



## Agenda Item 4

### Quality Management

#### Objective

To discuss US-specific concepts and drafting issues identified in converging

- QC Section 10, *A Firm's System of Quality Control*, with 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* (ISQM 1), and proposed ISQM 2, *Engagement Quality Reviews*; and
- AU-C section 220, *Quality Control for an Audit Conducted in Accordance with Generally Accepted Auditing Standards*, with Proposed International Standard on Auditing (ISA) 220 (Revised), *Quality for an Audit of Financial Statements* (ISA 220 (Revised)), (collectively the "Proposed Standards").

#### Quality Management Task Forces

Following the model used by the IAASB, the Quality Standards Task Force has been divided into two groups:

##### QM1

Sara Lord, *Chair*  
Sherry Chesser  
Kathryn Fletcher  
Kristen Kociolek  
Alan Long  
Tania Sergott  
Kimberly Stazyk

##### QM2/220

Jon Heath, *Chair*  
Harry Cohen  
Jeff Rapaglia  
Rick Reeder

#### Background

In February 2019, the IAASB issued exposure drafts of Proposed ISQM 1, Proposed ISQM 2, and Proposed ISA 220 (Revised), (collectively the "Proposed Standards"). The comment period ended on July 1, 2019. The AICPA submitted a comment letter that was generally supportive of the Proposed Standards.

The IAASB has discussed revised drafts of the proposed standards at its September 2019, December 2019, March 2020, and June 2020 meetings. The IAASB is expected to a vote to issue the Proposed Standards as final standards at its September 2020 meeting.

## Convergence

### *ASB Convergence Policy*

The ASB adopted a policy of convergence with the IAASB standards in 2008. [Note: to enhance the readability of this document, in this section references to the ISAs are meant to refer to all IAASB standards.] The convergence strategy was described as “ISA-plus”, with the expectation that nearly all ISA requirements would also be requirements of U.S. GAAS. However, there may be additional GAAS requirements that address issues specific to the U.S.

### *ASB Involvement in the Development of the Proposed Standards*

The ASB has been very much involved in developing the IAASB Proposed Standards. Bob Dohrer, who is a member of the IAASB, and Ahava Goldman, serving as his Technical Advisor, were on the ISQM 1 Task Force from 2015 through 2017, with Mr. Dohrer continuing as a correspondent member. In addition, the ASB Quality Control Task Force (a precursor to the Quality Management Task Forces with many of the same members) has been monitoring the project from inception and providing input to the American members of the IAASB.

### *PCAOB and Differences in QC Standards*

On December 17, 2019, the PCAOB issued a concept release entitled [\*Potential Approach to Revisions to PCAOB Quality Control Standards\*](#). The concept release outlines that the PCAOB is considering an approach that would use proposed ISQM 1 as a starting point. The PCAOB stated that

Information gathered through our oversight, outreach, and research activities persuades us that our QC standard should be built on an integrated risk-based framework, as Proposed ISQM 1 is. In addition, many firms that follow PCAOB standards are also subject to other QC standards (including the IAASB’s and the AICPA’s standards), so they are required to implement QC systems that comply with both PCAOB standards and those other standards. *Due to the foundational nature of QC systems, we believe that it would not be practical to require firms to comply with fundamentally different QC standards.* (emphasis added).

The comment period for the concept release ended on March 16, 2019. There were 35 respondents, as of April 22, 2020. Most respondents commented that they are supportive of a potential quality control standard that is principles based and scalable with *minimal incremental requirements to proposed ISQM 1.* (emphasis added).

## Timing

The ASB intends to follow the IAASB timing such that ASB exposure drafts could be issued shortly after the IAASB standards are finalized. Various timelines have been projected, based on the number of times that the ASB reviews drafts, the length of the exposure period, and the use of ASB conference calls.

