monitoring activities. For example, a self-review threat may arise when an individual who performs:

- An inspection of an engagement was:
  - In the case of an audit of financial statements, an engagement team member or the engagement quality reviewer of that engagement or an engagement for a subsequent financial period; or
  - For all other engagements, an engagement team member or the engagement quality reviewer of that engagement.
- Another type of monitoring activity had participated in designing, executing or operating the response being monitored.

#### *Evaluating Findings and Identifying Deficiencies* (Ref: Para. 47)

A172. Findings represent the information accumulated from the performance of monitoring activities and may also include the results of external inspections and other relevant information about the firm's system of quality management. Findings may be positive or negative in nature.

#### Positive Findings

A173. Positive findings may be useful to the firm as they indicate practices that the firm can support or apply more extensively, for example, across all engagements. They may also highlight opportunities for the firm to enhance the system of quality management.

#### Negative Findings

A174. Negative findings are considered by the firm in accordance with paragraph 47 to determine whether there are deficiencies in the system of quality management. Not all negative findings are a deficiency in the system of quality management.

A175. Factors that a firm may consider in determining whether a finding is a deficiency include:

- The nature of the finding, for example, a finding that indicates that personnel have not adhered to the firm's policies or procedures may be indicative of a deficiency in the culture of the firm.
- The design of the monitoring activity from which the finding arose, for example, the firm may consider the tolerable error rate of the activity and whether it was designed to focus on specific areas of risk or the whole population.
- The extent of the monitoring activity from which the finding arose, including the size of sample selected relative to the size of the entire population.
- The extent of the findings in relation to the sample of the population covered by the monitoring activity.

- If the finding relates to a response:
  - The nature of the assessed quality risk to which the response relates, and the extent to which the finding indicates that the assessed quality risk has not been addressed.
  - Whether there are other responses that address the same assessed quality risk and whether there are findings for those responses.
- Whether the finding, in combination with other findings, indicate a trend or systemic issue.

A176. A finding may affect multiple responses across different components. For example, a finding that suggests that personnel assigned to an engagement were not knowledgeable about the procedures they performed in the engagement may indicate deficiencies in responses related to human resources (i.e., inappropriate competence and capabilities) as well as those related to engagement performance (i.e., inappropriate direction, supervision and review).

A177. The effectiveness of the monitoring and remediation process may be evaluated through considering the findings arising from the monitoring activities, the results of external inspections and other relevant information source (e.g., network monitoring activities or complaints and allegations). For example, external inspection findings may indicate deficiencies in the system of quality management that have not been identified by the firm's monitoring and remediation process, which highlight a deficiency in that process.

#### Root Cause of the Identified Deficiencies (Ref: Para. 48(a))

A178. This ISQM requires the firm to investigate the root cause(s) of identified deficiencies. As highlighted in paragraph A174, not all negative findings from the performance of monitoring activities, results of external inspections and other relevant information are a deficiency in the system of quality management. Although not required by this ISQM, investigating the root cause of positive findings may reveal opportunities for the firm to improve, or further enhance, the system of quality management. Identifying the root cause of positive findings on engagements where identified deficiencies did not exist may also help the firm to identify the root causes of identified deficiencies that existed in other engagements and may assist the firm in determining how to remediate identified deficiencies.

A179. The objective of investigating the root cause(s) of identified deficiencies is to understand the underlying circumstances that caused the deficiencies. An improved understanding of the underlying cause(s) of identified deficiencies may:

- Facilitate the design and implementation of more effective actions to address identified deficiencies.
- Directly contribute to the improvement of quality at the engagement level through the participation of engagement teams in the root cause analysis process.
- Enable those assigned ultimate responsibility and accountability or operational responsibility for the system of quality management to proactively monitor actions taken to address identified deficiencies.
- Facilitate more effective communication to personnel by explaining the actual root cause(s) of identified deficiencies, rather than the deficiencies themselves.

