

Quality Control—Initial Scoping

I. Decision Summary – June IAASB Meeting

Summary of the IAASB's Discussions at Its June 2014 Meeting

As part of the initial information gathering in relation to the planned project on quality control, the Board provided feedback on Agenda Item 6-A, a Staff-prepared paper exploring various issues identified by the International Standards on Auditing (ISA) Implementation Monitoring project, outreach and the development of the *Framework for Audit Quality* (Framework). In general, the Board expressed caution about the project having a potentially broad scope, and highlighted the need for ample information gathering on the various issues that had been identified to assist the Board in considering an appropriate way forward.

In respect of the need to consider further enhancements to ISQC 1¹ or ISA 220² addressing engagement quality control reviews (EQCR), the Board variously raised matters to be further considered by the Working Group (WG) established to support the project:

- The need to further understand the root causes of issues with respect to EQCR (e.g., through discussions with firms and audit inspection bodies) to determine an appropriate response. In this context, it was suggested to look at the governance of the firms and the networks.
- The balance of emphasis within both ISQC 1 and ISA 220 between the roles and responsibilities of the engagement partner, engagement team and the engagement quality control reviewer, in particular if the Board was of the view that new requirements relating to EQCR or reviewers were necessary. Some concern was expressed about the risk that the role of the engagement quality control reviewer could be overemphasized, and that it may be more appropriate to focus attention on the policies and procedures in ISQC 1 that govern the early operational phases of the audit, including the appointment of the engagement team and the engagement partner, etc. In this regard, it was suggested the concept of accountability for quality by both the engagement partner and engagement quality control reviewer could be further explored.

On an initial basis, the Board did not support the possibility of placing the requirements in ISQC 1 and ISA 220 relevant to engagement quality reviews into a separate standard. In considering the comparison of the Framework to the provisions within ISQC 1, the Board noted there was merit in the WG further exploring the possibility of incorporating relevant aspects of the Framework into ISQC 1, to the extent not already addressed. It was also suggested that further consideration be given to highlighting the potential need to link engagement partner compensation with audit quality, although it was acknowledged that developing measures on which to base such compensation would likely prove challenging.

On the topic of off-shoring, the Board expressed concern that the manner in which the topic was initially explored in Agenda Item 6-A could be viewed as suggesting that the use of off-shoring was always detrimental to audit quality or was not adequately addressed in a firm's system of quality control. Based on experience with the use of off-shoring, a number of Board members suggested that a more in-depth

¹ International Standard on Quality Control (ISQC) 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

² ISA 220, *Quality Control for an Audit of Financial Statements*

discussion would be useful to inform the Board's consideration as to whether and, if so, how the topic needed to be addressed in the quality control standards. This discussion could address, for example, the risks and measures taken to reduce risks, examples of areas in which off-shoring was commonly used (e.g., for more routine/less judgmental areas) and the possible positive and negative effects on audit quality.

On the topic of the applicability of ISQC 1, both in respect of proportionate application to audits conducted by smaller firms and its application to other assurance and related services, the Board was generally of the view that ISQC 1 is capable of being applied to different types of firms and different types of engagements, and with members variously noting that revising the standard on a “think small basis” or developing a separate standard for small firms could have a negative impact on quality. Ms. de Beer agreed, noting that while it is important that ISQC 1 is workable for small and medium practices (SMPs), it would not be desirable to suggest that there were different requirements for SMPs. The WG was asked to further consider:

- Incremental changes to the structure within ISQC 1, such as introducing more conditional requirements and a risk-based approach, to highlight its application in different circumstances, rather than removing existing requirements.
- What further actions could be taken to further assist SMPs in applying ISQC 1, taking into account guidance that has been developed by National Standard Setters (NSS).

Way Forward

The WG will further explore these suggestions with Staff to inform further discussion with the IAASB and the development of a project proposal on the topic.

II. Key Topics

Engagement Quality Control Reviews

1. This topic was presented to the IAASB at its June 2014 meeting where the findings from the ISA Monitoring project were explored along with the proposal to develop a separate EQCR standard. As noted above, the views on this topic indicated that further exploration was warranted, but the Board did not believe that a separate standard on EQCRs was needed.
2. The WG has begun to perform further research on EQCR, including a comparison of ISQC 1 / ISA 220 to other standards for EQCRs, and discussions with regulators. Of further note, based on discussions with European regulators, issues with the application of ISQC 1 including EQCR is one of the top inspection findings.

