

Quality Management

I. Objective

To provide the ASB with preliminary feedback regarding select issues from the comment letters received on the exposure draft of the following proposed standards, and to obtain direction from the ASB on those select issues.

- [Proposed] Statement on Quality Management Standards (SQMS) *A Firm’s System of Quality Control (QM 1)*
- [Proposed] SQMS *Engagement Quality Reviews (QM 2)*; and
- [Proposed] Statement on Auditing Standards (SAS) *Quality Management for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards (220)*, (collectively the “Proposed QM Standards”).

II. Quality Management Task Forces

The Quality Standards Task Force has been divided into two groups:

QM1

Sara Lord, *Chair*
Sherry Chesser
Kathryn Fletcher
Phyllis Anderson
Alan Long
Tania Sergott
Kimberly Stazyk

QM2/220

Jon Heath, *Chair*
Harry Cohen
Tom Parry
Jeff Rapaglia
Rick Reeder
Mike Westervelt

The QM1 Task Force acknowledges and thanks Kristen Kociolek for her previous participation on the Task Force.

III. Background

In February 2021, the ASB issued the Proposed QM Standards for public comment. The comment period, extended from its original end date of June 11, ended on August 31. During the exposure period, the Task Forces held 15 roundtables with a total of 424 participants, excluding TF members and AICPA staff. The roundtables were publicized by state societies and included practitioners from firms of all sizes. Many participants were also peer reviewers.

IV. Comment Letters

171 comment letters were received. The comment letters can be viewed on the AICPA website by clicking [here](#). The breakdown of the comment letters by respondent is shown below. See Agenda Item 4A: Exhibit A, Respondents by Type, for a list of respondents.

| Type | # | Firm size criteria |
|-------------|---|--------------------|
| Firm: Big 4 | 4 | Big 4 firms |

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| Type | # | Firm size criteria |
|-------------------------------|------------|---|
| Firm: MFG | 12 | More than 75 professionals |
| Firm: G400 | 10 | 21-75 professionals |
| Firm: Medium | 6 | 11-20 professionals |
| Firm: Small | 50 | As indicated by respondent |
| Firm: Smaller | 5 | 6-10 professionals |
| Firm: Very small | 7 | 2-5 professionals |
| Firm: Sole Practitioner | 41 | 1 professional |
| ➤ Firm: Subtotal | 135 | |
| State Societies | 25 | Includes firm alliances and AICPA Technical Issues Committee |
| Regulators and State Auditors | 7 | Includes NASBA and GAO |
| Individuals | 4 | Retired CPAs (3); 1 CPA with a firm speaking as an individual |
| ➤ Grand Total | 171 | |

Note that 19 of the respondents indicated that they performed peer reviews (this includes responses from State Societies).

This is the largest number of comment letters received on an exposure draft in at least the last 15 years (narrowly edging out what became SSARS 21). This is a testament to the awareness efforts by the Task Force and AICPA staff (at all levels). This is also a testament to the extreme unpopularity of the proposed standards with smaller firms, particularly with regard to the issues of self-inspection and a cooling-off period.

Cost-benefit concerns:

69 letters, from a variety of respondents, expressed the concern that the standards were not scalable and would be so costly to implement that the small firms would choose to stop performing assurance engagements. (See table below and Agenda Item 4B, Exhibit B: Cost-Benefit Concerns). Roundtable participants generally supported scalability. However, as in the comment letters, significant concerns were expressed at each of the 15 roundtables about the cost to smaller firms, particularly in light of the cumulative impact of adopting the various and recent auditing and accounting standards. Many respondents noted concerns about resources, including the difficulty of finding peer reviewers and then finding other objective, competent people to perform inspections.

| Cost-benefit concerns | | # of firms with concerns/ # of that size firms responding |
|-------------------------------|-----------|--|
| Type | # | |
| Firm: Big 4 | 0 | |
| Firm: MFG | 1 | 1/12 |
| Firm: G400 | 4 | 4/10 |
| Firm: Medium | 2 | 2/6 |
| Firm: Small | 23 | 23/50 |
| Firm: Smaller | 3 | 3/5 |
| Firm: Very small | 3 | 3/7 |
| Firm: Sole Practitioner | 16 | 16/41 |
| ➤ Firm: Subtotal | 52 | 46/135 |
| State Societies | 15 | 15/25 |
| Regulators and State Auditors | 0 | |
| Individuals | 2 | 2/4 |
| ➤ Grand Total | 69 | 69/171 |

These cost-benefit concerns related to the quality management standards appear to arise primarily from the prohibition of self-inspection and the requirement for a two-year cooling-off period for engagement quality review (EQR) reviewers, which were proposed as new requirements in the United States.

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Many respondents seemed to tie (and in some instances conflate) the Quality Management Exposure Drafts to Peer Review. This is somewhat natural. Two salient and relatively consistent points were made:

- Some of the respondents believe smaller firms should be exempt from the proposed standards. However, one of the main drivers of the Enhancing Audit Quality Initiative (EAQ) was that various external reviewers (e.g. DOL, PCAOB) each found significant and concerning deficiency rates in their independent reviews of audits.¹
- Another point brought forth by some respondents is that the AICPA is making it harder for firms to pass peer review.² The AICPA 2020 Peer Review Board’s Annual Report on Oversight, explains that in 2019 and 2020 there was an increased focus on compliance with risk assessment standards, which led to an increase in non-conforming engagements. However, actual peer review “Pass” statistics have been flat for past 3 years; this is true for both system reviews (firms that perform audits) as well as for engagement reviews (firms that perform reviews or compilations as their highest level of service)³.