A180. Performing a root cause analysis generally involves those performing the assessment exercising professional judgment based on the evidence available. The firm's policies or procedures for the nature, timing and extent of the procedures to investigate the root cause(s) of identified deficiencies are required to take into account the nature of the deficiencies and their possible severity which may include:

- The nature and extent of the deficiency, for example, a deficiency that results in an engagement report being inappropriate has greater severity than a deficiency that resulted in the firm's policies or procedures not being followed but the engagement report was still appropriate.
- Whether the deficiency, in combination with all other identified deficiencies, indicates a trend or systemic issue, for example, there are multiple engagement reports affected by the same deficiency or certain policies or procedures appear to have high rates of non-compliance.

The procedures undertaken to understand the root cause(s) of an identified deficiency may be simple, for example, in circumstances when the possible severity of the deficiency is not significant, the root cause is apparent or, in the case of a smaller firm, those performing the root cause analysis are familiar with a variety of information to inform their understanding.

A181. There may be multiple root cause(s) of an identified deficiency, the root cause(s) may be complex and interrelated, and the root cause(s) may exist across various components of the firm's system of quality management. Furthermore, a root cause of an identified deficiency may relate to more than one identified deficiency or affect multiple components, for example, in circumstances when the root cause relates to an aspect of the firm's risk assessment process. There may also be circumstances when a single root cause relates to multiple identified deficiencies.

A182. Identifying a root cause(s) that is appropriately specific may support the firm's process for remediating identified deficiencies. For example, it may be identified that an engagement team did not exercise sufficient professional skepticism in complex areas of management judgment. However, the underlying root cause of this issue may relate to another matter, such as a cultural environment that does not encourage engagement team members to challenge individuals with greater authority or insufficient direction, supervision and review on the engagement.

#### Evaluating the Severity and Pervasiveness of Identified Deficiencies (Ref: Para. 48(b))

A183. Factors the firm may consider in evaluating the severity and pervasiveness of an identified deficiency include:

- The nature of the identified deficiency, including whether it relates to a quality objective, quality risk or a response;
- The root cause(s) of the identified deficiency;
- The frequency with which the underlying finding occurred; and
- The magnitude of the identified deficiency, the rate at which it occurred and the duration of time that it existed.

#### *Responding to Identified Deficiencies* (Ref: Para. 49–50)

A184. The nature, timing and extent of remedial actions may depend on a variety of other factors, including:

- The root cause(s), for example, whether it relates to an individual engagement, a certain category of engagements, or is more pervasive throughout the firm.

- The severity and pervasiveness of the identified deficiency and therefore the urgency in which it needs to be addressed.
- The effectiveness of the remedial actions in addressing the root cause(s), for example, the firm may need to implement more than one remedial action in order to effectively address the root cause(s), or may need to implement remedial actions as interim measures until the firm is able to implement more effective remedial actions.

#### Findings About a Particular Engagement (Ref: Para. 51)

A185. In circumstances when procedures were omitted or the report issued is inappropriate, the action taken by the firm may include:

- Consulting with appropriate individuals within the firm regarding the appropriate action.
- Discussing the matter with management of the entity or those charged with governance.
- Performing the omitted procedures.

The actions taken to correct the work performed for a specific engagement does not relieve the firm of the responsibility to investigate the root cause(s) of the identified deficiency related to the engagement.

#### *Ongoing Communication Related to the Monitoring and Remediation (Ref: Para. 52–54)*

A186. The information communicated about the monitoring and remediation to the individual(s) assigned ultimate responsibility and accountability for the system of quality management and the individual(s) assigned operational responsibility for the system of quality management provides the basis for the evaluation of the system of quality management, as required by paragraph 55.

A187. In determining the information to be communicated to personnel, including the nature and extent of such communication, the firm may consider the type of information that is relevant to the particular recipients, including the information needs of the recipients, as a result of their defined roles and responsibilities. For example:

- Information communicated to engagement teams may be focused on deficiencies that have been identified at an engagement level and therefore are likely to be relevant. It may also include positive findings that indicate practices that engagement teams could apply more extensively. In considering the information needs of the engagement team, the firm may take into account the responsibilities of the engagement team regarding such information. For example, proposed ISA 220 (Revised)<sup>33</sup> requires the engagement team to determine the relevance and effect on the audit of the results of the monitoring and remediation process, and to take appropriate action.
- Information communicated to all personnel may relate to matters relevant to compliance with the firm's independence policies or procedures as such policies or procedures may apply to all personnel.

