Response: Proposed ISQM 1

Respondent: CPA Australia

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<u>Note to Respondents:</u>

- The questions below are from the exposure draft of proposed International Standard on Quality Management (ISQM) 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,* which is available at www.iaasb.org/quality-management.

- Respondents are asked to respond separately to each of the exposure drafts and the overall explanatory memorandum.

- We request that comment letters do not include tables as they are incompatible with the software we use to help analyze respondents' comments.

General Comments on Proposed ISQM 1

CPA Australia represents the diverse interests of more than 164,000 members working in 150 countries and regions around the world. We make this submission on behalf of our members and in the broader public interest. We acknowledge the significant amount of work which the IAASB has put into developing the quality management approach in this revised standard with the aim of improving audit, assurance and related engagement quality. We consider that this standard will contribute to a more robust approach to quality management at the firm level, although we have concerns that it will be challenging for small and medium practitioners, in particular, to implement. Changes to the structure and presentation of the material in the standard could go some way to addressing this issue.

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?

    Response: We consider the proposed standard should enhance firms' management of engagement quality, if implemented effectively, but we are not sure that it will be easily scalable in practice. Ultimately, these will be questions for the post-implementation review. Nevertheless, focussing quality management on addressing quality risks and clarifying firms' responsibility for managing quality should be beneficial for engagement quality. The standard is scalable, at least in theory, as the firm is required to tailor its approach to its nature and circumstances and be responsive to the risks it identifies. In doing so the responses to quality risks can be scaled down to suit the size of the firm. However, the fact that the system is required to be so tailored, also makes implementation more challenging and the potential variability in outcomes greater, particularly for smaller firms with limited resources. Smaller firms are likely to need significant assistance from their professional

organisation to work through this very long standard and have confidence that they have met the requirements for a system of quality management.

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?

Response: We support the new quality management approach, as the design of the system is in response to identified risks and requires the nature and circumstances of the firm and the type of engagements it performs to be taken into account. This should make the system better suited to the firm and so more effective in managing quality.

(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?

Response: The length of the standard may make it challenging for firms to implement. Presenting the material in a more easily accessible format may alleviate this challenge. In particular, we recommend moving the detailed quality objectives and responses, currently included in the requirements, to a table, with examples of risks added. We suggest this could best be done in an appendix, covering each component with their related quality objectives, risks and responses presented in three columns. Responses may relate to multiple objectives and risks, but this could be indicated in the table. Currently, this material is very voluminous in the requirements and is a level of detail which arguably is better placed in another format which is easier to follow. By moving this detailed material, the requirements become very succinct and the approach much clearer.

The exercise of professional skepticism has been addressed in the proposed standard, however, it could be further supported by directly addressing professional skepticism in paragraph 23. The firm, through governance and leadership, needs to foster and support professional skepticism in the engagement teams.

(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?

Response: The standard is scalable, at least theoretically, as it enables flexibility in the identification of objectives, risk assessment and design of responses. However, working through the standard is complex. We suggest that the IAASB review the quality objectives and consider whether they can be simplified or consolidated. The threshold for identifying quality risks, being those with a "reasonable possibility of occurring", which the application material states means the "likelihood of its occurrence is more than remote", sets a low bar. In addition, the requirements specify numerous (32) responses, without taking into account the outcomes of the quality risk assessment. Inclusion of these responses in the requirements creates an expectation that they will either be carried out or a justification provided as to why they are irrelevant. This makes the standard, which aims to be principles-based, quite prescriptive for smaller firms which may not require all of the responses stipulated. The inclusion of responses in the absence of risks, is at odds with a scalable risk-based approach and makes implementation more difficult. In a risk-based approach you

would expect risks to be identified first and responses only then designed to address those risks, not the reverse.