The short-term timeline is as follows:

Sept. 2020	IAASB meeting: vote on final standards
Oct. 2020	ASB reviews first draft of proposed standards
Dec. 2020	ASB reviews second draft

**Agenda Items Presented:**

- 4A Overview of IAASB Quality Management Standards

**Issues for ASB Consideration**

This paper contains the following issues, which relate to potential changes from the IAASB Standards, for discussion by the ASB. In discussing these issues of potential divergence from the IAASB Standards, the Task Force considered, among other things, whether and if so, how, the U.S. is different from other jurisdictions around the world in a way that warrants divergence in this area.

<i>Issue #</i>	<i>Title</i>	<i>Related Standard and Paragraphs</i>
<a href="#">Issue 1</a>	Cooling-off period	ISQM 2, Par. 16A, A17A, A17B
<a href="#">Issue 2</a>	Completion of the EQR and dating of the report	ISQM 2 par. 21, 26; ISA 220 par. 36, A100-A103
<a href="#">Issue 3</a>	Self-inspection	ISQM 1, Par. 46
<a href="#">Issue 4</a>	Inspection of completed engagements	ISQM 1, par. 45, A157

### ***1. Cooling-Off Period***

The Exposure Draft of ISQM 2 required that the firm establish policies and procedures that addressed eliminating or reducing to an acceptable level threats to objectivity of the engagement quality reviewer related to the engagement or the engagement team. Application material to this requirement stated

A5. An individual who has served as the engagement partner is not likely to be able to perform the role of the engagement quality reviewer immediately after ceasing to be the engagement partner because it is not likely that the threats to the individual's objectivity with regard to the engagement and the engagement team can be reduced to an acceptable level. In recurring engagements, the matters on which significant judgments are made and the facts and circumstances around those significant judgments are not likely to vary to a degree such that an objective evaluation of those judgments can be made by the individual who served as the engagement partner in the immediate previous period. Accordingly, this ISQM requires the firm to establish policies or procedures that limit the eligibility of individuals to be appointed as engagement quality reviewers who previously served as the engagement partner, for example, by establishing a specified cooling-off period during which the engagement partner is precluded from being appointed as the engagement quality reviewer. Determining a suitable cooling-off period depends upon the facts and circumstances of the engagement, and applicable provisions of law or regulation or relevant ethical requirements. In the case of an audit of financial statements of a listed entity, it is unlikely that an engagement partner would be able to act as the engagement quality reviewer until two subsequent audits have been conducted.

The AICPA submitted a comment letter that said the following about this requirement:

We believe that the requirement should address the objectivity of the engagement quality reviewer and guidance should address the need for safeguards such as cooling-off periods and assessing competency.

We are not convinced that the engagement quality review would be less effective because the reviewer previously served on the engagement. We do believe this is a scalability issue; however, not one that is necessarily limited to small firms. Requiring a cooling-off period could result in firms that rotate engagement partner and engagement quality reviewer roles within a group of partners needing to use an external provider. This might have the unintended consequence of such firms choosing not to rotate engagement leadership (if not otherwise required to do so), which would not be an improvement in quality. We are also concerned about the availability of qualified resources with specific and relevant skill sets, such as a particular industry or topic-specific expertise. Given limited resources, for an engagement risk in which an engagement quality review is the appropriate response, an experienced person who recently served as the engagement partner could be a more effective engagement quality reviewer than someone else with less experience or competency related to that engagement risk.

We are concerned that paragraph A5 will be interpreted as creating a de facto requirement to have a 2-year cooling-off period for all engagements, not just listed entities, and certainly for entities of “significant public interest. If the reason for selecting a two-year period is related to an entity presenting comparative financial statements, that should be made clear, as many entities, such as local governments, often do not present comparative financial statements. Firms could then include whether the entity presents comparative financial statements as a consideration in determining the eligibility of an engagement quality reviewer.

We believe that the requirement for a cooling-off period is prescriptive and not principles-based. We note that such a requirement may result in a lessening in audit quality as some firms may follow the letter of the requirement but not the principle upon which the requirement is based. Accordingly, we urge the IAASB to revise this requirement to be more principles-based.