Communicating the root cause(s) of identified deficiencies may increase awareness and understanding of why deficiencies occurred, which may influence the behavior of engagement teams

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<sup>33</sup> Proposed ISA 220 (Revised), paragraph 36(b)

and personnel. Communicating remedial actions may enable the implementation of such actions in a more proactive manner.

*Evaluating the System of Quality Management (Ref: Para. 55–57)*

A188. An effective system of quality management provides reasonable assurance that the objectives stated in paragraph 18(a) and (b) have been achieved.

A189. The individual(s) assigned ultimate responsibility and accountability for the system of quality management uses the information obtained in accordance with paragraph 52 in evaluating the effectiveness of the system of quality management. The nature and extent of the information, including how the information is communicated, will vary based on the nature and circumstances of the firm. For example, in a smaller firm, the individual(s) assigned ultimate responsibility and accountability for the system of quality management may be directly involved in the monitoring and remediation and will therefore be aware of the information that supports the evaluation of the system of quality management. However, in a larger firm, the individual(s) assigned ultimate responsibility and accountability for the system of quality management may not have direct involvement in the monitoring and remediation process. Therefore, the individuals assigned operational responsibility for various aspects of the system of quality management may need to collate, summarize and present the information that supports the evaluation of the system of quality management in a manner that enables the individual(s) assigned ultimate responsibility and accountability for the system of quality management to form an appropriate conclusion.

A190. Prompt and appropriate action when the evaluation indicates that the system does not provide reasonable assurance that the objectives stated in paragraph 18(a) and (b) have been achieved may include:

- Taking steps to determine whether the reports already issued by the firm were appropriate.
- Taking measures to confirm that reports not yet issued by the firm are appropriate in the circumstances.
- Obtaining legal advice.

A191. Circumstances when it may be appropriate for the firm to communicate to external parties that the system does not provide reasonable assurance that the objectives stated in paragraph 18(a) and (b) have been achieved include:

- When the firm belongs to a network and the information is relevant to the network or other firms within the network who use the work performed by the firm, for example, in the case of a group audit.
- When a report issued by the firm is determined to be inappropriate as a result of the failure of the system of quality management, and management or those charged with governance of the entity need to be informed.

In some circumstances, the firm may be required by law or regulation to communicate to an oversight authority or a regulatory body that the system does not provide reasonable assurance that the objectives stated in paragraph 18(a) and (b) have been achieved.

### **Network Requirements or Network Services** (Ref: Para. 58–63)

A192. Network requirements may include, for example:

- Requirements for the firm to include quality objectives or identified quality risks in the firm's system of quality management that are common across the network firms.
- Requirements for the firm to include responses, including resources, in the firm's system of quality management that are common across the network firms. Such responses designed by the network may include network policies or procedures that specify the leadership roles and responsibilities, including how the firm is expected to assign authority and responsibility within the firm, network developed methodologies for the performance of engagements or IT applications.
- Requirements that the firm be subject to the network's monitoring activities. These monitoring activities may relate to network requirements (e.g., monitoring that the firm has implemented the network's methodology appropriately), or to the firm's system of quality management in general.

A193. Examples of network services include services or resources that are optional for the firm to use as a response in its system of quality management, such as voluntary training programs, or a service delivery center established at the network level, or by another firm or group of firms within the same network.

A194. The network may establish responsibilities for the firm in implementing the network requirements or network services. For example, in the case of implementing an IT application developed by the network, the firm may need to have the appropriate IT infrastructure and IT processes in place.

A195. The firm's understanding of the network requirements or network services and the firm's responsibilities relating to the implementation thereof may be obtained through inquiries of, or documentation provided by, the network about matters such as:

- The network's governance and leadership.
- The procedures undertaken by the network in designing, implementing and, if applicable, operating, the network requirements or network services.
- How the network identifies and responds to changes that affect the network requirements or network services or other information, for example, changes in the professional standards or information that indicates a deficiency in the network requirements or network services.
- How the network monitors the appropriateness of the network requirements or network services, which may include through the network firms' monitoring activities, and the network's processes for remediating identified deficiencies.

A196. Paragraph 41(c) requires the firm to establish policies or procedures that address the nature, timing, extent and content of communication with the network, for example, the matters described in paragraphs 58 and A195.