It may be possible to include the responses in application material or an appendix, as suggested above, and provide examples of risks which may be faced by firms to address each quality objective. To further demonstrate scalability, examples of risks and responses could be identified for different sized firms, such as International network firms, national networks and small firms or sole practitioners. By inclusion in an appendix, the objectives and responses then become examples which can be applied by firms, amended or added to in a genuinely scalable manner. This then provides granularity and illustrates the requirements without being prescriptive, which will help small to medium practices understand how to implement the requirements but not lock them into addressing a long list of objectives and responses.

| 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? |

Response: Aspects which we expect to create implementation challenges are:

- The requirements are not necessarily as clear as the introduction and may not be able to stand alone, which we consider they should. The introductory material provides a helpful overview of the standards and in some cases is clearer than the requirements themselves. We suggest that the IAASB check that each of the introductory statements is fully reflected in the requirements so reliance does not need to be placed on the introduction to understand the intention of the requirements. As the introduction in effect summarises or repeats the requirements, we suggest that this material could instead be repurposed. The introductions to all of the standards could be combined into an explanatory document which provides a useful overview of how all of the standards fit together and what they require.

- The volume of work required to address the required components, objectives and responses, identify corresponding risks and develop additional objectives and responses is significant. Under the 8 components, there are 33 objectives required to be addressed and 32 responses at a minimum. Whilst implementation may be challenging for large firms due to the scale of their business, for small firms, with limited resources, this will be a significant exercise. The standard would be less overwhelming if it was structured in a more manageable way, such as setting out the components, objectives, risks and responses in a table, as suggested above, and including diagrammatic representations of the process to be applied.

- As responses are provided without the risks which should drive those responses, we consider that this may undermine the risk-based approach. Implementation may start with the responses and work backwards to identify related risks, which would be counter to the intended approach.

- The expanded definition of engagement team, which is limited to those engaged by the firm in the extant standard, to include "individuals who perform procedures on the engagement", excluding external experts, may capture services outsourced, offshored or centralised, such as data analytics or technology providers. If these systems or services effectively perform procedures they will become subject to the system of quality management.

Encompassing these providers in the system will create challenges in obtaining the necessary information about their systems and procedures, particularly for a small firm with limited influence. It is likely to result in inconsistent approaches by firms.

- The inability for the firm to rely on the quality management system of the network is very onerous given the likely complexity of the network system (refer to *Section 3I – Networks and Service Providers*: "some networks may only share a brand name, while other networks may share common methodologies or policies or procedures"). The way in which the relationship between the firm and network firm is addressed in the standard will affect implementation and will mean that implementation will vary considerably between networks. The structure of each network will have a significant impact on the size and geographic spread of the entity which falls within the definition of "firm" and consequently the level at which the system of quality management will be implemented and can be relied upon. Responsibility for the system of quality management sits at the firm level, which in some instances may be a nationwide entity, whereas other firms will comprise only an individual office or location. The implementation challenges will vary significantly as a result and we expect will be proportionally greater for firms comprising one office which cannot rely on a network to benefit from economies of scale.

- Management of the relationship with service providers and obtaining the information needed for the firm to fulfil the new requirements. In the case of highly technical service providers such as software providers or technology services, it may be difficult, if not impossible, and unnecessarily time consuming for firms to evaluate whether they meet the quality objectives.

- The root cause analysis process requires investigation of all deficiencies and then evaluation of their severity and pervasiveness. Whilst the IAASB acknowledges that the requirement to determine the severity and pervasiveness of the deficiency follows the requirement to investigate the root cause of the deficiency, it notes that the process is likely to be iterative. However, although this is not clear in the requirements. The severity and pervasiveness should be considered for all deficiencies before root cause analysis is required to be undertaken, otherwise the requirement becomes too onerous. See response to Q.12.

- Readily understanding the changes in requirements and approach from the existing standard, ISQC 1, to the final standard, ISQM 1, once published, will be critical for practitioners to implement the new standard efficiently and effectively. To facilitate this we suggest providing a mapping document from the extant ISQC 1 to the final ISQM 1, rather than changes from the ED-ISQM 1. Practitioners need to understand what the differences are from what they are currently doing so they can understand which aspects require new processes and procedures and which aspects they can bring across from their current system of quality control.

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?

Response: Overall, we are supportive of the application material. Specific concerns are identified in our answers to specific questions.

Specific Questions

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

Response: Yes, we do support the 8 components, which we consider contain suitable enhancements to the existing 6 elements.