The IAASB, after consideration of comments received from all respondents, revised this requirement to explicitly require a cooling-off period of two years, or a longer period if required by relevant ethical requirements, before an engagement partner can assume the role of engagement quality reviewer. This requirement applies to all engagements for which an EQR is performed.

#### **ISQM 2 as of March 2020**

16A. The firm’s policies or procedures established in accordance with paragraph 16(b) shall also address threats to objectivity created by an individual being appointed as an engagement quality reviewer after previously serving as the engagement partner. Such policies or procedures shall specify a cooling-off period of two years, or a longer period if required by relevant ethical requirements, before an engagement partner can assume the role of engagement quality reviewer. (Ref: Para. A17A–A17B)

*Cooling-Off Period for an Individual After Previously Serving as the Engagement Partner*  
(Ref: Para. 16A)

A17A. In recurring engagements, the matters on which significant judgments are made often do not vary and therefore significant judgments made in prior periods may continue to affect judgments of the engagement team in subsequent periods. The ability of an engagement quality reviewer to perform an objective evaluation of significant judgments is therefore affected when the individual was previously involved with those judgments as the engagement partner. In such circumstances, it is important that appropriate safeguards are put in place to reduce threats to objectivity, in particular the self-review threat, to an acceptable level. Accordingly, this ISQM requires the firm to establish policies or procedures that specify a cooling-off period during which the engagement partner is precluded from being appointed as the engagement quality reviewer.

A17B. The firm’s policies or procedures also may address whether a cooling-off period is appropriate for an individual other than the engagement partner before becoming eligible to be appointed as the engagement quality reviewer on that engagement. In this regard, the firm may consider the nature of that individual’s role and previous involvement with the

significant judgments made on the engagement. For example, the firm may determine that an engagement partner responsible for the performance of audit procedures on the financial information of a component in a group audit engagement may not be eligible to be appointed as the group engagement quality reviewer because of that audit partner's involvement in the significant judgments affecting the group audit engagement.

The Task Force discussed unintended consequences of requiring a cooling-off period. Unintended consequences may include firms choosing not to rotate engagement leadership and firms setting more stringent criteria for engagements subject to engagement quality review than they otherwise might have. There is also a concern about firms struggling to find sufficiently qualified external reviewers, particularly in specialized industries.

The Task Force recognized that the cooling-off requirement applies only to the engagement partner, and that ISQM 2 does allude to the possibility of the engagement quality reviewer being someone other than the engagement partner. Par. A15, in discussing threats to the engagement quality reviewer's objectivity, states

An intimidation threat may be created when actual or perceived pressure is exerted on the engagement quality reviewer (e.g., when the engagement partner is an aggressive or dominant individual, or *the engagement quality reviewer has a reporting line to the engagement partner*). *Emphasis added.*

The Task Force also recognized that firms can implement review procedures that are consistent with engagement quality reviews in all respects except the requirement for a cooling-off period (of any length), and set criteria for the engagements for which the firm would require those review procedures.

The Task Force concluded that it supports convergence with the IAASB standard in requiring a cooling-off period.

The Task Force believes that the requirement that the cooling-off period be two years is overly prescriptive and as such, inappropriate for a principles-based standard. In addition, the Task Force believes that a prescribing the cooling-off period to be two years is excessively rigorous. It is not clear why two years, and not one, is necessary in all cases, and as written, the requirement seems to preclude a longer period if not required by relevant ethical requirements. The Task Force discussed whether, instead of setting two years as a hard and fast number, the ASB standard could identify factors for assessing the risk of the objectivity threat in setting the length of the cooling-off period, in keeping with the risk assessment process required by IQSM 1.

The Task Force was unable to identify anything unique in the U.S., however, with regard to engagement quality reviews and is therefore reluctant to recommend divergence. The Task Force believes that this issue should be specifically identified for feedback from respondents when the ASB proposed standards are issued for exposure.