### *The Firm's Risk Assessment Process* (Ref: Para. 59)

A197. The network requirements or network services may affect the firm's system of quality management in the following ways:

- The firm may need to identify and assess quality risks for quality objectives provided by the network.
- The firm may need to design and implement responses to address quality risks provided by the network, or the firm may need to assess the quality risks provided by the network.
- The firm may identify additional quality risks arising from responses provided by the network, for example, quality risks may arise from the implementation of a network IT application.

A198. The network requirements or network services may need to be adapted or supplemented by the firm to appropriately address the nature and circumstances of the firm and its engagements, for example:

- The quality objectives provided by the network may not be at a sufficient level of granularity for the firm, or additional quality objectives may need to be established.
- The firm may identify additional quality risks that have not been identified by the network.
- The responses provided by the network may not be designed to address the assessed quality risks and the reasons for the assessments given to the quality risks.

*Monitoring and Remediation Process (Ref: Para. 60–63)*

A199. The monitoring activities undertaken by the network may affect the nature, timing and extent of the firm's monitoring activities. For example, the network may undertake cyclical inspections of completed engagements of the firm, which may affect the extent of inspections of in-process or completed engagements undertaken by the firm.

A200. The results of the network's monitoring activities of the firm's system of quality management may include information such as:

- A description of the monitoring activities, including their nature, timing and extent;
- Findings from the monitoring activities and deficiencies identified; and
- The network's evaluation of the root cause(s) of the identified deficiencies, the assessed effect of the deficiencies and recommended remedial actions.

A201. The information about the overall scope and results of the monitoring activities across the network firms' systems of quality management may highlight trends and common areas of identified deficiencies across the network, or examples of quality that may be replicated across the network. Such information may be used by the firm to determine the nature, timing and extent of its monitoring activities. It may also indicate deficiencies in network requirements or network services used by the firm in its system of quality management.

A202. In some circumstances, the firm may obtain information from the network about deficiencies identified in a network firm's system of quality management that affects the firm, for example, when the network firm performs work for the firm's engagements, such as in the capacity of a component auditor. The network may also gather information from the network firms regarding the results of external inspections over the network firms' systems of quality management. In some instances, law or regulation in a particular jurisdiction may prevent the network from sharing information with other firms within the network or may restrict the specificity of such information.

A203. Paragraph 42 requires the firm to evaluate the design, implementation and operation of the components of the system of quality management, which includes the network requirements or

network services used by the firm. The network requirements or network services may be monitored by the network, the firm, or a combination of both. For example, the network may undertake monitoring activities at a network level for a common methodology, however various monitoring activities at a firm level may support the evaluation of the methodology, including engagement inspections.

A204. In some cases the firm may determine that the remedial actions by the network are inadequate, or such remedial actions may take time to effectively address the identified deficiency. In such cases, the firm may need to implement its own remedial actions to address the identified deficiency until such time as the network has effectively addressed the deficiency.

### **Service Providers** (Ref: Para. 64–65)

A205. The firm may use human resources, technological resources or intellectual resources that are obtained from a service provider. The service providers used by the firm include individuals or organizations that are external to the firm, excluding networks, network firms or other structures or organizations in the network. Examples of resources from a service provider include:

- Human resources used to perform the firm's monitoring activities or engagement quality reviews, or to provide consultation on technical matters.
- A commercial IT application used to perform audit engagements.
- Human resources used in the performance of engagements, for example, to attend a physical inventory count or inspect physical fixed assets at a remote location.
- External experts used in the performance of engagements. In such cases, there may be requirements in the other IAASB standards that address the competence, capabilities and objectivity of the external expert, understanding of the expert and agreement with the expert which apply in conjunction with the requirements of this ISQM.<sup>34</sup>
- The use of resources from a service provider does not include using the work of an entity's internal audit function in the performance of engagements, in accordance with ISA 610 (Revised 2013).<sup>35</sup>

A206. The determination of whether the matters described in paragraph 64 are relevant for a service provider depends on a variety of factors including:

- The nature of the resources provided by the service provider, including how and the extent to which it will be used within the firm.
- The reasons for the assessments given to the assessed quality risks to which the resource relates.
- Whether the resource itself gives rise to quality risks. For example, when the firm uses human resources from a service provider in the performance of engagements, there may be a quality risk that such resources do not have the competence and capabilities to perform the engagement, exercise inappropriate judgment when performing the engagement, do not implement the firm's responses at the engagement level or do not fulfill their responsibilities in accordance with relevant ethical requirements. Such quality risks may also affect the

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<sup>34</sup> See, for example, ISA 620, *Using the Work of an Auditor's Expert*.

