

Executive Summary

Overview

The Auditing Standards Board (ASB) has issued the following standards (collectively, the QM standards):

- Statement on Quality Management Standards (SQMS) No. 1, *A Firm's System of Quality Management*
- SQMS No. 2, *Engagement Quality Reviews*
- Statement on Auditing Standards No. 146, *Quality Management for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*

SQMS No.1 supersedes Statement on Quality Control Standards (SQCS) No. 8, *A Firm's System of Quality Control* (QC section 10), and SAS No. 146 supersedes SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification*, as amended, section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards* (AU-C section 220).¹

The biggest change is the introduction of a risk-based approach to achieving quality objectives, which helps identify and address risks specific to their practice, and creates a more scalable approach to quality for all firms.

The QM standards, among other things, do the following:

- Increase firm leadership responsibilities and accountability, and improve firm governance
- Introduce a risk-based approach focused on achieving quality objectives
- Address technology, networks, and the use of external service providers
- Increase focus on the continual flow of information and appropriate communication internally and externally
- Promote proactive monitoring of quality management systems and timely and effective remediation of deficiencies
- Clarify and strengthen requirements for a more robust engagement quality review (EQR)
- Enhance the engagement partner's (EP's) responsibility for audit engagement leadership and audit quality

¹ All QC and AU-C sections can be found in AICPA *Professional Standards*.

Effective Date

- Systems of quality management in compliance with SQMS No. 1 are required to be designed and implemented by December 15, 2025, and the evaluation of such² is required to be performed within one year following December 15, 2025.
- SQMS No. 2 is effective for
 - a. audits or reviews of financial statements for periods beginning on or after December 15, 2025, and
 - b. other engagements in the firm’s accounting and auditing practice beginning on or after December 15, 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.³
- SAS No. 146 is effective for engagements conducted in accordance with generally accepted auditing standards for periods beginning on or after December 15, 2025.

Introduction

This executive summary provides an overview of the QM standards.

Background

The development of the standards has been influenced by concerns about audit quality, as indicated by the results of peer reviews and studies by other regulators, such as the following:

- Risks to audit quality correlated with audits, reviews, and attestation engagements performed by EPs who perform a low volume of such engagements
- Consistency issues in the performance of engagements and a lack of focus on planning
- Over-reliance on intellectual resources, such as third-party quality control materials, that are not sufficiently tailored to the nature and circumstances of the firm
- Challenges experienced by smaller firms in applying the standards
- A need to improve firm governance and leadership and the culture and tone at the top of the firm

² See paragraphs 54–55 of SQMS No. 1.

³ See ET section 0.400.39 of the AICPA Code of Professional Conduct. All ET sections can be found in AICPA *Professional Standards*.

The ASB has a strategic objective to converge with the standards of the International Auditing and Assurance Standards Board (IAASB). Accordingly, SQMS Nos. 1 and 2 and SAS No. 146 were developed using International Standard on Quality Management (ISQM) 1, *Quality Management for Firms That Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*; ISQM 2, *Engagement Quality Reviews*, and International Standard on Auditing 220 (Revised), *Engagement Quality Management for an Audit of Financial Statements*, respectively, as the base starting point. The ASB took into consideration that the PCAOB issued Concept Release in December 2019 that considers using ISQM 1 as a starting point for a future PCAOB standard.

In converging, the ASB has used the terms *quality management* and *engagement quality review*, instead of the terms *quality control* and *engagement quality control review*, respectively, used in its current standards. In addition, “Statements on Quality Control Standards” have been retitled “Statements on Quality Management Standards.” These changes were made to reflect the new quality management approach for the firm’s system of quality management in SQMS No. 1, as described in the “Fundamental Aspects of the Standards” section that follows.

Fundamental Aspects of the Standards

SQMS No. 1

A New Approach Focused on Quality Management

The standard takes a new approach that emphasizes the responsibility of firm leadership for proactively managing quality, while at the same time being scalable to deal with differences in the size of firms and nature of the services they provide. The essence of the new approach is to focus firms’ attention on risks that may have an impact on engagement quality. Unlike extant QC section 10, the new approach requires a firm to customize the design, implementation, and operation of its system of quality management (SQM) based on the nature and circumstances of the firm and the engagements it performs. The standard takes a proactive approach to quality management, with an increased emphasis on a continual flow of remediation and improvement.