***Question for the ASB:***

1. Should the ASB require a cooling-off period? If so, should it be a prescribed period of two years, consistent with the IAASB standards, or of a length to be determined by the firm, with application material addressing how that period should be determined?

***2. Completion of Engagement Quality Review and Dating of the Auditor's Report (SQMS 2/220)***

Extant QC section 10 and AU-C 220 diverge from ISQC 1 and ISA 220, and are inconsistent with proposed ISQM 2 and proposed ISA 220, with regard to completion of the engagement quality review (EQR) and dating of the auditor's report. ISQC 1<sup>1</sup> and ISA 220<sup>2</sup> require that the engagement quality review be completed before the report is *dated*. QC section 10<sup>3</sup> and AU-C section 220<sup>4</sup> require that the engagement quality review be completed before the report is *released*.

The Exhibit to QC section 10, and AU-C section Appendix B, *Substantive Differences Between the International Standards on Auditing and Generally Accepted Auditing Standards*, both state that "The ASB believes that an engagement quality control review is an independent review of the engagement team's significant judgments, including the date selected by the engagement team to date the report. As noted in the application material to QC section 10, when the engagement quality control review results in additional procedures having to be performed, the date of the report would be changed."

This issue was discussed with the ASB at its May meeting without resolution. Subsequent outreach to PCPS Technical Issues Committee (TIC) members revealed that some firms treat the EQR as part of the engagement review process (part of the Engagement Performance element) and others treat it as a monitoring function and cover it in that element of quality control. If EQR is part of engagement performance, the report is not dated until EQR is done. If it is a monitoring process it is just done before report release. Smaller firms that need to use an external party for EQR appreciate the flexibility offered by using the release date when coordinating the external reviewer's schedule and end-of-the-engagement procedures (especially subsequent events).

Relevant paragraphs from proposed ISQM 2 and proposed ISA 220 are shown below.

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<sup>1</sup> Par. 36 of ISQC 1

<sup>2</sup> Par 19 of ISA 220

<sup>3</sup> Par. 41 of QC sec. 10

<sup>4</sup> Par. 21 of AU-C 220

## ISQM 2

11. In this ISQM, the following terms have the meanings attributed below:

- (a) 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.

21. The firm shall establish policies or procedures regarding the performance of the engagement quality review that address:

- (a) The engagement quality reviewer’s responsibilities to perform procedures in accordance with paragraphs 22–23 at appropriate points in time during the engagement to provide an appropriate basis for an objective evaluation of the significant judgments made by the engagement team and the conclusions reached thereon;
- (b) The responsibilities of the engagement partner in relation to the engagement quality review, including that the engagement partner is precluded from dating the engagement report until notification has been received from the engagement quality reviewer in accordance with paragraph 24 that the engagement quality review is complete; and (Ref: Para. A22–A23)
- (c) Circumstances when the nature and extent of engagement team discussions with the engagement quality reviewer about a significant judgment give rise to a threat to the objectivity of the engagement quality reviewer, and appropriate actions to take in these circumstances. (Ref: Para. A24)

A26. The timing of the procedures performed by the engagement quality reviewer may depend on the nature and circumstances of the engagement or the entity, including the nature of the matters subject to the review. Timely review of the engagement documentation by the engagement quality reviewer throughout all stages of the engagement (e.g., planning, performing, forming a conclusion and reporting) allows matters to be promptly resolved to the engagement quality reviewer’s satisfaction, on or before the date of the engagement report. For example, the engagement quality reviewer may perform procedures in relation to the overall strategy and plan for the engagement at the completion of the planning phase. Timely performance of the engagement quality review also may reinforce the exercise of professional judgment and, as applicable, professional skepticism, by the engagement team in planning and performing the engagement.