The cost-benefit concerns provide background helpful to the issues highlighted in section V. below.

V. Issues for ASB Consideration

The following is a list of the issues included in this discussion memorandum for discussion with the ASB. (See agenda item 4H, *Additional background information*, slides 1-2)

| Issue # | Title |
|-------------------------|---|
| Issue 1 | Self-inspection (SQMS 1) |
| Issue 2 | Cooling-off period (SQMS 2) |
| Issue 3 | Effective date (all proposed QM standards) |
| Issue 4 | Dating of the report when EQR is performed (SQMS 2) |

Comments received on all other aspects of the proposed QM standards will be brought to the ASB for consideration at future meetings.

Issue #1: Self-inspection

A. Background:

Monitoring procedures include, but are not limited to, inspection. Inspection includes, but is not limited to, review of engagement documentation, reports, and client’s financial statements (engagement review).

¹ For example, in 2014, the combined deficiency rate identified by PCAOB inspections for all sized firms was 39%, in 2017 it was 30%, and in 2019 the deficiency rate for the big four firms was 22% and non-big four firms was 31%. [\[Source\]](#) In May 2015, the DOL issued a [study](#) in relation to employee benefit plan audits that found 39% of the audits (nearly 4 out of 10) contained major deficiencies with respect to one or more relevant GAAS requirements.

² The [AICPA 2020 Peer Review Board Report on Oversight](#) explains that “The increase in non-conforming audit engagements in 2019 and 2020 was caused by an increased focus on compliance with risk assessment standards. The PRB issued guidance enhancing the evaluation of non-compliance with the risk assessment standards effective for peer reviews commencing on or after October 1, 2018. This led to an increase in the number of nonconforming audit engagements identified in 2019 and 2020.”

³ See the AICPA 2020 Peer Review Board Report on Oversight

Under extant QC section 10, engagement review is a required element of annual inspection and inspection is a required element of annual monitoring. (See agenda item 4H, *Additional background information*, slide 3.)

Self-inspection

Extant QC Section 10⁴, unlike ISQC 1, does not preclude firms from inspection of a completed engagement by an individual who served as an engagement team member or engagement quality reviewer on that engagement (referred to as “*self-inspection*”). The proposed QM standards, however, state that engagement team members or the engagement quality reviewer should be prohibited from performing the inspection of the completed engagement.

When the QC standards were last updated (in 2012), the ASB had concluded that it was not necessary to change existing practice to converge QC Section 10 with ISQC 1 because in the United States, the peer review process provides a safeguard via an independent review mechanism of a firm’s monitoring procedures, which may include self-inspection. However, in deliberating the current exposure drafts, the ASB decided to expose the proposed standards as converged with IQSM 1 in order to obtain feedback on self-inspection.

Respondents were asked whether they agree that inspection of completed engagements by those involved in the engagements should be precluded in order to enhance audit quality, and if not, to explain why and provide examples of safeguards that could lower the self-review threat to an acceptable level.

Other Country Exemptions

Staff reached out to colleagues in Canada, South Africa, the Netherlands and Germany about self-inspection in their countries.

Neither Canada nor South Africa permit self-inspection and both have no national exemption for small firms. The Netherlands also does not permit self-inspection but exempts very small firms from having a full scope quality system based on the idea that it is not necessary for very small firms, such as a sole practitioner, to have such a system to achieve the objective of ISQM1.

Germany is in the process of considering ISQM 1; however, its extant ISQC 1 permits self-inspection for small practices that do not have sufficient suitably qualified staff:

The personnel entrusted with the performance of an engagement review as part of inspections for monitoring purposes shall not have been involved in the performance of the audit engagement or in the engagement quality control review accompanying the engagement. If suitably qualified staff are not available within a small practice, the engagement review may also be carried out in the sense of a “self-verification” in the case of entities that are not public interest entities (Section 49 (4) WP/vBP professional statutes). In this case, it is permissible for the review to be carried out by persons who may be involved in the performance of the audit engagement or, if applicable, in the engagement quality review. The performance of the review by way of self-verification requires an appropriate time interval between the completion of the audit engagement included in the inspections. The reasons for conducting the review by way of self-verification shall be documented for evidence purposes. If the audit is also conducted in accordance with the ISAs, it should be noted that ISQC 1 does not permit self-verification (ISQC 1. A68). In this case, an external auditor should be engaged to perform the review. (*translation provided by IDW staff*).

⁴ Paragraph 52c of QC section 10.

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B. Feedback from Roundtables and Comment Letters

Roundtable Poll Results

| | | |
|--|------------|----------|
| Question: Please indicate your level of agreement that inspection of completed engagements by those involved in the engagements should be precluded in order to enhance audit quality. | | |
| | # | % |
| a-Strongly agree | 68 | 21 |
| b-Agree | 102 | 32 |
| c-Neutral | 50 | 16 |
| d-Disagree | 45 | 14 |
| e-Strongly disagree | 57 | 18 |
| | 322 | |