The Components of the SQM

A SQM addresses the following eight components:

1. The firm’s risk assessment process (new)
2. Governance and leadership (adapted from the leadership responsibilities for quality within the firm component in QC section 10)
3. Relevant ethical requirements (same name as component in QC section 10)
4. Acceptance and continuance of client relationships and specific engagements (same name as component in QC section 10)

5. Engagement performance (same name as component in QC section 10)
6. Resources (adapted from the human resources component in QC section 10)
7. Information and communication (new)
8. The monitoring and remediation process (adapted from the monitoring component in QC section 10)

As indicated by illustration 1, the components are highly integrated and do not operate in a linear manner.

Illustration 1: The components of an SQM



Objective of the Standard

The objective of the standard includes both the *objective of the firm* and the *objective of the SQM*. The *objective of the firm* in the context of the standard is to design, implement, and operate a *SQM* that provides the firm with reasonable assurance that the *objectives of the SQM* are achieved. The *SQM* is designed to achieve the following two objectives:

- a. The firm and its personnel fulfill their responsibilities in accordance with professional standards and applicable legal and regulatory requirements, and conduct engagements in accordance with such standards and requirements.
- b. Engagement reports issued by the firm are appropriate in the circumstances.

An effective SQM provides the firm with reasonable assurance regarding the achievement of the two objectives. In this context, reasonable assurance is not intended to be obtained through independent assurance that the system is effective (that is, for example, by having a peer review every year), but rather it is obtained through the operation of the system as a whole.

Risk Assessment Process

SQMS No. 1 includes a new approach that focuses firms' attention on risks that may have an impact on engagement quality. The firm's risk assessment process is a new component that comprises the process the firm is required to follow in implementing the risk-based approach to quality management.

The risk assessment is a three-step process:

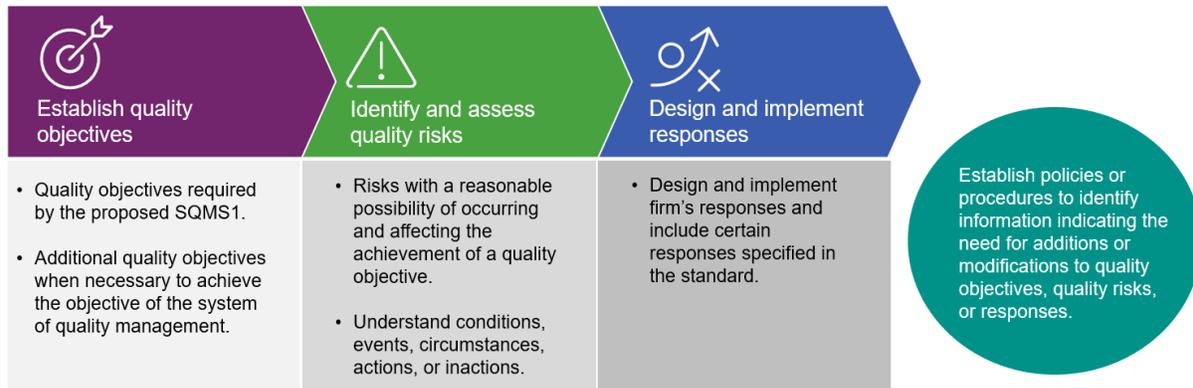
1. *Establish quality objectives.* The standard requires the firm to establish specific quality objectives, based on the nature and circumstances of the firm and its engagements, for each component except risk assessment and monitoring and remediation. The firm is required to establish additional quality objectives when necessary to achieve the objective of the SQM; however, the firm may not find it necessary to establish additional quality objectives.
2. *Identify and assess risks to the achievement of the quality objectives* (referred to in the standard as *quality risks*). Identifying and assessing quality risks involves:
 - a. understanding the factors (that is, the conditions, events, circumstances, actions, or inactions) that may adversely affect the achievement of the quality objectives, and
 - b. identifying and assessing the quality risks by taking into account how and the degree to which the factors may adversely affect the achievement of the quality objectives. (The assessment of identified quality risks does not require formal ratings or scores.)