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?

Response: Yes, we are supportive of the objective to design, implement and operate a system of quality management and the objectives of that system. We recognised that ISQM1 does not precisely elaborate on what the term "public interest" implies (refer also to our response to Question 11). For audit firms to implement ISQM 1, however, it is necessary to understand how to serve the public interest. Therefore, we suggest providing further clarification of the definition of public interest.

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?

Response: We support the risk assessment process as an effective approach to achieving the overall objective. However, we consider that the three-step process is not as clearly articulated in the requirements as it is in the explanatory memorandum and the introduction. The simple diagram of the process in that memo is helpful and should be included in the introduction or appendices to the standard. That process also needs to be more clearly reflected in the requirements under each component. The need to conduct a risk assessment is not actually stated under each component.

The standard needs to reinforce that the firm's risk assessment process component overlays the quality management process for the other seven components. The firm's risk assessment process component needs to be more clearly linked to the establishment of quality objectives, identification of quality risks and design and implementation of responses under each of the seven other components. We suggest that the requirements for this component need to be included as the first component after paragraph 22, as it provides the process for all of the other components. In addition, this link needs to be made clearer in paragraph 26. The requirement could be expanded as underlined: "The firm shall establish ~~the~~ quality objectives for each component of the system of quality management, including the quality objectives required by this ISQM."

	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?

Response: We agree with the risk assessment process being applied to the other components, so that the responses can be focused on the risks relevant to the firm.

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

Response: We support the approach to establishing quality objectives to meet the objective of the firm as articulated in paragraph 18. Although, we suggest that the requirements could be limited to the description of the matters which the quality objectives need to address under

each component, without necessarily including each of the 33 objectives provided under the components. This would make the standard more succinct and clearer.

In particular:

i.   Are the required quality objectives appropriate?

Response: The quality objectives are very granular and in some cases can be difficult to differentiate from what may be a response. We suggest that the discipline of moving the components, objectives, risks and responses to a table will help to highlight where the objectives may not be at the right level and where they cross over into responses and where there are inconsistencies between components in the level of detail required.

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

Response: The introduction (paragraph 10) and requirements (paragraph 26) are clear that additional quality objectives are expected to be established as necessary to achieve the objective of the standard and this is repeated in several places in the application material. There is a concern, that this could create an expectation, for example by regulators, that the firm should always identify additional objectives. However, it should be acceptable that, particularly for smaller firms, additional objectives will not always be necessary. Ideally, the quality objectives should be broad enough to cover a typical, or at least small, firm's needs and not require augmentation. The transfer of the quality objectives to a table in application material or an appendix, as already suggested, so that they become examples rather than being a definitive list would reinforce the need for firms to identify their own objectives which address the firm's circumstances and engagements.

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

Response: Whilst we are supportive of a risk-based approach we consider that it is not appropriate for the requirements to specify responses without identifying the risk to which each relates. Therefore, as stated previously, we suggest providing examples of risks and present the responses as examples only.

We note that the assessment of risk is based on "reasonable possibility" of occurrence and the "significance" of the effect on achieving the objectives. Whilst we support this concept of risk, we are concerned that the application material describes "reasonable possibility" as the likelihood of occurrence of the quality risk being "more than remote", although in our view, based on a plain English understanding of these phrases, the two terms are not equivalent. We recommend avoiding use of the phrase "more than remote" as it suggests a very low bar for identifying and assessing risk and would potentially suggest that the large majority of risks require assessment. Whilst these terms are consistent with the exposure draft for ISA 315, we also expressed the same concerns with respect to the wording in that proposed standard.

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

Response: We support the requirement for responses to address assessed risks.

We note that responses are defined as "policies and procedures" (paragraph 19(t)), which is intended to reflect the definition of controls in the COSO framework. Therefore, we suggest that the IAASB considers whether the term "controls" should be used. This could assist in linking the responses needed to service providers' reports, which may be required on their controls to show their response to quality risks equivalent to service organisations' controls reports under ISAE 3402.

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?

