



## Agenda Item 1

### Quality Management

#### Objective

To obtain feedback from the Auditing Standards Board (ASB) on the drafts of the following proposed standards:

- [Proposed] Statement on Quality Management Standards (SQMS) *A Firm's System of Quality Control* ("SQMS 1")
- [Proposed] SQMS *Engagement Quality Reviews*; and ("SQMS 2")
- [Proposed] Statement on Auditing Standards (SAS) *Quality Management for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards*, ("QM SAS") (collectively the "Proposed QM Standards").

#### Quality Management Task Forces

Following the model used by the International Auditing and Assurance Standards Board (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  
Tom Parry  
Jeff Rapaglia  
Rick Reeder

#### Background

At its September 2020 meeting, the IAASB voted to issue the following as final standards:

- 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);
- ISQM 2, *Engagement Quality Reviews* (ISQM 2); and
- International Standard on Auditing (ISA) 220 (Revised), *Quality for an Audit of Financial Statements* (ISA 220 (Revised)).

The ASB discussed preliminary issues at its May and July 2020 meetings, and reviewed drafts of the Proposed QM Standards at its October meeting.

The most significant matter discussed by the ASB in October concerned the cooling-off period required by SQMS 2 (see Matter for ASB Consideration #1 below). The other significant matter was the implications of the definition of engagement team and requirements of the proposed QM SAS on group audits (see Matter for ASB Consideration #2 below). The ASB also discussed the IAASB's proposed revisions to ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* and noted the need for the Group Audits Task Force and the Quality Standards Task Forces to work together in determining the best location in the auditing standards for guidance on applying the requirements of AU-C sec. 220 to a group audit.

The ASB also directed that certain editorial changes be made, which are noted in agenda items 1A, 1B and 1C.

Amendments to other AU-C sections resulting from the Proposed QM Standards will be brought to the ASB at its January meeting.

## **Matters for ASB Consideration**

### **1. Cooling-Off Period (SQMS 2)**

At its October meeting, the ASB discussed a mandatory cooling-off period for the eligibility of an individual to be appointed as engagement quality ("EQ") reviewer for an engagement on which the individual previously served as the engagement partner. The ASB requested background information on the IAASB's decision to require a mandatory cooling-off period of at least two years.

#### *Background of evolution of IAASB requirement*

- The ED of proposed ISQM 2, *Engagement Quality Review* (ED-ISQM 2) presented the IAASB view that matters on which significant judgments are made in recurring engagements 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 EQ 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, ED-ISQM 2 included a new requirement for the firm to establish policies or procedures that include limitations on the eligibility of an individual to be appointed as engagement quality reviewer for an engagement on which the individual previously served as the engagement partner. Furthermore, the application material in ED-ISQM 2 suggested such limitations may be accomplished by establishing a cooling-off period and noted that determining a suitable cooling-off period depends upon the facts and circumstances of the engagement, and applicable provisions of law or regulation and relevant ethical requirements. The application material further noted that, for an audit of a listed entity, it is unlikely that an engagement partner would be able to serve as the engagement quality reviewer until two subsequent audits have been conducted. The IAASB believed this application material recognized that audits of listed entities generally involve more complex judgments by engagement teams and that a cooling-off period would be in the public interest.

- The exposure draft asked for views on the need for additional guidance regarding a cooling-off period. 70% of the 91 respondents agreed on the need for guidance; about 17% (16 of 91) of respondents (including two Monitoring Group members) commented that there should be a requirement for a specific cooling-off period for an individual stepping into the role of EQ reviewer after serving as engagement partner.
- The IAASB decided, for the final standard, to require a cooling-off period as it believed it to be the only safeguard to the self-review threat to objectivity, given the importance of maintaining objectivity in performing an objective evaluation of the significant judgments made by the engagement team. This requirement applies to all engagements for which an EQ review is performed. In reaching this conclusion, the IAASB noted that other than for audits of listed entities or when required by law or regulation, EQ reviews are not mandated for other engagements, and the firm may employ responses other than an EQ review to address assessed quality risks. However, when an EQ review is required or has been determined by the firm to be the appropriate response, then the same requirements should apply in all cases, because the threats to the objectivity of the engagement partner stepping into the role of an EQ reviewer are not unique to certain types of engagements or to audits of listed entities. The IAASB indicated that a conditional requirement would create a perception of different levels of EQ review for different types of engagements, which could lead to inconsistent application in practice and potential confusion in the minds of stakeholders, and therefore would not be in the

public interest. By extension, this also applies to any variation in the length of the cooling-off period for different types of engagements. As the IAASB had suggested a two-year cooling-off period in the ED, that was the length of the cooling-off period required by the final standard.

Subsequent to the October ASB meeting, the Task Force became aware that the PCAOB exempts firms with fewer than five issuer audit clients and fewer than ten partners from cooling-off periods for EQ reviews provided that they are inspected at least once every three years (PCAOB Release 2009-004, *AS 7 -Engagement Quality Review*).