Key Differences between Auditing Standard No. 7³ (AS 7), the European Regulation⁴ and ISQC 1

3. Staff performed a comparison of AS 7 issued by the Public Company Accounting Oversight Body (PCAOB) to ISQC 1 / ISA 220 and to the European Regulation.
4. The details of this comparison are included in Supplement 1 to this paper. A number of key differences were identified as follows:
 - The type of engagements for which an EQCR would be required:
 - AS 7 applies to audits of financial statements and interim reviews of financial statements required by US Securities laws and therefore performed pursuant to PCAOB standards.
 - ISQC 1/ISA 220 applies to audits of financial statements of listed entities.
 - ISQC1/ISA 220 also applies to those engagements meeting the criteria set out as part of a firm's policies and procedures for all other audits and reviews of historical financial information and other assurance and related services engagements.
 - The European Regulation applies to audits of complete sets of general purpose financial statements of public interest entities⁵ required by European Union legislation.
 - AS 7 includes an objective of the EQCR.
 - In addition to competency and objectivity, only AS 7 requires the reviewer specifically to have integrity and independence. Further, a cooling off period has been established in AS 7.

³ AS 7, *Engagement Quality Review*

⁴ Regulation (EU) No 537/2014 of the European Parliament and of the Council of 16 April 2014 on specific requirements regarding statutory audit of public-interest entities and repealing Commission Decision 2005/909/EC

⁵ Public-interest entities are defined by Directive 2014/56/EU of the European Parliament and the Council of 16 April 2014 amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts, as (a) entities governed by the law of a Member State whose transferable securities are admitted to trading on a regulated market of any Member State within the meaning of point 14 of Article 4(1) of Directive 2004/39/EC; (b) credit institutions as defined in point 1 of Article 3(1) of Directive 2013/36/EU of the European Parliament and of the Council.. other than those referred to in Article 2 of that Directive; (c) insurance undertakings within the meaning of Article 2(1) of Directive 91/674/EEC; or (d) entities designated by Member States as public-interest entities, for instance undertakings that are of significant public relevance because of the nature of their business, their size or the number of their employees.

- AS 7 requires the reviewer to review more specific areas of the engagement, has the concept of a significant engagement deficiency and has a specific requirement for concurring approval of issuance.
 - AS 7 has specific documentation requirements in respect of the procedures performed by the reviewer, the European Regulation has requirements in respect of recording the information reviewed and conclusions drawn from procedures performed and the results of the review, ISQC 1 only requires documentation that the review has been performed. Further, AS 7 specifically requires the documentation to be included in the engagement documentation.
5. The WG proposes considering these differences as part of the quality control project proposal, with updates being made to ISQC 1 and ISA 220 as appropriate.

Analysis of EQCR Challenges

6. Feedback from the ISA Implementation project and from initial discussions with European regulators has highlighted the following issues with the performance of the EQCR:
- Insufficient time allocated to the reviewer to enable a thorough and robust review;
 - The reviewer becomes involved in the engagement too late in the process;
 - Insufficient depth of review procedures performed;
 - Reviews allocated to reviewers with insufficient relevant experience.

These findings are somewhat consistent with the results of the ISA Implementation project.

7. The WG believes that discussions with the firms would be necessary to further explore and understand internal methodologies in this area, however, it proposes that addressing these issues should form part of the quality control project.

Other EQCR Issues

8. A further area of potential concern identified was in respect of the selection of engagements that should be subject to an EQCR. It was proposed that an additional requirement or clarification of existing requirements, to focus selection of engagements for EQCR around the identified risks of the engagement would be appropriate such that engagements with a higher misstatement compliance, liability or reputational risk would be more likely to be selected.
9. However, comments from some regulators indicate that the external inspection issues identified are in respect of the performance of the EQCR itself, and not the engagement selection criteria.
10. Notwithstanding the above, consideration should be given to whether audit quality in general would be improved if additional requirements were introduced outside of the EQCR process, such as use of subject matter experts when appropriate. This potentially may result in a more efficient and effective method of addressing engagement issues as they arise in the audit process.

Engagement Team and Engagement Quality Control Reviewer Responsibilities

11. In connection with EQCR, the Board also recommended that the WG consider the balance of emphasis between the roles and responsibilities of the engagement partner, engagement team and the engagement quality control reviewer.

12. The WG notes that the International Ethics Standards Board for Accountants (IESBA) is engaged in a project to update the Code of Ethics for Professional Accountants in respect of auditor responsibilities. Also, the International Accounting Education Standards Board is finalizing a standard, IES 8⁶ that establishes the professional competence that a professional accountant performing the role of an engagement partner needs to maintain and further develop through continuing professional development.
13. The WG will liaise with the IESBA to determine if there is any impact on ISQC 1 and to ensure that any potential inconsistencies are minimized. The WG will also consider if the finalized IES 8 will have any impact on ISQC 1.

