



Agenda Item 2F

EXPOSURE DRAFT

PROPOSED STATEMENTS ON QUALITY MANAGEMENT STANDARDS (SQMS):

Proposed SQMS No. 1, *A Firm's System of Quality
Management*

Proposed SQMS No. 2, *Engagement Quality Reviews*

PROPOSED STATEMENT ON AUDITING STANDARDS

*Quality Management for an Engagement Conducted in
Accordance With Generally Accepted Auditing
Standards*

(Supersedes Statement on Quality Control Standards No. 8, A Firm's System of Quality Control, and Statement on Auditing Standards [SAS] No. 122, Statements on Auditing Standards: Clarification and Recodification, as amended, 220, Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards [AICPA, Professional Standards, QC sec. 10 and AU-C sec. 220]; Amends various other sections in SAS No. 122, as amended [AICPA, Professional Standards, AU-C secs. OPEN])

February __, 2021

Comments are requested by June __, 2021

Prepared by the AICPA Auditing Standards Board for comment from persons interested in auditing and reporting issues.

Comments should be addressed to Sherry Hazel at CommentLetters@aicpa-cima.com.



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Explanatory Memorandum

Introduction

This memorandum provides background to the following three standards for quality management at the firm and engagement levels ((collectively, the Proposed QM standards):

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

If issued as final, proposed SQMS 1 will supersede Statement on Quality Control (SQCS) No. 8, *A Firm's System of Quality Control*, and proposed QM SAS will supersede 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

Background

The mission of the ASB

The mission of the Auditing Standards Board (ASB) is to serve the public interest by developing, updating, and communicating comprehensive standards and practice guidance that enable practitioners to provide high-quality, objective audit and attestation services to nonissuers in an effective and efficient manner. The ASB accomplishes this mission in part by developing auditing, attestation, and quality control standards that inspire public trust in the profession. In developing and updating auditing standards, the ASB considers the standards of other standard-setters, such as the International Auditing and Assurance Standards Board (IAASB), the PCAOB, and the GAO.

IAASB Quality Management Project

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

QM Exposure Draft Wrap
January 11-14, 2021

In **December 2020**, the IAASB issued new standards relating to quality management at both the firm and audit engagement level (hereinafter referred to as the IAASB Quality Management Standards), comprising the following:

- International Standard on Quality Management (ISQM) 1 (Previously International Standard on Quality Control 1), *Quality Management For Firms That Perform Audits Or Reviews Of Financial Statements, Or Other Assurance Or Related Services Engagements*
- ISQM 2, *Engagement Quality Reviews*
- International Standard on Auditing (ISA) 220 (Revised), *Quality Management for an Audit of Financial Statements*

The IAASB determined the need to develop and revise these standards through a number of information gathering and outreach activities undertaken over the course of many years dating back to 2013. These activities highlighted a number of critical issues including

- a need to improve firm governance and leadership and the culture and tone at the top of the firm
- addressing the emergence of new trends, for example, how firms today communicate with stakeholders
- dealing with concerns about firms placing undue reliance on services or resources from their networks and network firms
- challenges experienced by smaller firms in applying the standards
- strengthening the engagement partner's responsibilities; and
- improving the robustness of a number of aspects of engagement quality control reviews

In addition to submitting a comment letter on the IAASB exposure draft, the ASB provided input to the development of the IAASB standards through the involvement of U.S. participants on the IAASB task forces and feedback to the IAASB at each stage of drafting the proposed standards.

PCAOB Quality Control Project

On December 17, 2019, the PCAOB issued a concept release entitled [*Potential Approach to Revisions to PCAOB Quality Control Standards*](#). The concept release outlines that the PCAOB is considering an approach that would use proposed ISQM 1 as a starting point. The PCAOB stated that

Information gathered through our oversight, outreach, and research activities persuades us that our QC standard should be built on an integrated risk-based framework, as Proposed ISQM 1 is. In addition, many firms that follow PCAOB standards are also subject to other QC standards (including the IAASB's and the AICPA's standards), so they are required to

implement QC systems that comply with both PCAOB standards and those other standards. *Due to the foundational nature of QC systems, we believe that it would not be practical to require firms to comply with fundamentally different QC standards.* (emphasis added).

The comment period for the concept release ended on March 16, 2019. There were 36 respondents as of May 11, 2020. Most respondents commented that they are supportive of a potential quality control standard that is principles based and scalable with *minimal incremental requirements to proposed ISQM 1.* (emphasis added).

