

ISA 220, ISQM 1 and 2 Exposure Drafts ADAA briefing paper

IAASB Quality Management project by Steven Ralls

February 2019

Background

In 2015 the IAASB released an Invitation to Comment (ITC) 'Enhancing Audit Quality in the Public Interest: A Focus on Professional Skepticism, Quality Control, and Group Audits'. This highlighted the Board's discussions on these topics and flagged potential standard-setting activities the IAASB would take to enhance audit quality. 87 comment letters were received ([link](#)) and so the IAASB has been working through changes to standards. The IAASB is seeking public comment on three interrelated standards that address quality management. Old ISA 220 runs to 12 pages, the replacement 33. Old ISQC 1 runs to 70 pages; new ISQM 1 to 100 and new ISQM 2 (no old); 29 pages. The Exposure Drafts have been published for comment by July 2019.

Why revise the Quality Management standards?

There are several reasons:

- To more proactively manage quality to address stakeholder expectations and concerns.
- To improve the scalability of the standards.
- To modernise the standards and keep them fit for purpose.

Key changes

- A new proactive risk-based approach to firms' system of quality management in ISQM 1.
- Modernising the standards for an evolving and increasingly complex environment including addressing the impact of technology, networks, and the use of external service providers.
- Increasing firm leadership responsibilities and accountability, and improving firm governance.
- More rigorous monitoring of quality management systems and remediation of deficiencies.
- Enhancing the engagement partner's responsibility for audit engagement leadership and audit quality.
- Addressing the robustness of engagement quality reviews, including engagement selection, documentation, and performance.

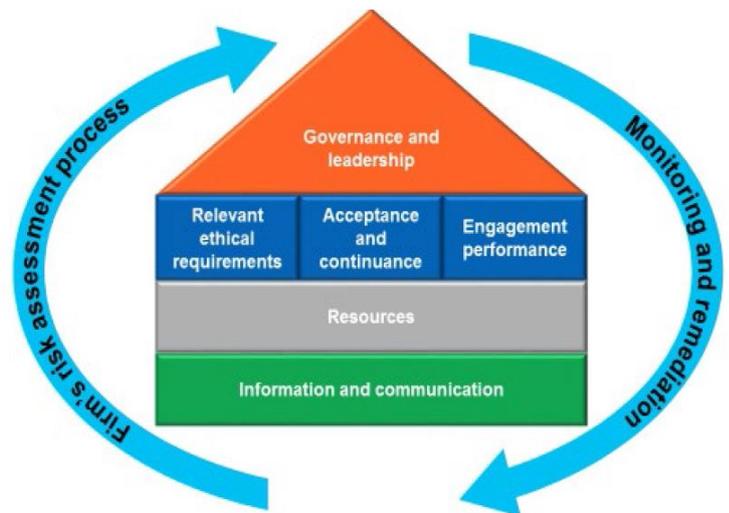
Scalable

Different audits have different levels of inherent risk. Most audit firms recognise this and apply different risk based approaches, although how they determine higher and lower risk audits and what activity should be included as a result can be somewhat opaque. ISQM 1 embeds this risk-based approach, it involves professional judgement in designing a system that is tailored to the nature and circumstances of the firm and the engagements it performs. It proactively identifies risks to audit quality and responses to them. It requires increased professional judgement in selecting engagements for engagement quality reviews. And there is a greater focus in ISA 220 (Revised) on the nature and circumstances of the audit engagement partner in managing quality.

ISQM 1 (previously ISQC 1)

Perhaps you didn't notice. The name of the standard has changed from 'Quality Control' to 'Quality Management'. Seems small, but a massive change in emphasis and approach. ISQC 1 had a list of things that made up a system of quality control. ISQM 1 has a list of Components that makes a system of Quality Control. That should sound familiar to the

COSO connoisseur. Because the IAASB naturally looked at other risk management and governance frameworks, such as COSO, in determining the Components of a Quality Management system for ISQM 1. This aligns the requirements on the audit firms with the requirements of ADAA Decree No 1 2017 and ISA 315 when relying on their audit clients' system of internal control.



In the IAASB's FAQs it states: "The eight components in ISQM 1 have similarities to the components of internal control described in draft ISA 315 (revised) and the COSO Integrated Framework...firms are not required to organise their systems according to these components...only meet all the requirements of the standard." More FAQs [here](#).

ISQM 1 requires a firm to customize the design, implementation and operation of its system of quality management (e.g. enhanced requirements and focus on governance and leadership, monitoring and remediation and circumstances when a firm belongs to a network). It requires a customized tailored approach and transition from policies and procedures addressing standalone elements in ISQC 1 to an integrated approach.

The new approach is expected to generate multiple benefits for firms:

- Tailoring improves robustness and effectiveness of activities and utilisation of resources.
- Proactive management and mitigation of risks and continuous improvement in activities in a changing environment.
- Focus on monitoring the system as a whole, timely and effective remediation promotes ongoing improvement.