<sup>35</sup> ISA 610 (Revised 2013), *Using the Work of Internal Auditors*

management of quality at the engagement level. For example, in circumstances when the firm uses human resources from a service provider to assist in the performance of engagement procedures, there may be a need for the engagement partner to have greater oversight on a more frequent basis and perform more in-depth reviews of work performed by the individual.

A207. The firm may establish policies or procedures that address circumstances when a service provider is used in the performance of engagements that set out the responsibility of the engagement team when engaging a service provider, which may include responsibility for certain matters in paragraph 64.

A208. Obtaining an understanding of the service provider may include understanding the conditions of the service, for example, how often updates will be provided for an IT application, limitations on the use of the IT application and how the service provider addresses confidentiality of data. Paragraph 41(c)(iii) requires the firm to establish policies or procedures that address the nature, timing, extent and content of communication with the service provider, for example, information to support the firm's understanding of the service provider and use of the resource (e.g., updates or changes to the resource or deficiencies in the resource).

A209. The firm's responsibilities in using the service provider may include matters such as the actions the firm needs to take in order to implement the resource or information the firm needs to communicate to the service provider in order that the resource can function effectively. For example, in the case of an IT application, the firm may need to have appropriate supporting IT infrastructure and IT processes in place.

A210. In determining whether the resource is appropriate, the firm may make inquiries of the service provider or request documentation from the service provider about matters such as:

- For human resources, the qualifications, experience and location of the individuals, including professional licenses or membership obligations, and how they develop and maintain the appropriate competence to perform the services.
- For technological or intellectual resources, the procedures undertaken by the service provider in designing, implementing and operating the resources.
- How the service provider identifies and responds to changes that affect the resources, for example, changes in the professional standards or information that indicates a deficiency in the resources;
- How the resource will be evaluated, monitored or remediated by the service provider.

There may be circumstances when the service provider supplies the firm with an assurance report on the description and design of their controls over the resource, and in some circumstances, it may also include assurance on the operating effectiveness of such controls.

#### **Documentation** (Ref: Para. 66–69)

A211. Documentation provides evidence that the firm complies with this ISQM, as well as law, regulation or relevant ethical requirements. It may also be useful for training personnel, ensuring the retention of organizational knowledge and providing a history of the basis for decisions made by the firm about its system of quality management. It is neither necessary nor practicable for the firm to document every matter considered, or judgment made, about its system of quality management. Furthermore, compliance with this ISQM may be evidenced by the firm through its information and communication

component, documents or other written materials, or IT applications that are integral to the components of the system of quality management.

A212. Documentation may take the form of formal written manuals, checklists and forms, may be informally documented (e.g., e-mail communication or postings on websites), or may be held in IT applications or other digital forms (e.g., in databases). Factors that may affect the firm's judgments about the form, content and extent of documentation may include:

- The size of the firm and the number of offices;
- The nature and complexity of the firm's practice and organization;
- The types of services the firm provides and the nature of the clients to whom services are provided; and
- The nature and complexity of the matter being documented, for example, whether it relates to an aspect of the system of quality management that has changed or an area of greater quality risk.

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.

A213. In some instances, an external oversight authority may establish documentation requirements, either formally or informally, for example, as a result of the outcome of external inspection findings. Relevant ethical requirements may also include specific requirements addressing documentation, for example, the IESBA Code requires documentation of particular matters, including certain situations related to conflicts of interest, non-compliance with laws and regulations and independence.

A214. In some circumstances, it may be appropriate for the firm to document its process and analyses for establishing the quality objectives, identifying and assessing quality risks and designing responses to such risks, to provide a history of the basis for decisions made by the firm about its system of quality management.