Convergence

It is the ASB's strategy to converge its standards with those of the IAASB, while taking into consideration the standards of other standard-setters. The ASB believes that it is particularly important to converge with the quality management standards of the IAASB for two primary reasons: one, for firms that perform engagements in accordance with the standards of the IAASB and the PCAOB, complying with fundamentally different quality control standards is not feasible, and, two, even more importantly, the ASB believes that the issues that led the IAASB to revise its standards are of equally critical importance in the United States.

In converging with the standards of the IAASB, the ASB uses the corresponding IAASB standard as the base in developing its standards. In making the proposed revisions to the accompanying proposed QM Standards, the ASB used ISQM 1, ISQM 2, and ISA 220 (Revised), respectively, as the base.

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 proposed for the firm's system of quality management in proposed SQMS 1, as described in the "Fundamental Aspects of the Proposed Standards" section below.

The ASB has made certain changes to the language of the IAASB standards to use terms or phrases that are more common in the United States, and to tailor examples and guidance to the U.S. environment. However, the ASB believes that such changes will not create substantive differences in application between the IAASB Quality Management Standards and the proposed QM Standards.

Fundamental Aspects of the Proposed Standards

SQMS 1

A New Approach Focused on Quality Management

The proposed 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 based on the nature and circumstances of the firm and the engagements it performs. The new approach also requires the firm to transition from policies and procedures that address standalone elements, as required by extant QC 10, to an integrated and iterative approach that reflects upon the system as a whole. The proposed standard takes a proactive approach to quality management, with an increased emphasis on a continual flow of remediation and improvement.

The components of the system of quality management

A system of quality management addresses the following eight components:

1. The firm's risk assessment process (new);
2. Governance and leadership (adapted from "leadership responsibilities for quality within the firm" in extant QC section 10);
3. Relevant ethical requirements (same name as extant QC section 10);
4. Acceptance and continuance of client relationships and specific engagements;
5. Engagement performance (same name as extant QC section 10);
6. Resources (adapted from "human resources" in extant QC section 10);
7. Information and communication (new); and
8. The monitoring and remediation process (adapted from "monitoring" in extant QC section 10).

As indicated by illustration 1, the components are highly integrated and do not operate in a linear manner. The new components, and significant changes to existing components, are discussed in more detail below.

Illustration 1:



Objective of the standard

The objective of the proposed standard is similar to the objective in extant QC section 10, and includes both the *objective of the firm* and the *objective of the system of quality management*. The *objective of the firm* in the context of the standard is to design, implement and operate a system of quality management that provides the firm with reasonable assurance that the *objectives of the system of quality management* are achieved. The system of quality management 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; and
- (b) Engagement reports issued by the firm are appropriate in the circumstances.

An effective system of quality management 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). Instead, reasonable assurance is obtained through the operation of the system as a whole.

Commented [AG1]: Note graphics are being revised by AICPA Graphic Design team.



Risk Assessment Process

As mentioned above, proposed SQMS 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 as follows:

1. Establish quality objectives. The proposed standard requires the firm to establish specific quality objectives for each component except monitoring and remediation. The firm is required to establish additional quality objectives when necessary to achieve the objective of the system of quality management; however, based on the nature and circumstances of the firm and its engagements, 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 proposed standard as *quality risks*). Identifying and assessing the 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. Professional judgment assists the firm in determining whether a risk is a quality risk, which is based on the firm's consideration of whether there is a

reasonable possibility of the risk occurring, and individually, or in combination with other risks, adversely affecting the achievement of one or more quality objectives. The firm takes into consideration how frequently the quality risk is expected to occur and how much time it would take for the quality risk to have an effect, and whether in that time the firm would have an opportunity to respond to mitigate the effect of the 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 their quality risks.

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



Commented [AG2]: Note graphics are being revised by AICPA Graphic Design team. Objective of the standard should be objective of the system of QM. Also change ISQM 1 to SQMS 1

Governance and Leadership

A firm's governance and leadership are of paramount importance to engagement quality, because that's how the firm establishes its culture and ethics and self-regulates, and serves as the framework for how the firm's decisions are made. Proposed SQMS 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 system of quality management to the firm's chief executive officer or the firm's managing partner (or equivalent). In addition, the firm is required to assign the following to designated individuals

- Operational responsibility for the system of quality management;
- Operational responsibility for specific aspects of the system of quality management, including compliance with independence requirements and the monitoring and remediation process.

Resources

Extant QC section 10 only addresses human resources. Proposed SQMS 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 engagement quality reviewers who are external to the firm.