## ISA 220

### *Engagement Quality Review*

36. For audit engagements for which an engagement quality review is required, the engagement partner should: (Ref: Para. A99)

- (a) Determine that an engagement quality reviewer has been appointed;
- (b) Cooperate with the engagement quality reviewer and inform other members of the engagement team of their responsibility to do so;
- (c) Discuss significant matters and significant judgments arising during the audit engagement, including those identified during the engagement quality review, with the engagement quality reviewer; and
- (d) Not date the auditor's report until the completion of the engagement quality review. (Ref: Para. A100–A103)

Completion of the Engagement Quality Review Before Dating of the Auditor's Report (Ref: Para. 36(d))

A100. ISA 700 (Revised) requires the auditor's report to be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements.<sup>5</sup> If applicable to the audit engagement, [proposed] SQM 2 requires that the engagement quality review be completed on or before the date of the auditor's report.

A101. The auditor's report cannot be dated until the completion of the engagement quality review. For example, if the engagement quality reviewer has communicated to the engagement partner concerns about the significant judgments made by the engagement team or that the conclusions reached thereon were not appropriate then the engagement quality review is not complete.<sup>6</sup>

A102. An engagement quality review that is conducted in a timely manner at appropriate stages during the audit engagement may assist the engagement team in promptly resolving matters raised to the engagement quality reviewer's satisfaction on or before the date of the auditor's report.

Task Force discussion:

Points raised during the Task Force discussion included the following:

- This is a project management issue.

<sup>5</sup> ISA 700 (Revised), paragraph 49

<sup>6</sup> Proposed ISQM 2, paragraph 21(b)

- If it is important to have an engagement quality review performed, then it should be done before the report is signed, just as the representation letter is obtained before the report is signed.
- Whether EQR is an engagement procedure or a monitoring procedure is a distinction without a difference.
- The U.S. is not different from other jurisdictions in this regard.

The Task Force recommends that the ASB Quality Management standards converge with the requirements in the IAASB Standards in this regard.

***Question for the ASB:***

2. Does the ASB agree with the Task Force recommendation regarding completion date of the EQR?

***3. Self-Inspection***

An existing difference between ISQC 1 and QC section 10 relates to the involvement of those performing the engagement or the engagement quality control review in inspecting the engagements. Both ISQC 1 (par. 48) and proposed ISQM 1 (par. 46) require firms to prohibit the engagement team members or the engagement quality reviewer of an engagement from performing any inspection of that engagement.

QC section 10 does not include this prohibition (see par. 52(c)). The ASB had concluded that it was not necessary to change existing practice because in the United States, the peer review process provides a safeguard and provides evidence that the monitoring procedures are effective.

Application material in ISQC 1 states

**Considerations Specific to Smaller Firms**

- A68. In the case of small firms, monitoring procedures may need to be performed by individuals who are responsible for design and implementation of the firm's quality control policies and procedures, or who may be involved in performing the engagement quality control review. A firm with a limited number of persons may choose to use a suitably qualified external person or another firm to carry out engagement inspections and other monitoring procedures. Alternatively, the firm may establish arrangements to share resources with other appropriate organizations to facilitate monitoring activities.

Application material in proposed ISQM 1 is more principles-based and addresses the self-review threat:

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

A171. The provisions of relevant ethical requirements are relevant in designing the policies or procedures addressing the objectivity of the individuals performing the monitoring activities. 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.

Application material in QC section 10 states the following:

*Considerations Specific to Smaller Firms*

A72. In small firms with a limited number of persons with sufficient and appropriate experience and authority in the firm, monitoring procedures may need to be performed by some of the same individuals who are responsible for compliance with the firm's quality control policies and procedures. This includes review of engagement working papers, reports, and clients' financial statements by the engagement partner or other qualified personnel after the report release date. To effectively monitor one's own compliance with the firm's policies and procedures, it is necessary that an individual be able to critically review his or her own performance, assess his or her own strengths and weaknesses, and maintain an attitude of continual improvement. Changes in conditions and the environment within the firm (such as obtaining clients in an industry not previously serviced or significantly changing the size of the firm) may indicate the need to have quality control policies and procedures monitored by another qualified individual.

