

## Quality Management

### I. Objective

- A. To provide the ASB with specific wording changes to address the direction provided to the Quality Management Task Forces at the ASB's October 2021 meeting on four specific issues to the following proposed standards:
- [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* , (collectively the "Proposed QM Standards").
- B. To review proposed revisions to the proposed QM SAS in response to comments received.

### 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. Issues for ASB Consideration

This discussion memorandum presents the Task Force response to the direction provided by the ASB at its October 2021 meeting on the following issues:

<b>Issue #</b>	<b>Title</b>
<a href="#">Issue 1</a>	Self-inspection (SQMS 1)
<a href="#">Issue 2</a>	Cooling-off period (SQMS 2)
<a href="#">Issue 3</a>	Effective date (all proposed QM standards)
<a href="#">Issue 4</a>	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.

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**Issue #1: Self-inspection**

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**A. Background**

Extant QC Section 10<sup>1</sup>, unlike ISQC 1 and ISQM 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 a triennial 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 ISQM 1 in order to obtain feedback on the proposed prohibition of self-inspection.

Feedback provided by commentators noted that preclusion of self-inspection is inconsistent with a risk-based approach. Further, particularly for smaller firms, the cost of precluding self-inspection (for example, costs associated with unintended negative consequences, including potentially driving small firms away from an assurance practice) seems to exceed the benefits. Accordingly, at its October 2021 meeting, the ASB directed that the proposed standard not prohibit self-inspection, while also making clear through the wording of paragraph 40 that it is preferable not to self-inspect, and add application material addressing the risks thereof and appropriate safeguards to overcome such threats.

**B. Proposed revisions**

The following revisions to QM 1 are proposed:

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| <p>40. The firm should establish policies and procedures that</p> <ul style="list-style-type: none"><li>a. require the individuals performing the monitoring activities to have the competence and capabilities, including sufficient time, to perform the monitoring activities effectively.</li><li>b. address the objectivity of the individuals performing the monitoring activities. Such policies or procedures should <del>prohibit</del> <b>be based on the premise that objectivity is enhanced when</b> the engagement team members or the engagement quality reviewer of an engagement <del>from</del> <b>are not involved in</b> performing any inspection of that engagement. (Ref: par. A168–A169B)</li></ul> |
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*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 Task Force is proposing that the last sentence in paragraph A168 be revised to address this concern. Other revisions

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<sup>1</sup> Paragraph 52c of QC section 10.

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.~~

**A 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. **For example, an engagement partner who is responsible for client acceptance also is responsible for monitoring compliance with the firm's client acceptance policies and procedures.**

**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 may use network services or a service provider to perform the monitoring activities. ***This standard does not preclude an individual from performing monitoring activities, including inspections, of their own compliance with a quality management system. However, such self-inspections may be less effective than compliance inspections by another qualified individual. When one individual inspects their own compliance, the firm has a higher risk that noncompliance with policies and procedures will not be detected. 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 their own performance, assess their own strengths and weaknesses, and maintain an attitude of continual improvement.***

**A169A. Responses that provide safeguards against the self-review threat and lessen the likelihood of deficiencies in the system of quality management include the following actions:**

- *Using network services or a service provider to perform the monitoring activities, thus eliminating the self-review threat*
- *Fostering a commitment to continuing professional education and providing effective training programs so that personnel stay current on accounting, auditing, and quality management standards*
- *Providing training on how to perform monitoring inspections and requiring the use of peer review or other inspection checklists*
- *Requiring the passage of time after the completion of an engagement before monitoring inspections are performed*

**A169B. Responses that lessen the likelihood of deficiencies in the system of quality management, and may be particularly helpful when self-inspections are performed, include the following actions:**

- *Establishing 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*
- *Establishing consultation policies that provide reasonable assurance engagement teams will consult when they encounter technical accounting and auditing difficulties*

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- *Taking corrective action in response to the results identified by the firm's internal monitoring, peer review results or other external inspections, for example, inspections by DOL, GAO, or HUD*
- *Requiring the use of an external service provider to perform either engagement quality reviews or monitoring procedures when*
  - *deficiencies identified by the firm's peer reviewers or other external inspections indicate that self-inspection is not effective*
  - *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*

### Questions for the ASB:

1. Does the ASB agree that the revisions above reflect the direction of the ASB at its October meeting?
2. Does the ASB have any suggestions for improving the wording of the revisions?

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

### A. Background:

After exposure of their proposed quality management standards, the IAASB added a requirement for a two-year cooling off period before a former engagement partner on a client can serve as the engagement quality reviewer on the engagement for that client.