The proposed 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 where they may come from, and mitigate the risk that the standard doesn't quickly become outdated because of changes in technology. Proposed SQMS 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 "Network" below).

Information and Communication

Extant QC section 10 does not address the broader need for information and communication across the system and the communication of relevant, reliable information with engagement teams, which is essential for the effective operation of the system of quality management and the performance

of engagements. It also does not acknowledge the two-way nature of communication. As a result, proposed SQMS 1 includes a new component, information and communication.

The proposed standard 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 two-way 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 quality management systems 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. This drives firms to think about what is appropriate in their circumstances; for example, less complex firms with fewer personnel may conclude, after due consideration, that no external communication about their system of quality management is needed. Firms may communicate through various mechanisms. In order to promote continual innovation in this area, the proposed standard provides flexibility regarding the specific information communicated, the form of that communication, and the nature, timing and extent of communication

Monitoring and Remediation

Proposed SQMS 1 more robustly addresses monitoring activities and shifts the focus from engagement level monitoring to monitoring the entire system of quality management. The requirements promote more proactive and effective monitoring activities and have increased the emphasis on tailoring the monitoring activities to provide a sufficient basis for the firm to evaluate the system. The new requirements have been designed to emphasize factors that the firm would consider in designing its monitoring activities, rather than prescribing all of the monitoring activities that need to be performed. The nature, timing and extent of monitoring activities will be driven by a number of factors at the firm, including the following factors:

- how the underlying system is designed,
- the nature and circumstances of the firms and engagements it performs,
- the extent of changes to the system, and
- the results of previous monitoring activities or external inspections.

The standard includes a requirement to inspect completed engagements and for engagement partners 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 engagement partners to select, and how frequently to select an engagement partner, taking into account factors such as other types of monitoring the firm does, areas of risk and how the system

is designed. See Issue 1 in the “Issues for Consideration” section below for further discussion of inspection of completed engagements.

The proposed standard includes requirements for evaluating findings and 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

A firm may belong to a network, which may establish requirements regarding the firm’s system of quality management or may make services (including resources) available that the firm may choose to implement or use in the design, implementation and operation of its system of quality management. For example, a firm may be subject to common policies or procedures established by the network, and the network may hold the firm accountable for complying with such policies or procedures. A network may also provide services to the firm such as IT applications, or a methodology or monitoring activities. Such requirements or services may be intended to promote the consistent performance of quality engagements across the firms that belong to the network. However, concerns have been raised that firms place undue reliance on network requirements or network services without sufficient consideration of whether the requirements or services are appropriate and suitable for the nature and circumstances of the firm. The firm is solely responsible for its own system of quality management; a network is not responsible for the firm’s system.

Proposed SQMS 1 requires that if a firm is subject to network requirements or uses network services, the firm understand how those requirements or services fit into the firm’s system of quality management, and determine whether the requirement or service needs to be adapted or supplemented to be appropriate for use in the firm’s system of quality management. The proposed 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 system of quality management, and the approach is focused on achieving quality objectives that are outcome-based. While this approach is expected to generate multiple benefits for engagement quality, one of the most important benefits is a tailored system of quality management 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.

The quality management approach in proposed SQMS 1 is more complex than the approach in extant QC section 10, and has added to the overall length of the standard. However, the ASB is of the view that the approach in extant QC section 10 is no longer fit for purpose and adaptable to the changing environment, given that it is more prescriptive in nature, and does not promote a scalable and tailored system of quality management that focuses on areas of risk. The ASB acknowledges that firms will need to invest time and resources to implement the revised standard initially; however, it is of the view that over time a more tailored and focused system of quality management will result in more effective use of firm resources and improvements in engagement quality.

The ASB intends to make nonauthoritative guidance available when the final standards are issued to help firms implement and apply the new quality management standards.

Request for comment:

1. Respondents are asked to provide their views on the changes described above. In addition, the ASB is seeking respondents' views on whether the requirements in proposed SQMS 1 are clear and understandable, and whether the application material is helpful in supporting the application of those requirements.

Proposed SQMS 2

Relationship between proposed SQMS 2 and proposed SQMS 1

Proposed SQMS 1 addresses the firm's responsibility for establishing a system of quality management, including the new quality management approach. An engagement quality review is a response, among others, that is designed and implemented by a firm to address assessed quality risks. Although the performance of an engagement quality review is undertaken at the engagement level, it is a response that is implemented by the engagement quality reviewer on behalf of the firm.