A risk arises from how, and the degree to which, a condition, event, circumstance, action, or inaction may adversely affect the achievement of a quality objective. Not all risks meet the definition of a *quality risk*.

3. *Design and implement responses to address the quality risks.* The nature, timing, and extent of the firm's responses to address the quality risks are based on, and responsive to, the reasons for the assessments given to the quality risks. Certain responses are specified in the standard; however, the specific responses required by the standard will not be sufficient for the firm to address all its quality risks.

Firms are also required to identify information indicating the need for additions or modifications to quality objectives, quality risks, or responses.

The risk assessment process



Governance and Leadership

SQMS No. 1 provides substantial enhancements to improve the robustness of firms' governance and leadership. In particular, it addresses the expected behavior of firm leadership in setting the tone at the top, the appropriate qualifications of leadership, and holding leadership accountable through performance evaluations. The standard also now addresses the importance of quality in the firm's strategic decisions and actions, including financial and operational priorities, as well as firm leadership's ability to influence decisions about the firm's resources.

The firm is required to assign ultimate responsibility and accountability for the SQM to the firm's CEO, managing partner (or equivalent) or, if appropriate, managing board of partners (or equivalent). In addition, the firm is required to assign the following to designated individuals:

- Operational responsibility for the SQM
- Operational responsibility for specific aspects of the SQM, including compliance with independence requirements and the monitoring and remediation process

Resources

Extant QC section 10 addresses only human resources. SQMS No. 1 expands this to address all resources that the firm needs both to operate the system and to perform engagements. These resources cover:

- technological resources, for example, audit tools or IT applications used by the firm for independence monitoring;
- intellectual resources, for example, the firm's methodology, guidance, templates, or tools; and

- human resources, which may include people outside the firm used in engagements, including component auditors or EQR reviewers who are external to the firm.

The standard focuses on what resources are needed, how they are used and maintained, and whether they are appropriate. The principles-based nature of the requirements relating to resources take into account the variety of resources used and their source. SQMS No. 1 also covers the use of resources from service providers and how to determine that those resources are appropriate for the intended use by the firm. A resource from a service provider could be a methodology, an IT application or people used in an engagement. Services that come from a firm's network, if the firm belongs to a network, are not considered as coming from a service provider (see the section "Network" that follows).

Information and Communication

SQMS No. 1 includes a new component, information and communication. The new component underscores the importance of a continuous flow of information and communication by linking the exchange of information to the firm's culture, so that it is driven from top leadership throughout the firm. The standard requires that the firm establish an information system with processes to identify, capture, process, and maintain information, acknowledging that less complex firms with fewer personnel and direct involvement of leadership may accomplish the objective with less rigorous or detailed policies and procedures.

Both internal and external communication are dealt with in the standard. From an internal perspective, it reinforces the need for robust communication throughout the firm. From an external perspective, the standard reinforces a key public interest issue, which is encouraging firms to be transparent to external parties about their SQM in a relevant, innovative, and proactive manner. In order to drive the proactivity of communication, the standard requires firms to establish policies and procedures that address when communications with external parties are appropriate. In order to promote continual innovation in this area, the standard provides flexibility regarding the specific information communicated, the form of that communication, and the nature, timing, and extent of communication.

Monitoring and Remediation

SQMS No. 1 enhances monitoring activities and shifts the focus from engagement level monitoring to monitoring the entire SQM. The standard promotes more proactive and effective monitoring activities through increased emphasis on tailoring the monitoring activities sufficient to provide a basis for the firm to evaluate the SQM.