A73. Having an individual inspect his or her own compliance with a quality control system may be less effective than having such compliance inspected by another qualified individual. When one individual inspects his or her own compliance, the firm has a higher risk that noncompliance with policies and procedures will not be detected. Accordingly, a firm with a limited number of persons with sufficient and appropriate experience and authority in the firm may find it beneficial to engage a suitably qualified external person or another firm to perform engagement inspections and other monitoring procedures.

Input received from members of PCPS TIC included the following:

- I struggle a little to get comfortable that the peer review process is an adequate safeguard, but I also think it would be difficult to insist that a small firm expend resources to hire out the inspection function in addition to getting a peer review.

- So from the old firm <5 people solo firm- we had to have self-inspection and had to go outside already for EQCR and a couple of other things- and that is a lot of people to hire external to firm:
  - EQCR-er (and we had to do EQCR on all audits where we only had one partner at our solo firm to comply with malpractice insurance)
  - And then if we had to external inspection with a different person
  - And then we have to use someone else for a peer reviewIt is just bonkers and part of the reason why I no longer have a solo firm.
- We will still need ability to do self-inspection, sometimes. We will have some issues related to the 2<sup>nd</sup> partner on the job being the only other expert in a certain industry (it is a nightmare on the PCAOB rotation issues), but for the privates, we would rather have an internal inspection done by someone that knows the industry well as well as knows our quality management and internal processes and we put in proper controls, etc. to be sure that the internal inspection is effective.
- As a general note, it is not always easy/possible to hire external people to do these. You need them to know your methodology and your policies. And they can't hold certain other roles. So just like the other firm you could need to have 3 different people that you have to hire on a particular engagement to properly oversight. I think there are safeguards that can be put in place for sure to allow for self-inspections. If they don't allow for some concept of self-inspections then they are in effect putting in an unrealistic barrier to entry for firms with less than 3 partners with audit experience (one that is engagement partner, concurring partner, then inspection partner) is my personal opinion. I am fairly strong opinioned in this and I don't mind if they have to have some extra required safeguards to make sure this is not abused, but I even medium-sized firms need the ability to have some self-inspections.

The Task Force had robust discussion about this issue.

Reasons to continue to permit one to inspect engagements on which one was an engagement team member that were discussed were:

- it is currently permitted;
- some practitioners are capable of doing self-inspection effectively; and
- having to hire sufficiently experienced external people, who may be difficult to identify, puts an expensive burden on the smallest firms.

The discussion also included the following observations:

- Inspection carries a cost to each firm. The larger firms may benefit from economies of scale, and their costs may be opportunity cost rather than out-of-pocket, but there is a cost associated with the person performing the inspection.
- Safeguards could be potentially be applied, including internal training and peer review.

- One member of the Task Force noted that effective training addresses not only technical expertise (for example, specialized knowledge of employee benefit plans) but also training in the firm's system of quality management and how to be a critical objective reviewer.
- Another member of the Task Force stated that training can increase competency but self-inspection cannot identify one's own lack of knowledge. For example, inspection may uncover that the engagement partner, being unaware of recently-effective standards, did not apply them to the engagement. But that engagement partner, inspecting their own work while being unaware of recently-effective standards, would never identify that the standards were not appropriately applied in that engagement.
- While subscribing to a third-party methodology might correct the deficiency of not being current on professional standards, it would not make self-inspection any more effective at identifying what one does not know.

A Task Force member noted that extant QC section 10 states that peer review can substitute for inspection for the period covered by the peer reviews. The task force did not believe this would change based on ISQM 1. However, the period covered by the peer review is only one year out of three. ISQM 1 requires that monitoring procedures be performed annually and requires an annual evaluation of the system of quality management.

Other than the peer review process, the Task Force was unable to identify anything unique in the U.S. with regard to self-inspection. The Task Force was not able to identify safeguards that could effectively lower the self-review threat. Accordingly, the Task Force recommends convergence with the IAASB standards with respect to self-inspection. The Task Force also recommends that this change from the current standard should be specifically identified for feedback from respondents when the ASB proposed standards are issued for exposure.