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

Why a separate standard

The requirements for engagement quality reviews currently reside in extant QC section 10² and AU-C section 220.³ Having a separate standard for engagement quality reviews is expected to provide a number of benefits, including:

- Clarifying that an engagement quality review can be a response to quality risks for any type of engagement, not only audit engagements.
- Placing emphasis on the importance of the engagement quality review.
- Facilitating the enhancement of the robustness of the requirements for the eligibility of engagement quality reviewers and the performance and documentation of the review.
- Providing a mechanism to more clearly differentiate the responsibilities of the firm and the engagement quality reviewer.

² Paragraphs .38-.48 of QC section 10, A Firm's System of Quality Control

³ Paragraphs .21-22 of AU-C section 220, Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards

- Increasing the scalability of proposed SQMS 1 because there may be circumstances when a firm determines that there are no engagements for which an engagement quality review should be performed (for example, a firm that performs only compilation engagements).

Objective of the standard

Proposed SQMS 2 addresses the responsibilities of multiple parties, that is, the firm and the engagement quality reviewer. However, because the engagement quality reviewer is acting on behalf of the firm, the objective of the standard has been framed as the objective of the firm.

The objectives of the ASB's standards are intended to be outcome-oriented (that is, the desired outcome of applying the requirements in the standard, and not an "executive summary" of those requirements). Accordingly, the objective of proposed SQMS 2 reflects the intended outcome, which is the performance of an engagement quality review.

Appointment and eligibility of reviewers

The proposals in proposed SQMS 2 and the aspects of proposed SQMS 1⁴ regarding engagement quality reviews are made with the public interest in the forefront. Certain stakeholders, such as regulators, believe that an engagement quality review is a strong response to quality risks that is in the public interest. Engagement quality reviews support the exercise of professional skepticism at the engagement level by providing an objective evaluation of engagement teams' significant judgments made in performing an engagement. The requirements in proposed SQMS 2 for the appointment and eligibility of the engagement quality 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 eligibility of the individual(s) within the firm responsible for the appointment of engagement quality reviewers.
- The eligibility of individuals to assist the engagement quality reviewer in performing the engagement quality review.
- The authority, competence and capabilities, including sufficient time to perform the EQ review, of the engagement quality reviewer.
- The engagement quality reviewer taking responsibility for the performance of the engagement quality review, including that the work of individuals assisting in the review is appropriate.

⁴ Paragraph 35(f) and related application material in proposed SQMS 1 address engagement quality reviews.

The requirements also address compliance with relevant ethical requirements, including that threats to objectivity of the engagement quality reviewer are eliminated or reduced to an acceptable level. To reduce threats to objectivity to an acceptable level, proposed SQMS 2 requires firm policies or procedures to include limitations on the eligibility of an individual to be appointed as engagement quality reviewer for an engagement on which the individual previously served as engagement partner. This limitation is necessary to make sure that the engagement quality reviewer is in a position to objectively evaluate and, where appropriate, challenge the significant judgments made and the exercise of professional skepticism by the engagement team. See Issue 2 in the “Issues for Consideration” section below for further discussion.

Performance and documentation of the EQ review

Significant judgments and significant matters

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

Timing of the review

An effective engagement quality review is achieved when the engagement quality reviewer 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, proposed SQMS 2 includes a new requirement addressing the engagement quality reviewer’s responsibility to perform the procedures at appropriate points in time during the engagement. The engagement partner is precluded from dating the engagement report before receiving this notification.

Documentation

Proposed SQMS 2 includes a specific requirement for the engagement quality reviewer to take responsibility for documentation of the engagement quality review, and adds a requirement that the documentation be filed with the engagement documentation. The proposed 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 engagement quality review procedures performed.

Request for comment:

2. Respondents are asked to provide their views on the changes described above. In addition, the ASB is seeking respondents' views on whether the requirements in proposed SQMS 2 are clear and understandable, and whether the application material is helpful in supporting the application of those requirements.

Proposed QM SAS

Overall Matters

The public interest is served by the consistent performance of quality engagements. The proposed QM SAS 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.

Proposed SQMS 1 addresses the system of quality management, which forms the foundation for the management of quality. Proposed QM SAS addresses how the engagement partner leverages the firm's system and manages quality at the engagement level. The proposed SAS makes clear that the engagement partner 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 engagement partner remains ultimately responsible, and therefore accountable, for compliance with the requirements of the proposed SAS. The phrase "take responsibility for..." is used for those requirements for which the engagement partner 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 proposed SAS expressly intends that the requirement or responsibility be fulfilled by the engagement partner. To fulfill the requirement, the engagement partner may obtain information from the firm or other members of the engagement team, (for example, information to make the required decision or judgment). For example, the engagement partner is required to determine that members of the engagement team collectively have the appropriate competence and capabilities to perform the audit engagement. To make a judgment on whether the competence and capabilities of the engagement team is appropriate, the engagement partner may need to use information compiled by the engagement team or from the firm's system of quality management.