The ASB has determined not to require a two-year cooling off period (or of any length) for engagement quality reviewers of audits of non-issuers in the U.S. (consistent with the opposition expressed by the majority of respondents), for reasons including the following:

- The inconsistency of requiring engagement quality reviewers to rotate when under AICPA professional standards, engagement partner rotation is not required
- Potential unintended negative consequences to audit quality, including fewer firms performing fewer engagement quality reviews, due to a lack of ability to meet the cooling-off requirements
- Other mechanisms in place that support the performance of an objective audit, including professional standards that require objectivity and professional skepticism and a peer review process that evaluates firm systems of quality control
- The belief that using the former engagement partner may enhance quality

The ASB directed that application material be updated to reflect that a cooling-off period may be an appropriate response to the self-review threat.

### B. Proposed revisions

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. **To address threats to objectivity, 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 whether to apply a cooling-off period and the length of that period depends upon the facts and circumstances of the engagement. A17.** 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.

**A17. Other 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 related to the matters for 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)**

**Question for the ASB:**

3. Does the ASB agree that the revisions above reflect the direction of the ASB at its October meeting?
4. Does the ASB have any suggestions for improving the wording of the revisions?

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**Issue #3: Effective Date of the Proposed Standards**

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**A. Background**

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. 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.

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? Several respondents suggested a rolling implementation date, tied to the firm’s peer review year-end. ASB members also were concerned about early adoption of the standard and its effect on peer review.

The ASB agreed that it is appropriate to provide sufficient time for every firm to undergo a peer review between the issuance of the standards and the effective date. ASB members liked the concept of a rolling implementation date but found it confusing to apply. The ASB directed staff to meet with Peer Review staff to obtain their perspective and bring a recommendation back to the Board.

**B. Early adoption considerations**

Proposed SQMS 1 has an “as of” effective date. An “as of” means that early *implementation* is necessary for the standard to have been adopted by the effective date. Firms need to start implementation in advance of “adopting” the standard; that is,

- design and implement the risk assessment process,
- evaluate whether quality risks exist for which the firm does not have appropriate responses,
- determine whether responses exist for which the firm does not have corresponding quality risks, and
- make changes to their system of quality management accordingly.

The IAASB *First-Time Implementation Guide: ISQM 1* states the following regarding implementation:

- The firm may take a phased approach to implementation, building up to the effective date. For example, this may entail designing and implementing policies or procedures for certain components and commencing the operation of those policies or procedures at various stages before the effective date. In this case, the firm would establish its own effective date for each of the policies or procedures.
  - This approach may lessen the impact of many changes all at once.
  - Although the firm would have implemented policies or procedures before the effective date, the firm would not be considered as “early adopting” SQMS 1 because only a portion of the new SOQM has been implemented.
- The firm may commence operation of all the new and revised policies or procedures at the effective date.
- The firm may pilot or test the new SOQM prior to the effective date. The pilot, or testing, may be on certain areas of the SOQM, or by a selection of engagements teams. The SOQM would not be considered in operation until the firm has formally implemented and commenced operation of the new SOQM in its entirety.

The following address concerns about having a “dual system” in relation to implementing the new QM standards prior to the effective date:

- The changes resulting from the new standard are mostly additive (risk assessment process and new component of information and communication). For example, a firm may pilot its risk assessment process in 2024, its peer review year (for purposes of this example). The firm's peer reviewer may be asked to evaluate the risk assessment process and provide feedback. The firm's risk assessment process may be deficient in 2024, but as long as the firm has not yet *adopted* the new system of quality management, the firm's system of quality control would not be considered deficient in 2024 because the extant standard does not require a risk assessment process. However, the firm would have to remediate those deficiencies by the effective date of SQMS 1.
- The extant standard is more prescriptive than the proposed standards. If a firm stops performing a requirement of the extant standard as a result of performing a risk assessment (as part of implementing the new standard) and deciding that the required response is not necessary to address a quality risk, the firm should be able to provide documentation of the justification for the departure and how the alternative policies or procedures in the circumstances were sufficient to achieve the objectives of the presumptively mandatory requirement.

#### **C. Feedback from discussion with Peer Review Staff**

Peer Review staff explained that, from their perspective, it is not necessary to have an effective date that coincides with a firm's peer review “fiscal year-end”. Peer Review deals with circumstances that affect changes in a firm's system of quality control during any given peer review year (e.g., mergers and changes of peer review year-ends) on a regular basis. They also deal with firms that make changes to improve their systems on a continuous basis.