***Questions for the ASB:***

3. Does the ASB believe that safeguards to the self-review threat exist that the Task Force has not identified? If so, what are potential effective safeguards?
4. Does the ASB agree with the Task Force recommendation to converge with ISQM 1 and no longer permit self-inspection?

***4. Inspection of completed portions of in-process engagements***

Paragraph 48(1) of ISQC 1 requires including, on a cyclical basis, inspection of at least one completed engagement for each engagement partner as a monitoring procedure. Paragraph A66 states "Inspection policies and procedures may, for example, specify a cycle that spans three years. In converging with ISQC 1 in 2011, the ASB believed that this requirement was overly

prescriptive and that a risk-based approach to inspections is more appropriate. Accordingly, this requirement was not included in QC sec. 10.

In the exposure draft of ISQM 1, this requirement is discussed as the subject of debate by the IAASB. 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 retained the requirement (see paragraph 45 of ED-ISQM 1), but took 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.
- (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.

The requirement in the exposure draft of ISQM 1 was as follows:

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. (emphasis added)*. 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.

The AICPA addressed this requirement in its comment letter on the exposure draft with the following:

We believe that this requirement should include the flexibility to inspect completed portions of in-process engagements, not only completed engagements, because we

believe this principles-based approach could provide for modernization and continuous improvement. We are aware of firms that are using cloud-based, data-visualization tools to provide real-time insights into their in-process engagements and inspection monitoring activities. These new tools provide avenues for continuous improvement and more timely and robust risk assessment. It also allows for faster root-cause assessment and remediation.

After exposure and consideration of comments received, the IAASB removed the reference to “Engagement inspections may include the inspection of in-process or completed engagements” from the requirements and added application material addressing inspection of in-process engagements, as follows:

44A. In determining the nature, timing and extent of the monitoring activities, the firm shall take into account: (Ref: Para. A156–A159)

- (a) The reasons for the assessments given to the quality risks;
- (b) The design of the responses;
- (c) The design of the firm’s risk assessment process and monitoring and remediation process; (Ref: Para. A161A–A161B)
- (d) Changes in the system of quality management. (Ref: Para. A162)
- (e) The results of previous monitoring activities, whether previous monitoring activities continue to be relevant in evaluating the firm’s system of quality management and whether remedial actions to address previously identified deficiencies were effective; and (Ref: Para. A163–A164)
- (f) Other relevant information, including complaints and allegations about actions or behaviors that do not demonstrate a commitment to quality, information from external inspections and information from service providers. (Ref: Para. A165–A167)

45. The firm shall include the inspection of completed engagements in its monitoring activities and shall determine engagements and engagement partners to select. In doing so, the firm shall: (Ref: Para. A158, A168–A170)

- (a) Take into account the matters in paragraph 44;
- (b) Consider the nature, timing and extent of other monitoring activities undertaken by the firm and the engagements and engagement partners subject to such monitoring activities; and
- (c) Select at least one completed engagement for each engagement partner on a cyclical basis determined by the firm.

A157. Monitoring activities may include the inspection of in-process engagements. Inspections of engagements are designed to monitor that an aspect of the system of quality management is designed, implemented and operating in the manner intended. In some circumstances, the system of quality management may include responses that are

designed to review engagements while in process which appear similar in nature to an inspection of in-process engagements (e.g., reviews 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). Determining the purpose of an action is necessary in determining its design and implementation, and where it fits within the system of quality management (i.e., whether it is a monitoring activity (inspection of in-process engagement) or a response to address an assessed quality risk (an engagement review)).