## **The Components of a System of Quality Management**

1. This appendix describes the eight components of a firm's system of quality management. The components in this ISQM have similarities to the components of internal control described in the Committee of Sponsoring Organizations of the Treadway Commission *Internal Control – Integrated Framework*. For example, the governance and leadership component is similar to the entity's control environment and the firm's risk assessment process is similar to the entity's risk assessment process.

### **Governance and Leadership**

2. The governance and leadership component creates the environment in which the other components of the system of quality management operate because it addresses the firm's culture, decision-making process, actions, organizational structure and leadership. The governance and leadership component also provides the basis for the system of quality management because the firm needs to establish structures, reporting lines and appropriate authority and responsibility in order that the other components of the system of quality management can be developed. For example, in order to establish a system of quality management, the firm needs to identify the individual(s) responsible for its development. Accordingly, the governance and leadership component has a pervasive effect on the system of quality management and the other components cannot be effective if the environment in which they operate is not appropriate.

### **The Firm's Risk Assessment Process**

3. The firm's risk assessment process sets out the process the firm is required to follow in implementing the risk-based approach to quality management, which consists of establishing quality objectives, identifying and assessing quality risks to the achievement of the quality objectives and designing and implementing responses to address the assessed quality risks.
4. The firm is required to establish the quality objectives set out in this ISQM and additional quality objectives beyond those required by this ISQM, when those objectives are necessary to achieve the objective of this ISQM.
5. Quality risks arise from conditions, events, circumstances, actions or inactions that affect the achievement of the quality objectives, and which are associated with the nature and circumstances of the firm and its engagements. For example:
  - (a) *Nature and circumstances of the firm*: The firm may have a service delivery center that includes personnel who perform specific tasks for engagement teams. This may create, or increase the likelihood of, the quality risks for the appropriate direction and supervision of the engagement team and review of the work performed because the personnel may not be in the same location as the engagement partner or the engagement team.
  - (b) *Nature and circumstances of the engagements*: The firm may only perform related services engagements and because of the nature of such engagements, the firm may not identify any quality risks relating to compliance with independence requirements, because independence may not be relevant. In relation to the types of entities for which engagements are undertaken,

the firm may perform engagements for entities in a particular industry, such as banks, insurance companies and pension funds. This may create the quality risk that personnel do not have the appropriate knowledge of the industry to perform the engagement.

The nature and circumstances of the firm and its engagements also affect the assessment of the likelihood of the identified quality risks occurring and the significance of the effect of the identified quality risk on the achievement of the quality objectives.

6. The responses designed and implemented by the firm consist of:

- (a) The responses required by this ISQM, which are organized by component; and
- (b) Additional responses determined by the firm.

The responses required by this ISQM alone will not be sufficient to address all of the firm's assessed quality risks for the quality objectives that are required to be established by this ISQM.

7. The responses designed and implemented by the firm, including the responses required by this ISQM, are affected by the nature and circumstances of the firm and its engagements. For example:

- (a) *Nature and circumstances of the firm:* In circumstances when the firm has a service delivery center that includes personnel who perform specific tasks for engagement teams, the firm may obtain technology to facilitate interaction between the engagement partner and personnel located in the central location, to support appropriate direction and supervision.
- (b) *Nature and circumstances of the engagements:* In circumstances when the firm performs engagements in a particular industry, the firm may provide training for personnel on matters unique to that industry, or recruit personnel with experience in the industry.

8. The firm's processes for establishing quality objectives, identifying and assessing quality risks and designing and implementing responses includes identifying changes in the nature and circumstances of the firm or its engagements and modifying the quality objectives, quality risks or responses, as appropriate, for changes in the matters described above.

### **Relevant Ethical Requirements**

9. The relevant ethical requirements component comprises the firm's processes for managing compliance with relevant ethical requirements, in order that the firm, its personnel and others subject to relevant ethical requirements, as applicable, fulfill their responsibilities in accordance with relevant ethical requirements. The processes include how threats to complying with relevant ethical requirements are identified, assessed and addressed and the firm's responses to breaches of the relevant ethical requirements. Relevant ethical requirements include those related to independence.