Ordinarily, the engagement team may depend on the firm's policies or procedures in complying with the requirements of this proposed 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.

Engagement partner's overall responsibility for managing quality on audits, including engagement performance and stand back

The engagement partner 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 the QM SAS. The diagram below illustrates how the engagement partner's overall responsibility to manage and achieve quality on the engagement 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. This overall responsibility includes:

- a) **Fulfilling leadership responsibilities**, including taking actions to create an environment for the engagement that emphasizes the firm's culture and the expected behavior of engagement team members, and assigning procedures, tasks or actions to other members of the engagement team;
- b) **Supporting engagement performance**, including taking responsibility for the nature, timing and extent of the direction, supervision and review of the work performed; and
- c) **A "standback" requirement** to determine whether the engagement partner has taken overall responsibility for managing and achieving quality, including determining that the engagement partner's involvement has been sufficient and appropriate throughout the engagement and that the nature and circumstances of the engagement have been taken into account. Note that this is a new requirement.



Relevant Ethical Requirements

In addition to enhancing the extant requirements, the proposed QM SAS includes requirements regarding:

- 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; and
- Determining whether relevant ethical requirements, including those related to independence, have been fulfilled.

It also includes new application material that links with the firm level requirements in proposed SQMS 1, describes possible appropriate actions if non-compliance is indicated, and links to the requirement in AU-C section 700, *Forming an Opinion and Reporting on Financial Statements*,⁵ for the auditor's report to include a statement regarding the auditor's independence.

Engagement Resources

The engagement partner 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 engagement and the resources—technological, intellectual, and human—assigned to the engagement. If the resources are insufficient or inappropriate, the engagement partner is required to take appropriate action.

Other new requirements

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

Request for comment:

3. Respondents are asked to provide their views on the changes described above. In addition, the ASB is seeking respondents' views on whether the requirements in the proposed QM SAS are clear and understandable, and whether the application material is helpful in supporting the application of those requirements.

⁵ Paragraph 28(c) of AU-C section 700, *Forming an Opinion and Reporting on Financial Statements*

Proposed Amendments to Existing Standards

Amendments to various AU-C and AT-C sections for consistency with the proposed QM Standards are proposed as shown in the Appendix to this Exposure Draft. Amendments to standards applicable to review and compilation engagements will be considered by the Accounting and Review Services Committee.

Effective Date

- Proposed SQMS 1:

Systems of quality management in compliance with proposed SQMS 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 1⁶ would be required to be performed within one year following December 15, 2023.

- Proposed SQMS 2:

Proposed SQMS 2 would be effective for:

- (a) Audits or reviews of financial statements for periods beginning on or after December 15, 2023; and
- (b) Other engagements in the firm's accounting and auditing practice beginning on or after December 15, 2023. 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.⁷

- Proposed QM SAS would be effective for engagements conducted in accordance with generally accepted auditing standards for periods beginning on or after December 15, 2023.

These effective dates are provisional but would not be earlier than December 15, 2023. The ASB believes that an 18-month implementation period, supported by appropriate implementation support materials, is both practical and in the public interest. The ASB notes that a rushed implementation may exacerbate risks to quality, lead to increased inspection

⁶ See paragraphs 54-55 of proposed Statement on Quality Management Standards No. 1, *A Firm's System of Quality Management*

⁷ See ET section 0.400.39 [AICPA, *Professional Standards*, ET sec. 0.400.39]

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findings, and would be inconsistent with the objectives of the project to enhance the ASB's quality management standards.

The following illustrates the timeline using the proposed effective dates:

Between now and December 15, 2023:

- Design and implement the system of quality management so that the system of quality management is fully operational on December 15, 2023.

On and after December 15, 2023:

- Operate under the system of quality management.
- If an EQ review is required by firm policies for an engagement, perform EQ reviews in accordance with SQMS 2 starting with
 - calendar year 2024 financial statement audit or review engagements
 - other engagements that begin on or after December 15, 2023
- Apply the requirements of the QM SAS starting with calendar year 2024 financial statement audits.