Response: Yes, we support the approach to responses being tailored to address risks. However, the provision of a mandatory list of responses, provided in the proposed standard, without risks having been assessed is inconsistent with the risk-based approach.

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?

Response: We consider that it could be made clearer that additional responses are required. This could be alleviated by covering the firm's risk assessment process before the other components, by moving this component after paragraph 22, and by making it clearer that the steps involved are covered under each component. Furthermore, the lists of responses should not be mandatory as this suggests they are definitive and will not need additional responses. Mandatory responses make the standard seem prescriptive contrary to the principles-based intention, and does not reflect that the responses should be addressing assessed risks. In addition, we question whether for some firms the responses provided may be sufficient and will not need augmentation or for others the responses may not all be necessary. Consequently, flexibility for judgement is limited even though this standard intends to be principles-based. Instead, the responses could be provided as examples in application or an appendix rather than in the requirements. This would better reflect the need for firms to develop their own responses to address identified risks.

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

Response: Yes, the standard communicates the responsibilities and accountability of senior leadership and the onus on the firm to take responsibility for quality management, although it does reflect a large firm's perspective.

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?

Response: Whilst many firms do allocate responsibility for ethics and independence to one individual, we do not consider it necessary to require all firms to do so. We do not think that the management of ethics and independence needs to be "called out" specifically as requiring assignment in a prescribed way. In some firm structures it may be unreasonable for

one individual to take responsibility for ethics or compliance with independence requirements for the entire firm. For example, a firm encompassing offices across an entire jurisdiction, rather than an individual office, may prefer to delegate that role on a different basis, such as at the office or region level. Responsibilities for oversight are reasonable, however responsibility for the outcomes should be shared and ultimately it should be the individual engagement leader's responsibility to ensure compliance of his/her team.

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

Response: Yes, we consider the standard addresses that appropriately.

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

Response: The standard addresses technology by expanding the element "human resources" to the new component "resources", which encompasses technological resources. Although it addresses technology in a minimal way, we consider it is sufficient for a principles based standard. We do not think that it will inhibit technological innovation, which is increasingly important as technologies evolve.

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?

Response: We support the requirements on communication with external parties and note that in Australia auditors or firms which audit 10 or more listed entities or other bodies prescribed are already required to issue a transparency report. Therefore, this requirement may not have a significant impact in this jurisdiction.

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?

Response: Paragraph 37(e) sets out which engagements will be subject to engagement quality review. This paragraph uses the term "significant public interest" whereas the term "public interest entity" is more widely used in national jurisdictions and used by IESBA, so may be more consistently interpreted. In addition, the guidance provided in interpreting the term "significant public interest" in paragraph A102 is very subjective and may result in a wide range of outcomes, which would be open to challenge by regulators (refer also to our response to Question 5).

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

Response: We agree that the requirements expect more robust monitoring and remediation and so should result in improvements in this regard.

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?

Response: We agree that the proposals will promote more proactive monitoring, such as requiring "appropriate combination of ongoing and periodic monitoring" and requiring root cause analysis to respond to deficiencies. However, we recommend that testing of operating effectiveness of the responses, that is, the controls or policies and procedures designed and implemented to address the quality risks, be more explicitly required by the standard.

(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?

Response: We consider it appropriate to retain the requirement for cyclical inspections of completed engagements and note that small firms or sole practitioners may not have the resources to conduct ongoing monitoring, and so will need the flexibility to instead focus on completed engagements. Whilst we are supportive of allowing the firms to determine a suitable cycle for inspections, we suggest removing the 3-year cycle suggested in application material paragraph A 169.

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

Response: We are supportive of the evaluation of findings and identifying deficiencies. However, we do not support the definition of "deficiency" as it is very broad and may cause problems in practice. We suggest that deficiencies should be restricted to operating effectiveness of responses and clearly separated from the suitability of the design of the system of quality management. Any shortcomings in the design of the system of quality management, including omitted or unsuitable quality objectives, inadequacies in the risk assessment or design of responses, should be dealt with separately from deficiencies in the operation of the responses. For example, it would be preferable for the design of the system to be reviewed and, if necessary amended prior to implementation of the system, as well as at the start of each period, and the operating effectiveness of the responses monitored during or at the end of the period. We suggest the IAASB consider whether a separate term is needed for the outcomes of the evaluation of the system's design, which would comprise the quality objectives, risk assessment and design of responses. Separating these aspects of monitoring would also reflect the different approach needed to assess design, compared to operation, of the system.