### **Acceptance and Continuance of Client Relationships and Specific Engagements**

10. The acceptance and continuance of client relationships and specific engagements comprises the firm's processes for consideration of matters in determining whether to accept or continue a client relationship or specific engagement. Such matters include the nature and circumstances of the engagement, the integrity and ethical values of the client, including management, and, when appropriate, those charged with governance and the firm's ability to perform the engagement in accordance with professional standards and applicable legal and regulatory requirements. This component also requires that the firm's financial and operational priorities do not lead to inappropriate judgments about whether to accept or continue a client relationship or specific engagement.

## **Engagement Performance**

11. The engagement performance component comprises the firm's actions to promote and support the consistent performance of quality engagements in accordance with professional standards and legal and regulatory requirements. This includes how the firm supports engagement teams in exercising professional judgment and, when applicable to the nature and circumstances of the engagement, exercising professional skepticism. Matters addressed in this component include the responsibilities of the engagement team, including in relation to direction, supervision and review, consultation, differences of opinion, the assembly and retention of documentation and engagement quality reviews.

## **Resources**

12. The resources component comprises the firm's processes for obtaining, developing, using, maintaining, allocating or assigning resources to enable the design, implementation and operation of the system of quality management. The resources relevant to the firm's system of quality management include human resources, technological resources and intellectual resources. Furthermore, financial resources are needed for obtaining, developing and maintaining the other types of resources. The firm may have competing priorities that affect the allocation or assignment of resources, however, the firm is required to have resource planning, and obtain, allocate or assign resources in a manner that supports the firm's commitment to quality and enables the design, implementation and operation of the firm's system of quality management.

## **Information and Communication**

13. The information and communication component comprises the firm's actions to obtain, generate or use relevant information to enable the design, implementation and operation of the system of quality management. This includes establishing an information system, whether through the use of manual or automated elements, to identify, capture, process and maintain relevant and reliable information.
14. The information and communication component also comprises two-way communication within the firm and communication with external parties, such as information about the firm's system of quality management. Such communication assists external parties in understanding the firm's activities to address quality through its system of quality management and the effectiveness of the firm's system.

## **Monitoring and Remediation Process**

15. Monitoring comprises the firm's processes for evaluating the design, implementation and operation of the system of quality management. It involves undertaking ongoing and periodic monitoring activities, and identifying and evaluating deficiencies in the system of quality management based on the findings from the monitoring activities, results of external inspections or other information sources (e.g., through the firm's complaints and allegations process). In order to understand how the deficiencies arose, this ISQM also requires the firm to understand the root cause of the identified deficiencies.
16. Remediation comprises the firm's actions for responding to identified deficiencies, which includes designing and implementing remedial actions and monitoring those actions to determine whether they appropriately address the identified deficiency. Remediation may also involve addressing the specific engagement, for example, when the identified deficiency indicates that the engagement report is inappropriate. Communication of the results of monitoring and remediation within the firm

also forms part of the firm's remedial actions, since personnel often need to be aware of the results in order to fulfill their roles and responsibilities.

17. This component also includes the responsibilities of the individual(s) assigned ultimate responsibility and accountability for the system of quality management to determine whether the system of quality management provides reasonable assurance that the objectives stated in paragraph 18(a) and (b) have been achieved.

### **Interrelationship of the Components**

18. The firm's risk assessment process sets out the process the firm is required to follow in implementing the risk-based approach to quality management, and in doing so the firm is required to include the quality objectives and responses set out in each of the components of this ISQM.
19. The governance and leadership component is important to the design, implementation and operation of the other components of the system of quality management because it provides the basis for the system of quality management and also creates the environment in which the other components of the system of quality management operate.
20. Other components such as information and communication and resources have quality objectives that enable the design, implementation and operation of the system of quality management, and therefore such components may include responses that affect or relate to the other components of the system of quality management. For example, the information and communication component contains the information system that provides the information needed for the operation of the other components or the resources component addresses the establishment of human resources that are needed to operate the various aspects of the system of quality management. There may be interrelationships within the components as well, for example, human resources are needed for the development of intellectual resources.
21. There are also relationships between components because there are matters that relate to each other, for example, aspects of the relevant ethical requirements component may be relevant when accepting and continuing client relationships and specific engagements.
22. The monitoring and remediation process monitors the entire system of quality management, and therefore the monitoring activities are undertaken over all of the components of the system of quality management.

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