By December 15, 2024:

- Perform the first annual evaluation of the system of quality management

Request for comment:

4. Respondents are asked to provide their views on whether the effective dates are clear and whether an 18-month implementation period is appropriate.

Issues for Consideration

In addition to overall views on the proposed changes to existing standards and the amendments described above, the ASB is requesting feedback from respondents on the following issues:

Issue 1 – Self-inspection

An existing difference between International Statement on Quality Control (ISQC) 1, *Quality Control For Firms That Perform Audits Or Reviews Of Financial Statements, Or Other Assurance Or Related Services Engagements*, and QC section 10 relates to the involvement of those performing the engagement or the engagement quality review in inspecting the engagements (also referred to as “self-inspection”). Both ISQC 1 (par. 48) and ISQM 1 (par. 46) require firms to include the inspection of completed engagements in its monitoring activities and

prohibit the engagement team members or the engagement quality reviewer of an engagement from performing any inspection of that engagement

QC section 10 does not include this prohibition (see par. 52(c)). The ASB had previously concluded that it was not necessary to change existing practice to converge with ISQC 1 because in the United States, the peer review process provides a safeguard and provides evidence that monitoring procedures involving self-inspection can be effective.

Application material in extant ISQC 1 states the following:

A68. In the case of small firms, monitoring procedures may need to be performed by individuals who are responsible for design and implementation of the firm's quality control policies and procedures, or who may be involved in performing the engagement quality control review. A firm with a limited number of persons may choose to use a suitably qualified external person or another firm to carry out engagement inspections and other monitoring procedures. Alternatively, the firm may establish arrangements to share resources with other appropriate organizations to facilitate monitoring activities.

Application material in ISQM 1 is more principles-based and addresses the self-review threat:

A171. 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.
- Another type of monitoring activity had participated in designing, executing or operating the response being monitored.

Application material in QC section 10 states the following:

Considerations Specific to Smaller Firms

A72. In small firms with a limited number of persons with sufficient and appropriate experience and authority in the firm, monitoring procedures may need to be performed by some of the same individuals who are responsible for compliance with the firm's quality control policies and procedures. This includes review of engagement working papers, reports, and clients' financial statements by the engagement partner or other qualified personnel after the report release date.

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. 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) may indicate the need to have quality control policies and procedures monitored by another qualified individual.

A73. Having an individual inspect his or her own compliance with a quality control 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. Accordingly, a firm with a limited number of persons with sufficient and appropriate experience and authority in the firm may find it beneficial to engage a suitably qualified external person or another firm to perform engagement inspections and other monitoring procedures.

In addition to considering the views of the members of the ASB and the Quality Standards Task Forces from firms of various sizes, the ASB reached out to the AICPA PCPS Technical Issues Committee, whose members are all from small firms.

Views considered by the ASB regarding having individuals inspect their own compliance with a system of quality management included the following:

- It can be difficult to find sufficiently experienced and knowledgeable external people, particularly for specialized industries or areas.
- Needing to hire separate external people to perform an engagement quality review, an inspection, and a peer review puts an expensive burden on the smallest firms.
- Inspection carries a cost to each firm. The larger firms may benefit from economies of scale, and their costs may be opportunity cost rather than out-of-pocket, but there is a cost associated with the person performing the inspection.
- Potential safeguards against the self-review threat include internal training. Effective training addresses not only technical expertise (for example, specialized knowledge of employee benefit plans) but also training in the firm's system of quality management and how to be a critical objective reviewer.
- Self-inspection cannot identify one's own lack of knowledge. For example, inspection may uncover that the engagement partner, being unaware of recently effective standards, did not apply them to the engagement. But that engagement partner, inspecting their own work while being unaware of recently effective standards, would never identify that the standards were not appropriately applied in that engagement. While subscribing to a third-party methodology might correct the deficiency of the firm's methodology not

being current on professional standards, it would not make self-inspection any more effective at identifying what one does not know.

- Extant QC section 10 states that peer review can substitute for inspection for the period covered by the peer reviews. However, the period covered by the peer review is only one year out of three. Proposed SQMS 1 requires that monitoring procedures be performed annually and requires an annual evaluation of the system of quality management.

Other than the peer review process, the ASB was unable to identify anything unique in the U.S. with regard to self-inspection, nor did the ASB believe that safeguards exist that could lower the self-review threat to an acceptable level. The ASB recognizes that the extant standard permits those involved in the engagement to inspect their own work, and some practitioners may be capable of doing so effectively. However, while concerned about the impact on smaller firms, the ASB believes that this requirement is necessary to enhance audit quality. Accordingly, proposed SQMS 1 convergences with the IAASB standards with respect to self-inspection.