Comment Letter Responses (Agenda item 4C – Exhibit C, Self-inspection)

| Self-inspection | Support Precluding Self- Inspection | Oppose | Exemption |
|-------------------------------|---|------------|-----------|
| Type | # | # | # |
| Firm: Big 4 | 3 | | 1 |
| Firm: MFG | 7 | 3 | 2 |
| Firm: G400 | 3 | 3 | 2 |
| Firm: Medium | | 5 | |
| Firm: Small | 5 | 29 | 4 |
| Firm: Smaller | | 5 | |
| Firm: Very small | | 3 | |
| Firm: Sole Practitioner | | 30 | 1 |
| ➤ Firm: Subtotal | 18 | 78 | 10 |
| State Societies | 1 | 20 | 5 |
| Regulators and State Auditors | 2 | 1 | |
| Individuals | 2 | 1 | |
| ➤ Grand Total | 23 | 100 | 15 |

C. Options

The Task Force considered three options regarding self-inspection:

- (1) Make no changes to the standard as proposed (that is, prohibit self-inspection)

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The majority of roundtable participants (53%), when polled, supported the prohibition of self-inspection. Generally speaking, participants agreed that from a purely theoretical basis, self-inspection should be precluded

However, the majority of comment letter respondents (67% or 115/171) either opposed the self-inspection preclusion or supported an exemption for small firms.

(2) *Retain the extant requirements (that is, do not prohibit self-inspection of completed engagements) with a requirement that firm responses (safeguards) to the risk of self-inspection be documented*

Many respondents argued that safeguards exist to lower the self-review threat to an acceptable level, and that by precluding self-inspection for all firms the ASB is requiring, in effect, that small firms hire a peer reviewer every year. Many firms believe that the cost of this would be onerous, or as number of comment letters said “will put small firms out of the assurance business”. Even larger firms expressed concern about this, on their own behalf and on behalf of smaller firms. Many firms stated that it can be difficult to find sufficiently experienced and knowledgeable external people, particularly for specialized industries or areas, and needing to hire three separate people to perform an engagement quality review, an inspection, and a peer review exacerbates that problem and is cost prohibitive.

Strong feelings have been expressed that for firms that do not have sufficient qualified internal staff to perform inspections (if self-inspection is prohibited), the costs outweigh the benefits and there will be unintended negative consequences of firms either avoiding EQR under all circumstances (so that, for example, the EQR reviewer could perform inspections) or ending their assurance practice.

The arguments cited for retaining the extant lack of prohibition of self-inspection are as follows:

- The prohibition of self-inspection is not consistent with a risk-based approach to quality management.
- Self-inspection currently appears to be operating effectively, in that AICPA Peer Review statistics indicate that many firms that use self-inspection are passing peer review.
- The peer review system that is in place already provides the safeguard for the public if a firm doesn't perform in accordance with professional standards. A common corrective action imposed on firms is having their inspections done by third parties acceptable to the peer reviewing administering entity.
- The perspective that “you don't know what you don't know” assumes that an independent reviewer is always more knowledgeable than the engagement team.
- Additional safeguards have been identified by respondents to address audit quality such that an additional independent review isn't necessary (that is, the risk of audit quality has been addressed through other responses). These include:
 - Strong client acceptance and engagement continuance policies that provide reasonable assurance that the firm doesn't accept or retain engagements it doesn't have the competency and resources to perform, mentioned by many roundtable participants as a safeguard they use
 - Effective training programs and a commitment to continuing professional education to stay current on accounting and auditing standards
 - Consultation policies that provide reasonable assurance the firm will consult when they encounter technical difficulties
 - Corrective action taken by the firm when indicated by the firm's most recent peer review results or those of other external inspections, for example, inspections by DOL, GAO, or HUD
- For firms that use self-inspection, often the following are in place:
 - Training on how to perform self-inspections

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- Policies that require the passage of time after the engagement is completed before performing self-inspections
- Use of peer review checklists in performing inspections

(3) Add an exception to the prohibition on self-inspection based on size

The SEC and PCAOB⁵ offer exemptions to certain requirements, such as partner rotation⁶ and “cooling-off” (or “time-out”) periods for EQR reviewers, based on firm size and number of issuer audit clients, in recognition of the difficulty of compliance with such requirements for smaller firms with fewer personnel.

As noted in the roundtable results in option (1) above, the consensus opinion is when the firm has sufficient qualified internal people, inspection of the engagement by someone who was not involved in the engagement is preferable. Based on feedback, *sufficient* means four or more, because often three qualified people are involved in the engagement: the engagement partner, the pre-issuance reviewer, and if relevant, the engagement quality reviewer.

However, there would be benefits to consistency in the approach for exemptions. Therefore, the following options could be considered:

- Exempt firms with fewer than four qualified internal personnel. Using the total number of partners may scope in partners who are not qualified to perform inspections, such as tax partners who do not perform assurance engagements or partners who lack the necessary specialized expertise.
- Exempt firms with fewer than five assurance clients and fewer than ten partners, to be consistent with similar SEC rules. [Note, these firms and their audit engagements would be subject to peer review at least once every three years].

D. Task Force recommendation

The Task Force considered the significant volume and quality of comment letters provided that identified the prohibition on self-inspection as a significant barrier to entry or retention in the profession by smaller firms. The Task Force also considered the intention of this standard to be scalable for all firms based on the performance of risk assessment tailored to their circumstances. Additionally, consideration was given to the history of the rationale for the disparity on this requirement between the US and international extant QC standards.