Matters for IAASB Consideration

1. Does the IAASB believe that:
 - The proposed project should consider changes to the scope of EQCRs, including:
 - Expansion to incorporate public interest entities;
 - Revision of other EQCR selection criteria
 - The proposed project should consider the key differences identified between ISQC 1 and AS 7; and that these differences should be addressed in ISQC 1, ISA 220 or both?
 - The analysis of challenges initially identified should form part of the proposed project?
 - Further actions in respect of engagement team responsibilities are warranted?

Remediation

14. The ISA Implementation Project suggested that, in relation to remediation, the IAASB consider acknowledgment of the importance of a firm's system of quality control addressing the root cause analysis of significant audit deficiencies that have been identified by external inspections.
15. At the June 2014 meeting, the IAASB discussed the guidance provided in ISQC 1 in respect of the firm's remediation process and the potential for greater emphasis and discussion in the standard around firm processes that ensure the appropriate evaluation of identified audit deficiencies and taking corrective action. Some Board members felt that the policies around the remediation process was not an area in ISQC 1 that needed attention.
16. Initial discussions with some regulators have identified remediation as an area of ISQC 1 that needed improvement. When ISQC 1 was initially drafted, external inspections were not as frequent or as prevalent as they are today. Accordingly, regulators have noted that the standard currently only considers the remediation of deficiencies noted as a result of the internal monitoring processes.⁷ The view has been expressed that ISQC 1 should also include requirements and guidance with respect to deficiencies identified by the external inspections.
17. These discussions also identified greater consistency in practice by firms to respond to inspection findings in respect of individual audits may be seen as a means to improving audit quality. Further, to complete the remediation process, it was suggested that a requirement to perform a root cause analysis on identified deficiencies be added to ISQC 1.

⁶ IES 8, *Professional Competence for Engagement Partners Responsible for Audits of Financial Statements (Revised)*

⁷ See ISQC 1 paragraphs 48–54

18. Regulators noted that some of the firms currently perform internal monitoring procedures on their network firms, however such a requirement is not embedded into ISQC 1; they therefore suggested a requirement for such a process be incorporated.
19. The WG will perform further research into the firm's views on remediation processes.

Matter for IAASB Consideration

2. Does the IAASB agree that the updates to ISQC 1 in respect of policies and procedures regarding remediation processes should form part of the quality control project?

Outsourcing and Shared Service Centers

20. As noted above, at its meeting in June 2014, the IAASB discussed the effects of off-shoring on audit quality. The Board felt that off-shoring could equally present opportunities for firms to improve audit quality through standardization of routine audit tests and the performance of more administrative tasks associated with the audit. The Board thought that off-shoring should not always be seen as being detrimental to quality and cautioned that any deliberations by the WG should present a balanced view.
21. The WG has also noted that, in addition to the type of off-shoring discussed at the June Board meeting, consistent with many businesses, firms are creating “centralized areas of excellence,” which are shared facilities that provide leadership, best practices and research, support and training for a focus area. Consideration should be given as to whether such areas of excellence should fall under the definition of off-shoring for incorporation into the quality control project.
22. The topic of off-shoring is one that has been identified as the highest priority by some regulators. It is estimated that in Europe up to 15% of the procedures performed on an audit engagement are being sent to centralized locations. Initial discussions with certain regulators indicate the perception that ISQC 1 does not extend to controls over these locations.
23. With respect to the approaches and methodologies that firms have in respect of off-shoring, initial indications are that there are different approaches both between the firms and amongst the network within the firms. Methodologies include incorporation of the centralized location into the core engagement team, lists of standard procedures that can be performed at the centralized location, and team flexibility on the procedures that are sent to the centralized location.
24. To further understand the methodologies, Staff has prepared a survey in conjunction with the ISA 600 Working Group to obtain the firms' input on the progress and substance of their methodologies with regard to outsourcing and shared service centers.
25. The WG will incorporate the results of this survey into its considerations of the scoping of the quality control project.

Matter for IAASB Consideration

3. Does the IAASB agree that updates to ISQC 1 to incorporate policies and procedures in respect of outsourcing and shared service centers should form part of the scoping for the quality control project?