The IAASB explained its reasoning in an Issues Paper at its December 2019 meeting:

20. However, respondents further commented as follows:

- a. The requirement and application material should be focused on risk, rather than a cyclical period. Respondents who did not support the approach to engagement inspections in ED-ISQM 1 also indicated that if the requirement is retained, it should be more risk-based.
- b. The reference to a three-year cycle in the application material may have unintended consequences, as it may be interpreted as a de facto requirement and may not be an appropriate period for all firms. Respondents who did not support the approach to engagement inspections in ED-ISQM 1 also echoed this view.
- c. The reference to in-process reviews in the requirement is confusing, since undertaking in-process reviews is not required. It was therefore suggested that it be moved to application material.
- d. Clarity is needed about how the requirement to perform engagement inspections relates to the requirement to evaluate the SOQM annually, i.e., in order to provide a basis for evaluating the SOQM, whether the intention is that engagement inspections need to be undertaken annually.
- e. How the requirement describes the purpose of engagement inspections needs clarification. Respondents provided various suggestions in this regard, such as referring to professional standards or referring to the components of the SOQM in general.

21. As highlighted in the preceding paragraph, respondents who did not support the approach to engagement inspections highlighted concerns about the focus on a cyclical period and reference to a three-year cycle in the application material. These respondents emphasized that the proposals are too prescriptive and contrary to a risk-based and proactive approach. They also highlighted that the proposals may reduce the ability of audit firms to dedicate resources to more innovative, timely and meaningful forms of monitoring that are more effective and efficient, including the use of technology-based initiatives.

22. The ISQM 1 TF understands the need to preserve the requirement for a firm to perform inspections of completed engagements. While the inspection of in-process



engagements is beneficial and may affect the extent of selection of completed engagements for inspection, it is optional for firms and the ISQM 1 TF therefore believes it should not be referenced in the requirements. Instead, the inspection of in-process engagements has been highlighted in the application material supporting paragraph 44 of **Agenda Item 7-A** (see paragraph A157 of **Agenda Item 7-A**). With this amendment, the requirement in paragraph 45 of **Agenda Item 7-A** is only focused on the inspection of completed engagements.

23. The ISQM 1 TF is of the view that the appropriate manner for selecting completed engagements for inspection under a risk-based approach is to determine the appropriate combination of:
  - a. Which engagements need to be selected for inspection and how often, based on the risks associated with such engagements. For example, the firm may determine that audits of financial statements of listed entities or engagements performed in certain industries need to be subject to inspection on a cyclical basis.
  - b. Which engagement partners need to be subject to inspection, based on factors such as how long it has been since the engagement partner was subject to inspection, the results of previous inspections of the engagement partner, or the experience of the engagement partner.
24. Furthermore, the selection of completed engagements for inspection would also be affected by the nature, timing and extent of other monitoring activities undertaken by the firm. For example, if the firm has undertaken inspections of in-process engagements:
  - a. The firm may reduce the extent of selection of completed engagements for inspection; or
  - b. The results of the inspections of in-process engagements may indicate areas of risk that may affect the selection of completed engagements for inspection.
25. Paragraph 45 of **Agenda Item 7-A** has been adjusted to reflect a focus on engagement risk, the appropriate combination of selecting engagements and engagement partners, and taking into account how other monitoring activities may affect the selection of engagements. The ISQM 1 TF is of the view that these revisions address respondents' concerns regarding the prescriptiveness of the requirements, lack of a risk-based approach and lack of flexibility to undertake other types of monitoring activities.
26. The ISQM 1 TF debated whether further revisions could be made to improve the flexibility of how the standard deals with the inspection of completed engagements, for example, by referring to another appropriate basis for selecting engagement partners instead of a cyclical basis. The ISQM 1 TF is of the view that referring to another appropriate basis could create further complexities in the standard. As a result, the ISQM 1 TF has retained the reference to a cyclical basis in the requirement, and adjusted the application material to improve the flexibility by removing the reference to three years.

The Task Force recommends that the ASB Quality Management standards converge with the requirements in the IAASB Standards with regard to inspection of completed engagements, and that additional application material be developed to address (1) the role of in-process reviews in cyclical inspections, and (2) the determination of the firm's cycle for inspection of engagement partners based on risk factors (such that some partners may be inspected more frequently than others).

***Question for the ASB:***

5. Does the ASB agree with the Task Force recommendation?