The Task Force believes that the risk assessment approach is an underlying foundation of the quality management standards. Additionally, as previously vetted, the US Peer Review system provides an independent review mechanism with appropriate follow-up responses should a firm’s current system of quality management not be operating effectively. The Task Force agreed that avoiding self-inspection leads to highest levels of objectivity and is best practice. However, competent inspectors who were not involved in the engagement may not be available or the cost may be higher than the benefit; this is true in all firms, but most especially in smaller firms and when firms are expanding into new services or industries. Some Task Force members preferred that self-inspection be prohibited; however, as a whole, the Task Force acknowledges that providing a risk-based safeguards approach to permit firms to design their monitoring systems, including their responses to the review of completed engagements, is aligned with the overall intent of the standard to be risk based and scalable. The Task Force also carries forward the extant view

⁵ See Section 10A(j) of the Exchange Act; Exchange Act Rule 10A-2; PCAOB Rule 3520, Auditor Independence; and AS 1005, Independence (formerly AU 220).

⁶ SEC rules state that “in order for audit firms with fewer than five audit clients that are issuers and fewer than ten partners to qualify for the exemption from partner rotation, the [PCAOB] must conduct a review of all of the firm’s engagements subject to the rule at least once every three years.”

that the Peer Review program in the US provides independent monitoring that is relevant to this consideration.

As such, the Task Force recommends that the prohibition on self-inspection not be retained in the final standard.

The Task Force liked the approach taken by Germany, which prohibits self-inspection when firms have a viable alternative but leaves it up to firms to determine that threshold. The Task Force debated a specified-exemption requirement and considered that it may be challenging for the board to develop appropriate guidance for the implementation of a specific quantity of personnel, engagements, or other threshold that is relevant for all situations. It also appears counter to the risk assessment approach to take a purely quantitative approach to permitting an exception.

Accordingly, the following revisions to QM 1 are proposed:

40. The firm should establish policies and procedures that
- a. require the individuals performing the monitoring activities to have the competence and capabilities, including sufficient time, to perform the monitoring activities effectively.
 - b. address the objectivity of the individuals performing the monitoring activities. Such policies or procedures should prohibit the engagement team members or the engagement quality reviewer of an engagement from performing any inspection of that engagement ***when practicable. If suitably qualified individuals who are not associated with the engagement are not available within a practice, the firm is permitted to perform “self-inspection” by a qualified engagement team member or the engagement quality reviewer of that engagement.*** (Ref: par. A168–A169A)

Paragraphs A168-A169

Four respondents raised a concern (see agenda item 4D) that paragraph A168 implicitly prohibits any individual who designed, executed or operated the system from being part of the inspection of the system. This concern is indirectly reflected in other comment letters, mostly from small practitioners. The last sentence in paragraph A168 was revised to address this concern. Other revisions to paragraph A169 and the addition of two paragraphs are proposed to address safeguards against the self-review threat.

Individuals Performing the Monitoring Activities (Ref: par. 40b)

A168. 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.

The self-review threat may also arise when an individual who performs another type of monitoring activity participated in ~~designing, executing, or operating~~ the response being monitored.

A169. ~~In some circumstances, for example, in the case of a less complex firm, there may not be personnel who have the competence, capabilities, time, or objectivity to perform the monitoring activities. In these circumstances, the firm~~ ***When practicable, a firm with a limited number of persons with sufficient and appropriate experience and authority in the firm*** may use network services or a service provider to perform ***engagement inspections and other*** the monitoring activities. ***However, the cost or lack of availability of suitably qualified external service providers may be such that the firm may determine that it is not practicable to do so.***

A169A. ***Having an individual inspect his or her own compliance with a quality management 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. The firm is required, as part of the risk assessment process, to determine responses (also referred to as “safeguards”) to such risk.***

A169B. ***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. Safeguards against the self-review threat include the following:***

- ***Strong client acceptance and engagement continuance policies that provide reasonable assurance that the firm doesn’t accept or retain engagements it doesn’t have the competency and resources to perform***
- ***Effective training programs and a commitment to continuing professional education to stay current on accounting, auditing, and quality management standards***
- ***Consultation policies that provide reasonable assurance engagement teams will consult when they encounter technical accounting and auditing difficulties***
- ***Triennial peer review and consideration of the results thereof and their effect on the design of inspection procedures, including the decision to self-inspect***
- ***Corrective action taken by the firm after consideration of deficiencies identified by the firm’s internal monitoring, peer review results or other external inspections, for example, inspections by DOL, GAO, or HUD***
- ***Training on how to perform monitoring inspections***
- ***The use of peer review or other inspection checklists***
- ***Policies that require the passage of time after the completion of an engagement before performing monitoring inspections***
- ***Policies that require the use of an external service provider to perform either engagement quality reviews or monitoring procedures when 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) occur***

E. Annual Inspections of Completed Engagements

A few respondents questioned whether the requirement to inspect completed engagements of each engagement partner on a cyclical basis could be combined with the ability to allow Peer Review to substitute for inspection in the year of peer review. Accordingly, a firm with one or two partners would put the partners on a three-year cycle and only inspect completed engagements once every three years.

The Task Force believes paragraph 39 requires the inspection of completed engagements annually as part of the monitoring procedures. Because the Task Force is recommending not precluding self-inspection, the Task Force believes that it is not overly prescriptive for monitoring to include annual inspections of completed engagements.

Proposed revision to clarify this are as follows:

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39. The firm should include the inspection of completed engagements in its **annual** monitoring activities and should determine which engagements and engagement partners to select. In doing so, the firm should:
- a. take into account the matters in paragraph 38;
 - 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; (Ref: par. A167) and
 - c. select at least one completed engagement for each engagement partner on a cyclical basis determined by the firm.

The above language requires inspection of at least one completed engagement annually, but not for each engagement partner each year. Paragraph A165 provides examples of policies and procedures that a firm may establish to apply a cyclical basis for the inspection of completed engagements for each engagement partner.