At its October ASB meeting, the ASB considered the following three options:

- No cooling-off period, with application guidance similar to that exposed by the IAASB in the exposure draft of ISQM 2.
  - ASB members expressed concern that, combined with the requirement prohibiting self-inspection, requiring a cooling-off period would mean that some firms would need one person performing the inspection and another person performing the EQ review. Specifically, the conversation focused on the fact that this requirement might disproportionately affect smaller firms. Firms may not be able to identify qualified people, and this might result in fewer EQ reviews being performed, which would be an unintended negative consequence.
  - The Task Force noted the following with respect to PCAOB requirements:
    - If the PCAOB doesn't require a cooling-off period for every EQ review performed for issuer audit engagements, it seems overly prescriptive to require a cooling-off period for every EQ review performed on nonissuer engagements.
    - On the other hand, the PCAOB Auditing Standards require an EQ review for every audit and attestation examination engagement. Many, if not, most engagements performed by small firms for issuer audit clients might not meet the firm's criteria for an EQ review performed as a response to an assessed quality risk (other than being an issuer). However, an EQ review might be an appropriate response for engagements performed by the same firm for a nonissuer audit client.
- Required cooling-off period of two years
  - This results in full convergence with the IAASB standard, based on the ASB's inability to identify any differences in the U.S. that would affect a firm's determination of whether an EQ review is an appropriate response to an assessed quality risk.

- If a cooling-off period is required, any potential issues of identifying eligible EQ reviewers for a period of two years instead of one year do not seem to be so burdensome as to warrant divergence.
- Required cooling-off period of one year, with application material addressing when a longer period may be appropriate.
  - The ASB did not identify any differences in the U.S. that would affect a firm's determination of whether an EQ review is an appropriate response to an assessed quality risk, nor identify other safeguards against the self-review or familiarity threat.
  - Because the vast majority of audits are for annual periods, a minimum cooling-off period would be one year. The following related application material addressing when a longer cooling off period may be appropriate would be included in the standard:

A17. Determining whether a cooling-off period of more than one year is appropriate to address familiarity and self-review threats depends upon the facts and circumstances of the engagement and engagement partner, and may include the following considerations:

- The degree to which the following vary between periods in which the individual was the engagement partner:
  - changes in the matters on which significant judgments are made, and
  - the facts and circumstances around those significant judgments

For example, if a business combination with a material effect on the financial statements has occurred, the significant judgments made in the current period may vary from those of the prior period to such an extent that an objective evaluation of those judgments could be made by the individual who served as the engagement partner in the previous period. Conversely, if comparative financial statements are presented, in the absence of other appropriate safeguards, an engagement partner might not be able to act as the engagement quality reviewer until no period in which the individual served as engagement partner is presented.

- Whether the engagement quality reviewer would be penalized by the firm's system of quality management for identifying a misstatement related to a year in which the reviewer was the engagement partner

At its October meeting, the majority of the ASB supported requiring a one-year cooling-off period with application material addressing when a longer period may be appropriate. The exposure draft will ask respondents to comment on which of the three options described above they prefer.

**Questions for the ASB:**

1. The ASB is asked to confirm that, while the exposure draft will discuss all three options, the option presented in the proposed standard will be required a one-year cooling-off period with application material addressing when a longer period may be appropriate.

**2. Definition of engagement team and consequences for component auditors and service providers (SQMS 1 and QM SAS)**

A member of the ASB expressed concern about the definition of 'engagement team' and the incorporation of component auditors into that definition. The concern is that certain requirements in proposed SQMS 1 and QM SAS that address the firm and engagement partner's responsibility related to the engagement team would be onerous to apply in a group audit when the engagement team includes component auditors.

Definitions

The extant definition of *engagement team* is

All partners and staff performing the engagement and any individuals engaged by the firm or a network firm who perform procedures on the engagement. This excludes an auditor's external specialist engaged by the firm or a network firm.

The revised definition of *engagement team* is

All partners and staff performing the engagement, and any other individuals who perform procedures on the engagement, excluding an external specialist and internal auditors who provide direct assistance on an engagement.

The change from *any individuals engaged by the firm* to *any other individuals* is what scopes in component auditors. Under the new definition, the engagement team members can include individuals who are not firm personnel (that is, partners or staff of the firm). Such individuals may be *service providers*, which is defined as

An individual or organization external to the firm that provides a resource that is used in the system of quality management or in performing engagements. Service providers exclude the firm's network, other network firms or other structures or organizations in the network.

Paragraph A27 of proposed SQMS 1 states that service providers include component auditors from other firms not within the firm's network. (Note that not all service providers are component auditors, and component auditors from network firms are not considered service providers.)

Specific Concerns and Task Force Responses

Both Task Forces considered comments received on specific paragraphs from an ASB member.

QM SAS

Additional application material has been added to paragraph A1, A91 and A107 to clarify or provide examples related to group audits.