The objective of the firm is to design, implement and operate a system of quality management that provides reasonable assurance:

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

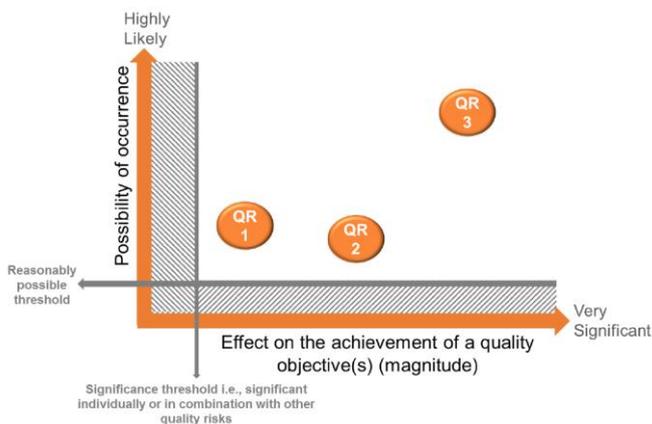
The first bullet used to read 'the firm and its personnel comply with...' the new terminology 'fulfil their responsibilities' and 'conduct in accordance with' are much more demanding and wider terms than 'comply'.

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This change is seen further in the objectives. They have been carried over from ISQC 1, adapted (Governance, Resources, Remediation) and added to (The firm's risk assessment process, Information and communication). Risks of not meeting the objectives must be documented and their likely occurrence mapped. The ED uses the analysis below.



The response of the firms to the objective of monitoring and remediation will be interesting. Historically, the appointment of an engagement quality reviewer (EQR), would be seen as a monitoring control. However, there are examples of audits failing even with an EQR in place. Therefore, the control didn't work. Is this a finding or a deficiency? It could be either. Deficiencies need to be remediated. So maybe the EQR needs retraining, or perhaps the evidence presented to the EQR was misleading, which might mean the audit team needs retraining. Hence the standard requires the root cause of deficiencies to be identified so appropriate action can be taken to remediate the deficiency.

The language of remediation is interesting because it comes from Sarbox and COSO. Read the full Explanatory Memorandum and standard and practical examples in the links below.

[IAASB-Proposed-ISQM-1-Explanatory-Memorandum.pdf](#)

[IAASB-Practical-Example-Proposed-ISQM-1.pdf](#)

ISQM 2 Engagement Quality Reviews

The biggest change is that the IAASB conclude because the EQR is acting on behalf of the firm, the objective of ISQM 2 should be framed as an objective of the firm. Hence the requirements for the performance of EQRs is removed from ISA 220 which now deals with how the engagement partner and team communicates with the EQR.

Concerns raised in the ITC included selection, qualification, experience and objectivity of the EQR. These are dealt by including additional requirements and application guidance.

ISQC 1 included eligibility requirements for EQRs focussing on technical, experience, authority and objectivity. ISQM 2 expands and enhances the robustness of the eligibility requirements. In addition, there are requirements to address the importance of being involved at the right time(s) and of there being sufficient time for the EQR.

ISQC 1 refers to the EQR having the necessary authority but does not explain how that authority is obtained. The IAASB considers this to be very much to be a firm led thing Through, title, culture, and policies to enhance and protect the reputation of the EQR in the firm. ISQM 2 also addresses the cooling off period of the audit engagement partner becoming the EQR. A time period isn't set. The firm should set a period that safeguards the EQR's objectivity. Documentation of the EQR is reported by regulators as problematic. ISQM 2 includes enhanced requirements and guidance. ISQM 2 in the link. [IAASB-Proposed-ISQM-2-Explanatory-Memorandum.pdf](#)

ISA 220 Quality Management for an audit of financial statements

"In revising ISA 220, the IAASB sought to address 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. In support of these goals, the IAASB agreed to:

- Highlight the importance of the public interest role of audits, and improve the emphasis on the importance of the appropriate application of professional judgment and exercise of professional scepticism.
- Clarify the role and responsibilities of the engagement partner, particularly required involvement throughout the audit, and retain the emphasis on the engagement partner's responsibility for managing and achieving quality at the engagement level.
- Clarify the relationship between ED-220 and the ISQMs, including additional clarification of the engagement partner's and engagement team's interaction with the firm, and the engagement team's, ability to depend on the firm's quality management policies or procedures."

In addition, the IAASB has included new material on the importance of the use of professional skepticism and professional judgment in performing audit engagements. This application material describes impediments to professional skepticism, auditor biases, and actions the engagement partner can take to deal with impediments to the exercise of professional skepticism. Read the full proposed standard in the link. [IAASB-Proposed-ISA-220-Revised-Explanatory-Memorandum.pdf](#)

Final thoughts

The IAASB has/is undertaking a huge amount of work from their ITC 'Enhancing Audit Quality in the Public Interest' with substantial changes in particular to ISA 540, 315, 220, and ISQM 1, 2. Although ISA 540 is not yet due for adoption and the others are still at the exposure draft stage, they do not need to be complied with. However, because they are auditing standards, and are concerned with improvements in the quality of audit evidence, we suggest in your ITT for audit services or in reappointing your incumbent auditor, you ask what your Statutory Auditor's views are on these and what changes they are making as a result.

The Sarbanes Oxley Act requires management of companies listed on the US Stock Exchanges to certify the effectiveness of their system of internal control for their financial statements as of the reporting date and for the auditor to attest that statement and provide an assurance opinion on the effectiveness of the management's system of internal control. ADAA Decree No 1 2017 has the same requirement for the auditor. Should the same be required of the audit firms for their system of quality management?



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