The new requirements emphasize factors that firms should consider in designing monitoring activities, rather than prescribing such activities. The nature, timing, and extent of monitoring activities will be driven many firm specific factors, including the following:

- How the underlying system is designed
- The nature and circumstances of the firm and engagements it performs

- The extent of changes to the system
- The results of previous monitoring activities or external inspections

The standard includes a requirement to inspect completed engagements and for EPs to be inspected on a cyclical basis. The firm determines its inspection criteria, including how often to select completed engagements, which completed engagements to select, which EPs to select, and how frequently to select an EP, taking into account factors such as other types of monitoring the firm does, areas of risk, and how the system is designed.

The standard includes requirements for evaluating findings, identifying deficiencies, and evaluating the severity and persuasiveness of the deficiencies. These include a new requirement to investigate the root cause of identified deficiencies. The requirement is intended to be flexible to encourage firms to scale the nature, timing, and extent of the procedures to investigate the root cause of the deficiencies so that they are appropriate and tailored to the circumstances. The evaluation of the severity and pervasiveness of deficiencies is also used by leadership in evaluating the system and concluding whether it achieved its objectives.

A number of improvements were also made to address remediation, including requirements of leadership to assure that remedial actions have been implemented and are effective.

Networks

SQMS No. 1 requires that if a firm is subject to network requirements or uses network services, the firm should understand how those requirements or services fit into the firm's SQM and determine whether the requirement or service needs to be adapted or supplemented to be appropriate for use in the firm's SQM. The standard addresses monitoring activities undertaken by the network and requires the firm to determine the effect of network-level monitoring activities on the firm's monitoring activities. The firm is also required to understand the overall scope of the monitoring activities undertaken by the network across the network firms, including monitoring activities to determine that network requirements have been appropriately implemented across the network firms and to obtain information annually about the results of the network's monitoring activities. This is intended to drive improvements at the network level because firms will need networks to provide more information than they may be providing now.

Scalability

The new quality management approach drives a firm to think about the nature and circumstances of the firm and the engagements it performs in designing, implementing, and operating its SQM, and the approach is focused on achieving quality objectives that are outcome-based. Although this approach is expected to generate multiple benefits for engagement quality, one of the most important benefits is a tailored SQM that is suitable for the nature and circumstances of the firm and the engagements it performs. Thus, this approach is inherently scalable for firms of different sizes and complexity.

SQMS No. 2

Relationship Between SQMS No. 2 and SQMS No. 1

SQMS No. 1 requires that the firm determine when an EQR is an appropriate response to quality risks. SQMS No. 2 contains requirements for policies and procedures addressing the appointment and eligibility of EQR reviewers and performance of EQRs. Although there will no longer be requirements for the performance of EQRs in AU-C section 220, SAS No. 146 contains requirements regarding the EP's responsibilities relating to the EQR, which largely focus on how the EP and the engagement team interact with the EQR reviewer.

Why a Separate Standard?

The requirements for EQRs currently reside in extant QC section 10⁴ and AU-C section 220.⁵ Having a separate standard for EQRs is expected to provide a number of benefits, including the following:

- Clarifying that an EQR can be a response to quality risks for any type of engagement, not only audit engagements
- Placing emphasis on the importance of the EQR
- Facilitating the enhancement of the robustness of the requirements for the eligibility of EQR reviewers and the performance and documentation of the EQR
- Providing a mechanism to more clearly differentiate the responsibilities of the firm and the EQR reviewer
- Increasing the scalability of SQMS No. 1 by not including requirements that would be irrelevant in circumstances when a firm determines that there are no engagements for which an EQR is an appropriate response to address the quality risks

Objective of the Standard

The objectives of the ASB's standards describe the desired outcome of applying the requirements in the standard. Accordingly, the objective of SQMS No. 2 reflects the intended outcome, which is the performance of an objective review of the engagement team's significant judgments and the conclusions reached thereon (that is, an EQR).

⁴ Paragraphs .38-.48 of QC section 10, *A Firm's System of Quality Control*.

⁵ Paragraphs .21-.22 of AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*.