*Application material addressing non-firm engagement team members*

The proposed Quality Management SAS includes the following application material (bold italics/strikethrough indicate changes from IAASB ISA 220):

.A22 Within the context of the firm’s system of quality management, engagement team members from the firm are responsible for implementing the firm’s policies or procedures that are applicable to the audit engagement. Engagement team members from another firm are neither partners nor staff of the engagement partner’s firm~~7~~. **As such**, they may not be subject to the firm’s system of quality management or the firm’s policies or procedures. Further, the policies or procedures of another firm may not be similar to that of the engagement partner’s firm. For example, policies or procedures regarding direction, supervision and review may be different, particularly when the other firm is in a jurisdiction with a different legal system, language or culture than that of the engagement partner’s firm. Accordingly, if the engagement team includes individuals who are from another firm, different actions may need to be taken by the firm or the engagement partner to implement the firm’s policies or procedures in respect of the work of those individuals.

The QM 2/220 Task Force considered a comment that paragraph A22 be moved to the introductory section and that the paragraph state that “[Engagement team members from another firm] **are not** subject to firm’s system of quality management or the firm’s policies or procedures.” The QM2/220 Task Force did not believe that this is true in all circumstances and accordingly did not make this change.

*Consultation*

Paragraph 35 of the proposed QM SAS states the following:

The engagement partner should:

- (a) Take responsibility for the engagement team undertaking consultation on:
  - (i) Difficult or contentious matters and matters on which the firm’s policies or procedures require consultation; and
  - (ii) Other matters that, in the engagement partner’s professional judgment, require consultation;

- (b) Determine that members of the engagement team have undertaken appropriate consultation during the audit engagement, both within the engagement team, and between the engagement team and others at the appropriate level within or outside the firm;
- (c) Determine that the nature and scope of, and conclusions resulting from, such consultations are agreed with the party consulted; and
- (d) Determine that conclusions agreed have been implemented.

A concern was expressed that applying this requirement in a group audit would require the group engagement partner to communicate to the component auditor all consultations required by the group auditor's methodology and, having reviewed the information provided by the component auditor and determining that only certain of the consultations reported would be of significance to the group audit opinion, to nonetheless need to obtain an understanding from the component auditor of the resolution of all the consultations reported.

The QM2/220 Task Force is seeking direction from the ASB on how to address this concern. One suggestion was to change the requirement from *determine* to *take responsibility for*; however, this would be a divergence from the ISA that would be perceived as ISA-minus. Alternatives include adding language to the QM SAS, either in paragraph 35 or in application material, that indicates that the engagement partner uses professional judgment in determining which consultations are subject to the requirements of paragraph 35 (b)-(d), or asking the Group Audits Task Force to address this when they revise AU-C section 600.

#### SQMS 1

Additional application material to addresses concerns relating to group audits have been added to paragraphs A14, new paragraph A66A, and new paragraph A112A.

#### **Questions for the ASB:**

- 2. Does the ASB agree with the approach taken by the QM2/220 Task Force regarding concerns about implications for group audits?
- 3. Does the ASB agree with the application material added to SQSM 1?
- 3. The ASB is asked for direction on how to address the concern about applying the requirement in paragraph 35 of the proposed QM SAS.

### **3. Definition of relevant ethical requirements**

In all three of its Quality Management standards, the IAASB revises the extant definition of relevant ethical requirements to refer to *professional accountants* instead of the *engagement team and engagement quality reviewer*. The term *professional accountant*, which is defined as “a member of a member body of IFAC”, is used in the IESBA Code of Conduct. The AICPA Code of Professional Conduct refers to *member*, which is defined as a member of the AICPA.

In discussions with AICPA Ethics staff, it was agreed that because of the potential for confusion about how the AICPA Code of Professional Standards applies to licensed CPAs who are not members of the AICPA, it is not suggested that the Proposed QM Standards use the term *member*. The definition of relevant ethical requirements retains the phrase *engagement team and EQ reviewers* in the proposed QM SAS and includes it in proposed SQMS 2. For SQMS 1, the phrase *firm and its personnel* has been revised to *firm, engagement team, engagement quality reviewers, and other firm personnel* to address engagement team members or engagement quality reviewers who are not firm personnel.

### **Agenda Items Presented:**

- **1A** Proposed SQMS *A Firm’s System of Quality Control*, marked from October meeting
- **1B** Proposed SQMS *Engagement Quality Reviews*, marked from October meeting
- **1C** Proposed SAS *Quality Management for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards*, marked from October meeting
- **1D** Proposed SQMS *A Firm’s System of Quality Control*, marked against ISQM 1
- **1E** Proposed SQMS *Engagement Quality Reviews*, marked against ISQM 2
- **1F** Proposed SAS *Quality Management for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards*, marked against ISA 220 (Revised)

Ms. Lord and Mr. Heath will be using agenda items 1A, 1B and 1C in the discussion of the proposed standards.