Question for the ASB:

1. Does the ASB agree with the recommendation of the Task Force to not preclude self-inspection and to strengthen the emphasis on safeguards?
2. Does the ASB agree with the recommendation of the Task Force about requiring annual inspections of completed engagements based on the parameters described above?

Issue #2: Cooling-Off Period for Engagement Quality Reviewers

A. Background: A cooling-off period is one safeguard against the self-review threat to objectivity. Under the AICPA’s code of professional conduct all members are required to maintain objectivity in discharging their professional responsibilities. Firms often utilize multiple methods to maintain objectivity – for example, one method is by requiring personnel to attest to compliance with firm policies and procedures regarding objectivity and independence. (See agenda item 4H, *Additional background information*, slides 4-5.)

B. Feedback from Roundtables and Comment Letters

Roundtable Poll Results

| Should a cooling-off period be required before a former engagement partner can serve as an engagement quality reviewer on that engagement? | # | % |
|--|------------|-----------|
| Yes | 97 | 32 |
| No | 208 | 68 |
| | 305 | |

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Comment Letter Responses (Agenda item 4E: Exhibit E, Cooling-Off)

| | Oppose | Support | Exemption |
|-------------------------------|-----------|-----------|-----------|
| Type | # | # | |
| Firm: Big 4 | 1 | 1 | 1 |
| Firm: MFG | 5 | 6 | 1 |
| Firm: G400 | 5 | 4 | |
| Firm: Medium | 4 | | |
| Firm: Smaller | 5 | | |
| Firm: Very small | 2 | | 1 |
| Firm: Sole Practitioner | 8 | | 2 |
| Firm: Small | 17 | 2 | 1 |
| ➤ Firm: Subtotal | 47 | 13 | 6 |
| State Societies | 18 | 3 | 1 |
| Regulators and State Auditors | 1 | 3 | |
| Individuals | | 1 | |
| ➤ Grand Total | 66 | 27 | 7 |

Note the above numbers do not include 36 respondents who did not support the standard without mentioning cooling-off specifically. See Agenda item 4B, “Cost-Benefit”. 7 respondents supported a cooling-off period but believed that an exemption should be provided for smaller firms because of the cost burden and the difficulty in obtaining qualified external people to serve as EQR reviewers.

Some larger firms that supported the requirement were concerned about the effects on smaller firms. Many respondents, both during the roundtables and in letters, expressed concern about the available, competent resources to perform the reviews if, in order to effectuate this requirement, they had to go outside of their firm. Some respondents also indicated that while using external resources effectively guarantees a higher level of objectivity, no similar guarantee exists that the external resource will have a similar or higher level of competency. Several respondents indicated that having a new engagement partner provides the appropriate level of objectivity, such that allowing the former partner to serve in the role of EQR would be appropriate.

The majority of respondents did not support a cooling-off period. Reasons included the following:

- It can be difficult to find sufficiently experienced and knowledgeable external people, particularly for specialized industries or areas, and needing to hire three separate people to perform an engagement quality review, an inspection, and a peer review exacerbates that problem as well as being cost-prohibitive. 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.
- Firms transitioning clients to a new engagement partner often use the past engagement partner as the EQR reviewer as a quality response. They believe that the cooling-off period prioritizes objectivity at the expense of competence and that it will have the unintended negative consequence of lowering audit quality in the U.S.
- To avoid the cooling-off period, firms may change their criteria so that fewer engagements would be subject to EQR; again, an unintended negative consequence that would not improve audit quality.
- To avoid the cooling-off period, firms that rotate engagement partner and engagement quality reviewer roles within a group of partners may choose not to rotate engagement leadership (if not otherwise required to do so), which would be an unintended negative consequence
- A prescribed cooling-off period is inconsistent with a risk-based approach to quality management and inconsistent with a lack of required engagement partner rotation. Allowing firms to apply

safeguards against the familiarity threat using a risk-based approach for engagement partners but not for EQR reviewers is not consistent.

C. Options

The Task Force considered three options with regard to the cooling-off period:

1. *Make no changes to the standard as proposed (that is, require a two-year cooling off-period)*

Firms that currently use the role of an EQR to transition engagement partners, would not be prohibited from using the “rotating-off” audit partner as an advisory partner or other audit partner on the engagement; however, when the criteria the firm has established for requiring an EQR are met, the firm would utilize a different person in the EQR role.

Those who favored a cooling-off period were slightly more supportive of two years, although several favored a one-year period for smaller firms.

2. *Do not require a cooling-off period and add application material addressing threats to objectivity.*

Another option considered is to not require a cooling-off period, but to provide application guidance that a cooling-off period may be one safeguard against self-review threat. Note that this was the position taken by the ASB in its comment letter on the exposure draft of the IAASB QM standards. It would also be most consistent with objective of developing a principles-based standard focused on a risk-based approach (i.e. it wouldn't be prescriptive in nature).

3. *Require a cooling off period and add an exemption for certain firms based on size*

The Task Force considered adding an exemption for firms based on size. However, many firms believe that using the former engagement partner as EQR reviewer when transitioning to a new engagement partner is an appropriate quality risk response. In this regard, requiring a cooling-off period is different from precluding self-inspection. Even those who believe self-inspection is acceptable would agree it is not optimal, whereas a required cooling-off period was cited by many firms as harmful to audit quality. An exemption based on size would thus preclude larger firms from performing a quality risk response that they believe is appropriate, while permitting smaller firms to do so.