Peer Review's primary consideration for the effective date, consistent with what many respondents said, is having sufficient time so that each firm would have the benefit of undergoing one peer review before the standards become effective. This would allow the peer reviewer to inform and educate the firm about the upcoming changes and provide feedback on the firm's efforts, if any have been done at that date, to implement the standards, as discussed above.

#### **D. Effective date options and recommendation**

If each firm undergoes peer review once every three years, then setting an effective date that is at least three years from the issuance of the standard allows every firm to have undergone one peer review between the issuance of the standard and the effective date. This way every firm has the same effective date, and it is simple to understand.

Although this would result in a longer implementation period than has been customary for ASB standards, FASB tends to have implementation periods of similar length. The public interest is best served by allowing firms sufficient time to correctly implement the standard.

The standards are expected to be approved for issuance in May 2022.

#### *Options considered*

The Task Force discussed an effective date of 1/1 for proposed QM 2 and the proposed QM SAS but decided not to change the convention of using the 15<sup>th</sup> of the month, because of the possibility of entities with 52/53-week years. The Task Force also considered an effective date of 1/1 for QM 1, but concluded that being consistent with the effective date of the other standards would be less confusing. Accordingly,

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the Task Force recommends that the effective date as exposed be revised only to change the year from 2023 to 2025.

	Exposure draft	Proposed
QM 1	Systems of quality management in compliance with proposed SQMS No. 1 would be required to be designed and implemented by December 15, 2023, and the evaluation of the system of quality management required by proposed SQMS No. 1 <sup>2</sup> would be required to be performed within one year following December 15, 2023.	Systems of quality management in compliance with proposed SQMS No. 1 would be required to be designed and implemented by December 15, 2025, and the evaluation of the system of quality management required by proposed SQMS No. 1 <sup>3</sup> would be required to be performed within one year following December 15, 2025.
QM 2	Proposed SQMS No. 2 would be effective for <ul style="list-style-type: none"> <li>a. audits or reviews of financial statements for periods <u>beginning</u> on or after December 15, 2023, and</li> <li>b. other engagements in the firm’s accounting and auditing practice <u>beginning</u> on or after December 15, 2023.</li> </ul>	Proposed SQMS No. 2 would be effective for <ul style="list-style-type: none"> <li>a. audits or reviews of financial statements for periods <u>beginning</u> on or after December 15, <b>2025</b>, and</li> <li>b. other engagements in the firm’s accounting and auditing practice <u>beginning</u> on or after December 15, <b>2025</b>.</li> </ul>
QM SAS	The proposed QM SAS would be effective for engagements conducted in accordance with generally accepted auditing standards for periods <u>beginning</u> on or after December 15, 2023.	The proposed QM SAS would be effective for engagements conducted in accordance with generally accepted auditing standards for periods <u>beginning</u> on or after December 15, <b>2025</b> .

**Question for the ASB:**

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

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

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**A. Background**

Paragraph .41 of extant QC section 10, and paragraph .21 of extant 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

<sup>2</sup> See paragraphs 54–55 of proposed SQMS No. 1.

<sup>3</sup> See paragraphs 54–55 of proposed SQMS No. 1.

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 extant 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 24*b* of proposed SQMS No. 2 and paragraph 36*d* of the proposed QM SAS require that the engagement quality review be completed before the report is dated.

At its October 2021 meeting, the ASB decided to retain the extant requirement that the EQR has to be completed before the report is released, and not before the report is dated. The ASB believes that the flexibility of using the report release date, the logistical cost of restricting the time available for completing the EQR, and the potential for unintended negative consequences outweigh the benefits of this prescriptive requirement.

## B. Proposed revisions

Note for purposes of this issues paper, footnotes have been omitted from the following paragraphs.

QM 2

7. For purposes of the SQMSs, the following terms have the meanings attributed as follows:

**Engagement quality review.** An objective evaluation of the significant judgments made by the engagement team and the conclusions reached thereon, performed by the engagement quality reviewer and completed ~~on or before the date of the~~ engagement report **is released**.

...