The current definition would result in deficiencies if an objective is not established even if it is addressed in the responses. Likewise, if a risk has not been identified but has been addressed in the responses, it will still amount to a deficiency. In addition, it is not clear what the meaning of "established" is, in relation to quality objectives. Does this mean identified or described?

Paragraph 47 could clarify that not all findings will result in a deficiency. Further guidance is needed on the extent and nature of findings which would lead to a deficiency, as this is not clear.

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

Response:

We suggest that the requirements do not actually require "the firm to investigate the root cause(s) of identified deficiencies" as stated in paragraph A178, but only requires policies and procedures for root cause analysis. Currently the requirements jump from establishing policies and procedures (see paragraph 48) to designing and implementing remedial action (see paragraph 49). Arguably, the requirements need to include the actual conduct of root cause analysis. The requirements need to clarify whether root cause analysis should be conducted for all deficiencies or just severe or pervasive deficiencies and the objective of that analysis. For example, the objective may be to identify the underlying causes of severe or pervasive deficiencies to inform remedial action. Furthermore, we suggest that this root cause analysis should not be limited to audit deficiencies as inspection and quality review programs may identify deficiencies in assurance or related services.

In particular:

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

Response:

We are concerned that root cause analysis is required for all deficiencies and is a factor (see paragraph A183) in evaluating the severity and pervasiveness of an identified deficiency, rather than the severity and pervasiveness of the deficiency determining whether root cause analysis is required to be conducted. Given that firms can still conduct root cause analysis on deficiencies which are not severe or pervasive or on positive findings if they choose, we think the requirement should be restricted to severe or pervasive deficiencies.

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

Response:

Yes, we agree with the approach to positive findings in that root cause analysis is not required but the information value of positive findings is highlighted.

(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?

Response: We consider that this requirement may be unreasonably onerous for small to medium practitioners and may need to have different frequencies for differently-sized firms. In addition, as with our answer to question 8(a), we do not think it is necessary to specify that responsibility for the system of quality management for the entire firm needs to fall to one individual. Whilst many firms may allocate responsibility onto one individual, we do not consider it necessary to require firms to do so, as whether this is reasonable will depend on

the firm's structure. For example, a firm encompassing offices across an entire jurisdiction, rather than an individual office, may prefer to delegate that role on a different basis such as at the office or region level.

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?

Response: We support the IAASB's efforts to address the risk that firms place undue reliance on network requirements or network services and to improve the communication and transparency between the network and network firms. However, the new requirements put significant onus on the network to communicate the system of quality management, and the firm to understand the detail of that system and assess whether it meets the quality objectives. It is not clear the extent to which the firm needs to determine for themselves whether the system is operating effectively, or they can rely on the outcomes of the monitoring process. The proposed requirements could diminish the benefits of being part of a network and will have cost implications for firms.

14)	Do you support the proposals addressing service providers?

Response: Whilst it seems reasonable to make sure that the firm's quality management extends to service providers, the practical implications of implementing the requirement are significant. For example, to obtain and effectively evaluate the design, implementation and operation of the technological resources would not be achievable for many firms. The reason that the service is outsourced is usually that the firm does not have the necessary expertise itself and so would not be able to effectively evaluate the quality management information provided, if indeed it can be obtained. The application material rightly states that the service provider may need to supply the firm with an assurance report on the description and design of their controls over the resource, much like the current ISAE 3402 report on controls. This will create a significant additional cost to engaging such services and may not be available from many 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?

Response: We are not aware of any jurisdictional problems with changing the name of the standard.

Editorial Comments on Proposed ISQM 1

We suggest the following editorial amendments:

- The standard needs to address all types of engagements so we suggest deleting "audit" in the following application material:

  Para. 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.