Modernization of ISQC 1

Framework for Audit Quality

26. At the June IAASB Board Meeting, Staff presented an initial comparison of the Framework to the requirements in ISQC 1 on the areas of Values, Ethics and Attitudes at the firm level. The WG has extended this comparison to incorporate the other areas at the firm level discussed in the Framework, namely: Knowledge, Experience and Time; and Audit Process and Quality Control Procedures. Similar to the initial analysis, only a few areas where ISQC 1 does not appear to address the matters in the Framework were identified. (See Supplement 2 to this paper).
27. The areas that the WG thought may need to be further addressed in the ISAs are as follows:
- Values, Ethics and Attitudes
 - Governance arrangements—including guidance⁸ relating to the public interest nature of the audit function such that other areas of the practice are not inappropriately promoted; and the frequency of communication of expected behaviors.
 - Necessary personal characteristics are promoted through appraisal and reward systems—including guidance relating to the use of competence frameworks in the appraisal and reward systems that embed appropriate personal characteristics and behaviors.
 - Financial considerations—including more guidance on actions which may be considered to be detrimental to audit quality.
 - Knowledge, Time and Experience
 - Partners and staff have sufficient time and resources to deal with issues as they arise—including an extension of the current application material to include senior staff.
 - Engagement teams are properly structured—including guidance on appropriate allocation of partners and staff based on the risk of the engagement and available time to properly perform the engagement.
 - Provision of timely appraisals and appropriate coaching—including guidance relating to the performance of timely appraisals; and the selection of appropriate individuals to provide coaching.
 - Specific training is given to partners and audit staff on audit and accounting and where appropriate specialized industry issues—specifically including systems to provide partners and staff with specialized industry training.
 - Audit Processes and Quality Control Procedures
 - Audit methodology is adapted to developments in professional standards and to findings from internal quality reviews and external inspections—including development of guidance relating to the performance of root cause analyses.
 - The audit methodology encourages individual team members to apply professional skepticism and exercise appropriate judgment—including guidance discussing potentially over prescriptive methodologies that may stifle professional judgment.

⁸ The term “guidance” is used in this context to incorporate a requirement in the ISAs, application material in the ISAs or both.

- Rigorous quality control procedures are established and audit quality is monitored and appropriate consequential action taken—including guidance relating to quality control and monitoring policies and procedures where common methodologies are shared across a network of firms.
28. In addition to a review of the Framework, the WG considered other current projects and initiatives undertaken by other bodies in the area of the governance of audit firms; and other feedback that indicates the belief that ISQC 1 should be re-written on a risk assessment basis that allows for conditional requirements and that can be better incorporated in firms' internal quality control procedures and methodologies irrespective of the firm size.
29. Other than a review of the Framework, the WG believes that incorporating current projects and initiatives undertaken by other bodies in the area of the governance of audit firms and the overall modernization of ISQC 1 would be a longer term, more strategic project that could be included in the next revision of the IAASB work plan.

Matter for IAASB Consideration

4. Does the IAASB agree
- With the analysis of the comparison of the Framework to ISQC 1, and if so, believe that these areas should be addressed through revisions to the ISAs?
 - That further considerations with respect to corporate governance of audit firms and their networks is an area that should be further explored as part of a longer term, strategic project that could be included in the next revision of the IAASB work plan?

Proportionality and Application to Assurance Engagements

30. As noted above, the IAASB at its June 2014 meeting generally thought that ISQC 1 was capable of being proportionately applied and that a separate standard for small- and medium-sized firms was not warranted.
31. Subsequent to the Board meeting, initial feedback from the Small and Medium Practices Committee (SMPC), indicates that small- and medium sized firms generally believe that ISQC 1 was written with large firms and audits in mind and that it is cumbersome and burdensome for smaller practices to apply. However, to date, it is not clear, with any level of specificity, which requirements are causing this concern or the specific application issues. Staff and SMPC continue to further investigate the nature of specific concerns, both with the application of ISQC 1 to audits and to other assurance engagements.
32. The WG also considered the guidance that currently exists in respect of the proportionate application of ISQC 1, and noted through a review of the NSS Resources Directory that, in addition to the IAASB and SMPC guidance, many jurisdictions have developed their own guidance on the application of the International Standards to the audits of smaller entities.
33. Notwithstanding concerns expressed by small and medium sized firms with respect to the construct of ISQC 1, and absent a re-write of the standard, discussion with the SMPC would also suggest that sufficient guidance has already been issued with respect to the implementation of ISQC 1 by the various bodies, and that raising awareness of this guidance may be part of the solution.
34. The WG will have further discussions with the SMPC in respect of the potential for future streamlining of existing guidance incorporating, as appropriate, guidance issued by the NSS.

35. The WG believes that, based on the IAASB's current thinking, further updates to ISQC 1 in respect of its proportionate application would form part of a longer term project.

Matter for IAASB Consideration

5. Does the IAASB agree that:
- Given the volume of existing guidance on the proportionate application of ISQC 1, promoting the awareness of this guidance is an appropriate short term course of action?
 - More extensive updates to ISQC 1 should form part of a longer term project?