Appointment and Eligibility of Reviewers

The requirements in SQMS No. 2 for the appointment and eligibility of the EQR reviewer (whether internal to the firm or external) are more robust than those in extant QC section 10. Requirements and application material have been added to address the following:

- The eligibility of the individuals within the firm responsible for the appointment of EQR reviewers
- The eligibility of individuals to assist the EQR reviewer in performing the EQR
- The authority, competence, and capabilities of the EQR reviewer, including sufficient time to perform the EQR,
- The EQR reviewer taking responsibility for the performance of the EQR, including that the work of individuals assisting in the EQR is appropriate

The requirements also address compliance with relevant ethical requirements, including that threats to objectivity of the EQR reviewer are eliminated or reduced to an acceptable level.

Performance and Documentation of the EQR

Significant Judgments and Significant Matters

The requirements for the performance of the EQR focus the EQR reviewer's attention on significant judgments and significant matters. The standard includes a stand-back requirement for the EQR reviewer to determine whether the performance requirements of the SQMS with respect to the performance of the EQR have been fulfilled. Once the EQR reviewer has made this determination, the EQR reviewer is required to inform the EP that the EQR is complete.

Timing of the Review

An effective EQR is achieved when the EQRR is involved at appropriate points in the engagement, consistent with when significant judgments are being made by the engagement team because doing so facilitates the resolution of issues in a timely manner. Accordingly, SQMS No. 2 includes a new requirement addressing the EQR reviewer's responsibility to perform the procedures at appropriate points in time during the engagement.

Documentation

SQMS No. 2 includes a specific requirement for the EQR reviewer to take responsibility for documentation of the EQR and adds a requirement that the documentation be filed with the engagement documentation. The standard also includes an overarching requirement for the documentation to be sufficient to enable an experienced practitioner, having no previous

connection to the engagement, to understand the nature, timing, and extent of the EQR procedures performed.

SAS No. 146

Overall Matters

The public interest is served by the consistent performance of quality engagements. SAS No. 146 addresses public interest considerations by encouraging proactive management of quality at the engagement level, emphasizing the importance of the exercise of professional skepticism, enhancing the documentation of the auditor's judgments, and reinforcing the need for robust communications during the audit.

SAS No. 146 addresses how the EP leverages the firm's system and manages quality at the engagement level. The SAS makes clear that the EP has overall responsibility for managing and achieving quality. This includes creating an environment that emphasizes the firm's culture and expected behavior of engagement team members. These behaviors include the responsibility of all engagement team members for quality; the importance of professional ethics, values, and attitudes; and the importance of professional skepticism to a quality audit.

The EP remains ultimately responsible and, therefore, accountable, for compliance with the requirements of the SAS. The phrase *take responsibility for...* is used for those requirements for which the EP is permitted to assign the design or performance of procedures, tasks, or actions to appropriately skilled or suitably experienced members of the engagement team. For other requirements, the SAS expressly intends that the requirement or responsibility be fulfilled by the EP. To fulfill the requirement, the EP may obtain information from the firm or other members of the engagement team, (for example, information to make the required decision or judgment).