Request for comments:

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

Issue 2 – Cooling-off period for engagement quality reviewers

The ED of proposed ISQM 2, *Engagement Quality Review*, (ED-ISQM 2) presented the IAASB view that matters on which significant judgments are made in recurring engagements often do not vary and, therefore, significant judgments made in prior periods may continue to affect judgments of the engagement team in subsequent periods. The ability of an EQ reviewer to perform an objective evaluation of significant judgments is therefore affected when the individual was previously involved with those judgments as the engagement partner. In such circumstances, it is important that appropriate safeguards are put in place to reduce threats to objectivity, in particular the self-review threat, to an acceptable level. Accordingly, ED-ISQM 2 included a new requirement for the firm to establish policies or procedures that include limitations on the eligibility of an individual to be appointed as engagement quality reviewer for an engagement on which the individual previously served as the engagement partner. Furthermore, the application material in the exposure draft of ISQM 2 suggested such limitations may be accomplished by establishing a cooling-off period and noted that determining a suitable cooling-off period depends upon the facts and circumstances of the engagement, and applicable provisions of law or regulation and relevant ethical requirements. The application material further noted that, for an audit of a listed entity, it is unlikely that an engagement partner would

be able to serve as the engagement quality reviewer until two subsequent audits have been conducted. The IAASB believed this application material recognized that audits of listed entities generally involve more complex judgments by engagement teams and that a cooling-off period would be in the public interest.

The IAASB exposure draft asked for views on the need for additional guidance regarding a cooling-off period. 70% of the 91 respondents agreed on the need for guidance; about 17% (16 of 91) of respondents (including two IAASB Monitoring Group members) commented that there should be a requirement for a specific cooling-off period for an individual stepping into the role of EQ reviewer after serving as engagement partner.

The IAASB decided, for the final standard, to require a cooling-off period as it believed it to be the only safeguard to the self-review threat to objectivity, given the importance of maintaining objectivity in performing an objective evaluation of the significant judgments made by the engagement team. This requirement applies to all engagements for which an EQ review is performed. In reaching this conclusion, the IAASB noted that other than for audits of listed entities or when required by law or regulation, EQ reviews are not mandated for other engagements, and the firm may employ responses other than an EQ review to address assessed quality risks. However, when an EQ review is required or has been determined by the firm to be the appropriate response, then the same requirements should apply in all cases, because the threats to the objectivity of the engagement partner stepping into the role of an EQ reviewer are not unique to certain types of engagements or to audits of listed entities. The IAASB indicated that a conditional requirement would create a perception of different levels of EQ review for different types of engagements, which could lead to inconsistent application in practice and potential confusion in the minds of stakeholders, and therefore would not be in the public interest. By extension, this also applies to any variation in the length of the cooling-off period for different types of engagements. As the IAASB had suggested a two-year cooling-off period in the ED, that was the length of the cooling-off period required by the final standard.

The PCAOB standards also require a two-year cooling-off period before a former engagement partner can serve as the engagement quality reviewer. However, the PCAOB exempts firms with fewer than five issuer audit clients and fewer than ten partners from cooling-off periods for EQ reviews provided that they are inspected at least once every three years (AS 1220, *Engagement Quality Review*, paragraph .08).

The ASB considered the following three options:

- 1) No cooling-off period, with application guidance similar to that exposed by the IAASB in the exposure draft of ISQM 2.
 - o ASB members expressed concern that, combined with the requirement prohibiting self-inspection, requiring a cooling-off period would mean that some firms would need one person performing the inspection and another person

- performing the EQ review. Specifically, the conversation focused on the fact that this requirement might disproportionately affect smaller firms. Firms may not be able to identify qualified people, and this might result in fewer EQ reviews being performed, which would be an unintended negative consequence.
- ASB members also noted that no research exists to support the supposition that a cooling-off period improves audit quality.
 - The Task Force noted the following with respect to PCAOB requirements:
 - If the PCAOB provides an exemption from the cooling-off period in certain situations or circumstances, it seems overly prescriptive to require a cooling-off period for every EQ review performed on nonissuer engagements.
 - On the other hand, the PCAOB Auditing Standards require an EQ review for every audit and attestation examination engagement. Many, if not, most engagements performed by small firms for issuer audit clients might not meet the firm's criteria for an EQ review performed as a response to an assessed quality risk (other than being an issuer). However, an EQ review might be an appropriate response for engagements performed by the same firm for a nonissuer audit client.
- 2) Required cooling-off period of one year, with application material addressing when a longer period may be appropriate.
- The ASB did not identify any differences in the U.S. that would affect a firm's determination of whether an EQ review is an appropriate response to an assessed quality risk, nor identify other safeguards against the self-review or familiarity threat.
 - Because the vast majority of audits are for annual periods, one year may be an appropriate minimum cooling-off period.