D. Task Force recommendation

Given the opposition expressed by the majority of respondents, the reasons therefor, including the belief that using the former engagement partner enhances quality, and the potential for the unintended negative consequences to audit quality, including fewer firms performing audits or firms performing fewer engagement quality reviews, as well as other mechanisms in place that support the performance of an objective audit, the consensus of the Task Force is that it would not be appropriate to implement the requirement for a cooling-off period of any length for audits of non-issuers in the U.S. When determining whether to provide for a principles-based solution or an exemption (rules) based solution, similar to the considerations above for self-inspection, the Task Force recommends safeguards approach rather than an exemption-based approach. They also recommend that application guidance be updated to reflect that a cooling-off period may be a response to the self-review threat.

The following revisions could be made if a cooling-off period is not required. These revisions are consistent with those suggested in the ASB comment letter on the IAASB QM standards ED.

19. The firm's policies or procedures established in accordance with paragraph 18(b) should also address threats to objectivity created by an individual being appointed as the engagement quality reviewer after previously serving as the engagement partner. ~~Such policies or procedures should specify a cooling-off period of two years, or a longer period if required by relevant ethical requirements, before the engagement partner can assume the role of engagement quality reviewer. (Ref: par. A16–A17)~~

~~A16. On recurring engagements, the matters on which significant judgments are made often do not vary. Therefore, significant judgments made in prior periods may continue to affect judgments of the engagement team in subsequent periods. Therefore, the ability of an engagement quality reviewer to perform an objective evaluation of significant judgments is 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 proposed SQMS 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.~~ ***Policies and procedures designed to maintain the objectivity of an engagement quality reviewer who served as the engagement partner on the previous year's engagement may address the following areas:***

- ***The extent of changes in the matters on which significant judgments are made and the facts and circumstances around those significant judgments compared to the period(s) in which the individual was the engagement partner. For example, if a new accounting pronouncement has been implemented, 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.***
- ***The procedures and incentives placed by the firm's system of quality management on objective reviews (for example, the engagement quality reviewer would not be penalized for identifying a misstatement related to a year in which the reviewer was the engagement partner)***

A17. A firm may 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. 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.

Question for the ASB:

2. Does the ASB support the recommendation of the Task Force to remove the required cooling-off period and updates shown above to related application guidance?

Issue #3: Effective Date of the Proposed Standards

A. Background

There are two aspects of the effective date that need consideration: one is the implementation period (how long after issuance the standards become effective) and the other is the effective date itself.

- **Implementation period (between issuance and the effective date)**

Assuming the standards are finalized in the second quarter of 2022, the effective date proposed in the exposure draft proposed “as of”⁷ December 15, 2023, for QM 1 results in an 18-month implementation period. Many respondents expressed the belief that 24-30 months would be more appropriate. One respondent noted that the ASB’s comment letter on the IAASB QM Standards exposure draft recommended a 24-month implementation period. Delaying the effective date by one year (i.e., as of December 31, 2024) would result in a 30-month implementation period. This would also provide time for service providers and other regulators to develop implementation material or update their guidance.

- **Effective Date: Month and day of the effective date**

Auditing standards are generally effective for audits of financial statements for periods ending on or after December 15 [year]. December 15 is used to accommodate for the possibility of 52/53-week fiscal years. That reason is not relevant to the SQMSs. More relevant is a firm’s peer review year-end date. Depending on their practice, firms generally have a 12/31, 3/31, 6/30 or 9/30 year end, with December 31 being probably the most popular. Both SQCS No. 7 and No. 8 were effective as of January 1 (2009 and 2012, respectively).

B. Feedback from Roundtables and Comment Letters

Roundtable feedback

The implementation period was not the subject of a poll at the roundtables.

Comment Letter Responses (Agenda item 4F: Implementation period)

Comments by respondents indicated concern about most firm’s ability to implement the proposed effective date and the need for implementation guidance to be available as soon as possible after the standards are issued.

| | 18 mos. ok | 18 mos. Only w/ guidance | Delay | Never/ Wait for PCAOB |
|-------------|------------|-----------------------------|-------|--------------------------|
| Type | # | # | # | # |
| Firm: Big 4 | | | | 1 |
| Firm: MFG | 3 | 2 | 7 | |

⁷ An “as of” effective date means that early *implementation* is necessary for the standard to have been adopted by the effective date.

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| | | | | |
|-------------------------------|-----------|----------|-----------|----------|
| Firm: G400 | 1 | 1 | 5 | |
| Firm: Medium | | | 1 | |
| Firm: Smaller | 1 | | 2 | |
| Firm: Very small | | | 3 | |
| Firm: Sole Practitioner | 1 | | 5 | |
| Firm: Small | | 2 | 4 | |
| ➤ Firm: Subtotal | 6 | 5 | 27 | 1 |
| State Societies | 3 | 2 | 13 | 1 |
| Regulators and State Auditors | 2 | | 2 | |
| Individuals | 1 | | | 1 |
| ➤ Grand Total | 12 | 7 | 42 | 3 |