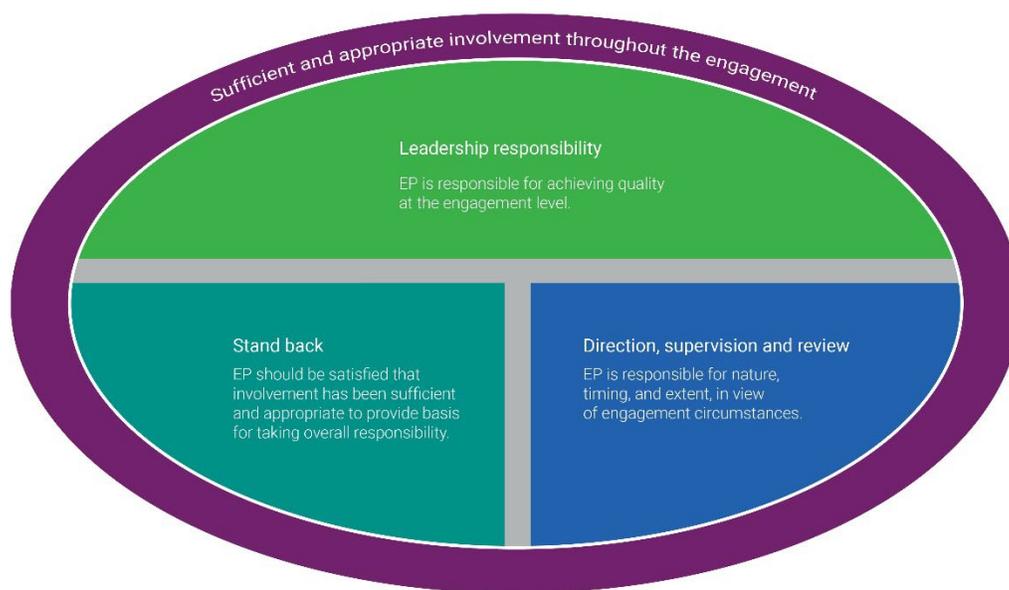
Ordinarily, the engagement team may depend on the firm's policies or procedures in complying with the requirements of this SAS, unless the engagement team's understanding or practical experience indicates that the firm's responses to quality risks are ineffective in context of the specific engagement or information provided by the firm or other parties indicates that the firm's policies or procedures are not operating effectively.

EP's Overall Responsibility for Managing Quality on Audits, Including Engagement Performance and Stand Back

The EP needs to be sufficiently and appropriately involved throughout the engagement as this is fundamental to providing the engagement leadership required to achieve high quality audits and, therefore, to meeting the objective of SAS No. 146. The following diagram illustrates the EP's overall responsibility to manage and achieve quality on the engagement and how it is demonstrated through sufficient and appropriate involvement throughout the engagement, such

that the significant judgments made and the conclusions reached are appropriate given the nature and circumstances of the audit.

The engagement partner's overall responsibility



Group Audit Engagements

Engagement team members in a group audit engagement may include personnel who are external to the firm (for example, engagement team members who are from network firms or are service providers, such as component auditors from firms not within the firm's network). AU-C section 600, *Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors)*, deals with special considerations that apply to an audit of group financial statements, including when component auditors are involved. Application guidance in SAS No. 146 states that the firm or EP may take different actions with respect to component auditors or other personnel who are external to the firm than the actions applicable to firm personnel. Additionally, examples are included in application guidance in SAS No. 146 of considerations that may be made when component auditors are members of the engagement team.⁶ Conforming amendments to AU-C section 300, *Planning an Audit*, clarify in paragraph .09 that the audit plan should include a description of the nature, timing, and extent of the planned direction and supervision of engagement team members and the review of their work. This includes engagement team members who are external to the firm, such as component auditors.

⁶ See paragraphs A24, A25, A38, A54, A60, A76, A80, A91, A92, and A107 of SAS No. 147.

Relevant Ethical Requirements

In addition to enhancing the extant requirements, SAS No. 146 includes requirements regarding the following:

- Understanding of the relevant ethical requirements and whether other members of the engagement team are aware of those requirements and the firm’s related policies or procedures
- Threats to compliance with relevant ethical requirements
- Determining whether relevant ethical requirements, including those related to independence, have been fulfilled

SAS No. 146 also includes new application material that links with the firm-level requirements in SQMS No. 1, describes possible appropriate actions if noncompliance is indicated, and links to the requirement in AU-C section 700, *Forming an Opinion and Reporting on Financial Statements*,⁷ for the auditor’s report to include a statement regarding the auditor’s independence.

Engagement Resources

The EP is required to take responsibility for the direction and supervision of the engagement team and review of their work. This includes tailoring the nature, timing, and extent of this responsibility to the nature and circumstances of the engagement and the resources — technological, intellectual, and human — assigned to the engagement. If the resources are insufficient or inappropriate, the EP is required to take appropriate action.

Other New Requirements

The SAS clarifies what the EP needs to review, which are significant matters and significant judgments, and formal written communications to management and those charged with governance.

⁷ Paragraph .28c of AU-C section 700, *Forming an Opinion and Reporting on Financial Statements*.