The ASB considered the following application material to accompany a requirement for a one-year cooling-off period addressing when a longer period may be appropriate:

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

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

For example, if a business combination with a material effect on the financial statements has occurred, the significant judgments made in the current period may vary from those of the prior period to such an extent that an objective evaluation of those judgments could be made by the individual who served as the engagement partner in the previous period.

Conversely, if comparative financial statements are presented, in the absence of other appropriate safeguards, an engagement partner might not be able to act as the engagement quality reviewer until no period in which the individual served as engagement partner is presented.

- A threat to the engagement partner’s objectivity when serving as the engagement quality reviewer may exist if the firm’s system of quality management penalizes engagement partners if deficiencies are found in their engagements.
- 3) Required cooling-off period of two years
- This results in full convergence with the IAASB standard, consistent with the ASB’s strategy. The ASB was unable to identify any differences in the U.S. that would affect a firm’s determination of whether an EQ review is an appropriate response to an assessed quality risk.
 - The IESBA Code of Ethics for Professional Accountants (IESBA Code) requires partner and engagement quality reviewer rotation and cooling-off periods for engagements for public interest entities. Nonetheless, the IAASB required a two-year cooling-off period for all engagements when an EQ review has been determined by the firm to be the appropriate response, regardless of the type of entity.
 - If a cooling-off period is required, any potential issues of identifying eligible EQ reviewers for a period of two years instead of one year do not seem to be so burdensome as to warrant divergence.

Commented [AG3]: Note: this text was changed per ASB discussion.

The ASB decided to require a two-year cooling-off period, consistent with ISQM 2. The ASB is interested in respondents’ views on this issue.

Request for comments:

6. Respondents are asked for their views on whether a cooling-off period for an engagement quality reviewer should be required, and if so, the appropriate length of the required cooling-off period.

Issue 3 – Completion of Engagement Quality Review and Dating of the Auditor’s Report

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 be completed before the report is released. The Exhibit to QC section 10, and AU-C section 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

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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.”

Paragraph 21(b) of ISQM 2 requires that the firm’s policies or procedures preclude the engagement partner from dating the engagement report until the completion of the engagement quality review. Paragraph 36(d) of ISA 220 (Revised) requires that the engagement quality review be completed before the report is dated. In developing the Proposed Quality Management Standards, the ASB did not identify any differences between the U.S. and other jurisdictions that would warrant divergence from requiring that the engagement quality review be completed before the report is dated. Accordingly, paragraph 24(b) of proposed SQMS 2 and paragraph 36(d) of the proposed QM SAS are consistent with the equivalent paragraphs in the IAASB Quality Management Standards.

Request for comments:

7. Respondents are asked for their views on whether the engagement quality review should be required to be completed before the report is dated, rather than before the report is released.

Guide for Respondents

Respondents are asked to provide comments on the issues above as well as the changes to the proposed QM Standards.

Comments are most helpful when they refer to specific paragraphs, include the reasons for the comments, and, where appropriate, make specific suggestions for any proposed changes. When a respondent agrees with proposals in the exposure draft, it will be helpful for the ASB to be made aware of this view, as well.

Written comments on the exposure draft will become part of the public record of the AICPA and will be available on the AICPA’s website after **June __, 2021**, until a final standard is issued. Responses should be submitted in Word format, sent to commentletters@aicpa-cima.com, and received by **June __, 2021**. Respondents may also submit a PDF version of their response for posting to the AICPA website.

Supplement to the Exposure Draft

To assist respondents in identifying changes and in responding to this request to comment on the

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proposed QM Standards, the Audit and Attest Standards staff has prepared documents that provide a detailed comparison of each proposed QM Standard to the corresponding IAASB Quality Management Standard. No comparison has been prepared of the proposed QM Standards with the extant standards that they would supersede because the changes are too extensive for a paragraph-level comparison to be useful.

This staff-prepared supplementary material is available on the AICPA Web site at [\[insert link\]](#). It is for informational purposes only and does not form part of the exposure draft; however, it may be useful for respondents in formulating comments.

Comment Period

The comment period for this exposure draft ends on **June __**, 2021.

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(2020–2021)

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