C. Options

The Task Force considered the following options (For simplicity's sake, these are presented in terms of QM 1), which are explained in further detail below:

| Potential Option | Potential Implementation Date |
|---|---|
| 1. Tie effective date to a date that allows each firm to have a peer review performed between the issuance of the proposed standards and their effective date | The first day of a firm's peer review year beginning after December 31, 2024 such that firms would implement the standard on a rolling basis, over a three-year period |
| 2. Tie effective date to the firm's peer-review year-end (not year of peer review) | The first day after a firm's peer review year-end beginning after December 31, 2024. (i.e., for firms with a peer review year-end of December 31, 2024, the standards would be effective January 1, 2025. For firms with a peer review year-end of June 30, 2025, the standards would be effective July 1, 2025). |
| 3. Date certain | As of January 1, 2025 |

1. *An effective date that allows a firm to undergo one peer review between the issuance of the standards and their implementation.*

Respondents noted that firms could benefit from undergoing peer review before the effective date, so as to obtain feedback on changes being made in advance of the effective date. Accordingly, the effective date could be linked to the year in which firms have their peer review, with having firms adopt the proposed standard as of the first day of the year after their first peer review after January 1, 2024. This would result in some firms having to implement the standard two or three years before other firms do, based on where they were in the peer review cycle when the standard was issued.

Alternatively, firms that had not undergone peer review in the 30 months between the issuance of the standards and January 1, 2025 (that is, firms with peer review years ending in 2024) could be given a one-year extension to the first day of their peer review year after December 31, 2025. That would allow every firm the chance to have had at least one peer review between the time the standards are issued and the effective date, and at least one year between that peer review and the effective date.

The Task Force considered this approach and concluded that it was too complex, and would result in too much inconsistency in when the standards were effective for various firms.

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2. *An effective date that is tied to a firm’s peer-review year-end date.*

A few respondents expressed concern about implementation of the proposed standards in the middle of a peer review year. One respondent expressed concern as follows: if the ASB retains a fixed effective date, how will peer reviewers evaluate a firm’s system of quality when no single system of quality will have been in effect for the entirety of the year under review?

One firm suggested a rolling implementation date. Under this scheme, a firm would adopt the proposed standards as of the first day of their peer review year after December 15, 2024. (Note, this is not the same as the year in which peer review takes place). For example, the effective date for a firm whose peer review year ends on December 31 would adopt January 1, 2025, and a firm whose peer review year ends on September 30 would adopt the QCM standards on October 1, 2025. All firms would be required to have designed and implemented the system of quality management required by QM 1 within calendar 2025.

3. *An effective date of January 1, 2025.*

A “date certain” is consistent with the effective date of previous quality control standards. It is also straightforward and the same for every firm. This would allow an implementation period of 30 or 42 months.

The effective dates of SQMS 2 and the QM SAS, which apply to engagements, would be changed accordingly, such that calendar-year 2025 engagements would be the first for which they would be effective.

If QM 1 has an effective date of January 1, 2025, then

- Proposed SQMS No. 2 would be effective for
 - a. audits or reviews of financial statements for periods ~~beginning~~ **ending** on or after December 15, ~~2023~~**2025**, and
 - b. other engagements in the firm’s accounting and auditing practice beginning on or after ~~December 15, 2023,~~ **January 1, 2025**. An engagement in the firm’s accounting and auditing practice begins when an engagement letter or other agreement to perform attest services is signed, or when the firm begins to perform the engagement, whichever is earlier.⁸
- The proposed QM SAS would be effective for engagements conducted in accordance with generally accepted auditing standards for periods ~~beginning~~ **ending** on or after December 15, ~~2023~~**2025**.

Although the majority of respondents who responded to the question indicated that the effective dates were clear, there is enough confusion to indicate the need to address the effective dates in implementation guidance and awareness efforts after the standards are issues.

If QM 1 has a “rolling” effective date during 2025 based on a firm’s peer-review year-end, then

- Proposed SQMS No. 2 would be effective for
 - a. audits or reviews of financial statements for periods ~~beginning~~ **ending** on or after December 15, ~~2023~~**2025**, and

⁸ See ET section 0.400.39 of the AICPA Code of Professional Conduct. All ET sections can be found in AICPA *Professional Standards*.

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- b. other engagements in the firm’s accounting and auditing practice beginning on or after ~~December 15, 2023~~, **the first day after a firm’s peer review year-end beginning after December 31, 2024**. An engagement in the firm’s accounting and auditing practice begins when an engagement letter or other agreement to perform attest services is signed, or when the firm begins to perform the engagement, whichever is earlier.⁹
- The proposed QM SAS would be effective for engagements conducted in accordance with generally accepted auditing standards for periods ~~beginning~~ **ending** on or after December 15, ~~2023~~**2025**.

D. Task Force recommendation

The Task Force recommends that the effective date be pushed back one year and be tied to a firm’s peer-review year-end date (option 2 above).

Question for the ASB:

3. Does the ASB agree with the Task Force recommendation regarding the effective date of the Proposed Standards?

Issue #4: Dating of the report when EQR is performed

A. Background

Paragraph .41 of QC section 10, and paragraph .21 of AU-C section 220, require that when an engagement quality control review is performed, the engagement quality control review is completed before the report is released. The exhibit to QC section 10 and AU-C Appendix B, “Substantive Differences Between the International Standards on Auditing and Generally Accepted Auditing Standards,” both state 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.”

Consistent with ISQM 2 and ISA 220 (Revised), paragraph 24b of proposed SQMS No. 2 and paragraph 36d of the proposed QM SAS require that the engagement quality review be completed before the report is dated.

B. Feedback from Roundtables and Comment Letters

Roundtable poll results

| Does your firm currently require that the engagement quality review be completed before the report is dated or before the report is released? | # | % |
|---|------------|-----------|
| a-Before the report is dated. | 154 | 58 |
| b-Before the report is released. | 113 | 42 |
| | 267 | |

⁹ See ET section 0.400.39 of the AICPA Code of Professional Conduct. All ET sections can be found in AICPA *Professional Standards*.