24. The firm should establish policies or procedures regarding the performance of the engagement quality review that address the following:

- a. The engagement quality reviewer’s responsibilities to perform procedures in accordance with paragraphs 25–26 at appropriate points in time during the engagement to provide an appropriate basis for an objective evaluation of the significant judgments made by the engagement team and the conclusions reached thereon
- b. The responsibilities of the engagement partner in relation to the engagement quality review, including that the engagement partner is precluded from ~~dating~~ **releasing** the engagement report until notification has been received from the engagement quality reviewer in accordance with paragraph 27 that the engagement quality review is complete (Ref: par. A24–A25)

A24. Proposed Statement on Auditing Standards (SAS) *Quality Management for an Engagement Performed in Accordance With Generally Accepted Auditing Standards* establishes the requirements for the engagement partner in audit engagements for which an engagement quality review is required, including

- determining that an engagement quality reviewer has been appointed;
- cooperating with the engagement quality reviewer and informing other members of the engagement team of their responsibility to do so;
- discussing significant matters and significant judgments arising during the audit

engagement, including those identified during the engagement quality review, with the engagement quality reviewer; and

- not ~~date~~ **releasing** the auditor's report until the completion of the engagement quality review.

**A24A. If the engagement quality review is completed after the report is dated and identifies instances where additional procedures are needed or additional evidence is required, the date of the report is changed to the date when the additional procedures have been satisfactorily completed or the additional evidence has been obtained, in accordance with the professional standards applicable to the engagement. Such instances may be indicative of a deficiency or deficiencies in the firm's system of quality management.**

A28. The timing of the procedures performed by the engagement quality reviewer may depend on the nature and circumstances of the engagement or the entity, including the nature of the matters subject to the review. Timely review of the engagement documentation by the engagement quality reviewer throughout all stages of the engagement (for example, planning, performing, and reporting) allows matters to be promptly resolved to the engagement quality reviewer's satisfaction ~~on or~~ before the ~~date~~ **release** of the engagement report. For example, the engagement quality reviewer may perform procedures in relation to the overall strategy and plan for the engagement at the completion of the planning phase. Timely performance of the engagement quality review also may reinforce the exercise of professional judgment and, when applicable to the type of engagement, professional skepticism, by the engagement team in planning and performing the engagement.

Note that first sentence of proposed paragraph A24A is paragraph A43 of extant QC section 10. The second sentence is newly proposed guidance.

QM SAS

12. For purposes of GAAS, the following terms have the meanings attributed as follows:

**Engagement quality review.** An objective evaluation of the significant judgments made by the engagement team and the conclusions reached thereon, performed by the engagement quality reviewer and completed ~~on or~~ before the ~~date of the~~ engagement report **is released**.

36. For audit engagements for which an engagement quality review is required, the engagement partner should (Ref: par. A103)

- a. determine that an engagement quality reviewer has been appointed,
- b. cooperate with the engagement quality reviewer and inform other members of the engagement team of their responsibility to do so,
- c. discuss significant matters and significant judgments arising during the audit engagement, including those identified during the engagement quality review, with the engagement quality reviewer, and
- d. not ~~date~~ **release** the auditor's report until the completion of the engagement quality review. (Ref: par. A104–A106)

**Documentation**

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- 41.** In applying AU-C section 230, *Audit Documentation*, the auditor should include the following in the audit documentation: (Ref: par. A117–A120)
- a. Significant issues identified, relevant discussions with personnel, and conclusions reached with respect to
    - i. fulfillment of responsibilities relating to relevant ethical requirements, including those related to independence
    - ii. the acceptance and continuance of the client relationship and audit engagement
  - b. The nature and scope of, and conclusions resulting from, consultations undertaken during the audit engagement and how such conclusions were implemented
  - c. If the audit engagement is subject to an engagement quality review, that the engagement quality review has been completed ~~on or~~ before the **date release** of the auditor's report
- A104.** AU-C section 700 requires the auditor's report to be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements. If applicable to the audit engagement, proposed SQMS *Engagement Quality Reviews* and this proposed SAS require that the engagement partner be precluded from ~~dating~~ **releasing** the engagement report until notification has been received from the engagement quality reviewer that the engagement quality review is complete. For example, if the engagement quality reviewer has communicated to the engagement partner concerns about the significant judgments made by the engagement team or that the conclusions reached thereon were not appropriate, then the engagement quality review is not complete.

### **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?

### **IV. Revisions to the Proposed Quality Management SAS**

The QM 2 Task Force did not identify any additional substantive issues raised by respondents to the Exposure Draft that warranted proposed revisions to the requirements of the proposed QM SAS. Comments from respondents on the QM SAS are provided in agenda item 5A, and proposed revisions to the QM SAS are provided in agenda item 5B.

### **Question for the ASB:**

5. Does the ASB agree with the revisions proposed to the QM SAS?

### **Additional Agenda Items Presented**

- Item 5A, Comment Letter Analysis: QM SAS
- Item 5B, Proposed QM SAS, marked with suggested revisions.

Ms. Lord and Mr. Heath will use this issues paper and agenda item 5B for discussion purposes.