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| | | |
|---|------------|-----------|
| a-Changing would be very challenging for most engagements. | 45 | 34 |
| b-Changing would not be challenging | 89 | 66 |
| | 134 | |

Comment letter responses: (Agenda item 4G: Dating of report when EQR performed)

| | Before report is dated | Before report is released |
|-------------------------------|------------------------|---------------------------|
| Type | # | # |
| Firm: Big 4 | 4 | |
| Firm: MFG | 9 | 1 |
| Firm: G400 | 2 | 4 |
| Firm: Medium | 1 | 1 |
| Firm: Smaller | 2 | 1 |
| Firm: Very small | 1 | 2 |
| Firm: Sole Practitioner | 1 | |
| Firm: Small | 3 | 1 |
| ➤ Firm: Subtotal | 23 | 10 |
| State Societies | 8 | 5 |
| Regulators and State Auditors | 1 | 3 |
| Individuals | 1 | |
| ➤ Grand Total | 33 | 18 |

The majority of respondents indicated support for the proposed requirement to complete the engagement quality review prior to dating the audit report. One respondent (an association of small firms) stated that they “considered this requirement and did not have any reason for opposition, but we were also unsure that this represents an issue. As a result, we are unsure why this change is recommended.”

Some who opposed the requirement did so for theoretical reasons:

No, it should not be a requirement that the engagement quality review be completed prior to dating the audit report. While our quality assurance monitoring process may perform both types of reviews (pre-dating and pre-issuance), depending on risk, we do not require the review to be completed before the report is dated. We understand having the review dated prior to the report date serves the outcome-based objectives of the proposed standards. It may also be more efficient in terms of finishing the audit and avoiding rework later, and in setting report delivery expectations with the client.

However, requiring the review to be complete before the report is dated embeds the quality monitoring process into the audit process, almost in an additional supervisory review form, and does not allow for a complete evaluation of the engagement partner’s judgment as it relates to taking responsibility for quality and significant decisions during and at the end of the audit (e.g. evaluating the sufficiency and appropriateness of audit evidence). The outcome-based objectives could still be attained by having the engagement quality review completed before report issuance, which would allow for a more complete assessment of audit quality and personnel.

Most of those who opposed the requirement did so for logistical reasons. Many of those who opposed, but not all, are small firms who expressed concern that the AICPA is trying to put them “out of business” and do not support convergence with IAASB standards because they have no engagements that require IAASB standards. From their perspective, imposing this requirement— which is an existing difference between QC

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section 10 and ISQC 1 — is placing convergence above scalable standards. This requirement won't make a meaningful difference in practice quality, because it is common practice, but it will make things harder for smaller firms who are trying to do the right thing by having an EQR in the first place.

A few respondents requested additional application material clarifying what is meant by "completion" of the EQR, specifically what is allowed for the file assembly guidelines in which some documentation can be completed after release of report.

C. Options

The Task Force discussed two options with regard to this requirement.

1. Keep the requirement as exposed

The majority of respondents, both from the roundtables and the comment letters, require that the EQR be completed before the report is dated, and changing to that policy would not be challenging for the majority of firms for which it is not current practice. This requirement illustrates the principle that "best practices become requirements".

2. Keep the extant requirement

18 (35%) of the 51 comment letter respondents who addressed this issue, and 42% of roundtable participants polled, did not support this requirement. Challenges for completing the engagement quality review prior to the dating of the report focused most commonly on situations when the engagement quality reviewer is external to the firm. These included challenges with coordination of the timing of the engagement quality reviewer's work in relation to dating and obtaining representation letters from management and those charged with governance and the timing of obtaining legal representation letters and updates thereto. The extant standard allows firms flexibility, and the effect on assurance quality of removing that flexibility is unlikely to be material.

D. Task Force Recommendation

When discussing the recommendation, one Task Force member expressed concern that there may be more pressure to issue the report if the report is dated before the EQR is complete, which supports retaining this requirement. Conversely, one Task Force member expressed concern that although requiring the EQR be completed before the report is dated is a best practice, not all best practices need to become requirements for the sake of convergence – especially if the effect is unlikely to materially change practice. The Task Force discussed whether creating this requirement would be a sufficient enhancement to audit quality to warrant change, given the feedback received related to the flexibility permitted in the extant standards. Upon consideration of the feedback of the majority of respondents that either already adopted this practice or determined it would not be challenging to adopt, the Task Force recommends retaining the requirement.

Question for the ASB:

4. Does the ASB agree with the Task Force recommendation regarding retaining the requirement to complete the engagement quality review prior to dating the audit report?

Additional Agenda Items Presented

- Item 4A, List of Respondents, by Comment Letter Number and by Type and Firm Size
- Item 4B, QM Comment Letter Analysis: Cost-Benefit and Lack of Scalability
- Item 4C, QM Comment Letter Analysis: Self-inspection
- Item 4D, QM Comment Letter Analysis: Paragraph A168
- Item 4E, QM Comment Letter Analysis: Cooling-off period
- Item 4F, QM Comment Letter Analysis: Implementation period
- Item 4G, QM Comment Letter Analysis: Dating the report when an EQR is performed
- Item 4H, Additional background information related to the Discussion Paper

Ms. Lord and Mr. Heath will use this issues paper for discussion purposes.