Agenda Item
6

Quality Management (Firm level): Considerations in Relation to the Draft Exposure Draft of Proposed ISQC 1 (Revised)[1]

Objective of the IAASB discussion

The objective of this Agenda Item is to obtain the IAASB's input on the draft Exposure Draft (ED) of Proposed ISQC 1 (Revised), set out in **Agenda Item 6–A**. This paper provides an overview of the Quality Control Task Force's (QCTF) considerations in developing the draft ED.

Introduction

1. This paper should be read in conjunction with **Agenda Item 6–A**. **Agenda Item 6–B** provides a comparison of the requirements in extant ISQC 1 to **Agenda Item 6–A**.

2. The QCTF presented a working draft of Proposed ISQC 1 (Revised) to the IAASB in June 2017. This was followed by a discussion in relation to the "quality management process" (i.e., the quality objectives, quality risks and responses) in August 2017 and "documentation" in September 2017. The QCTF has yet to address certain discrete topics in relation to Proposed ISQC 1 (Revised) that will be presented to the IAASB in 2018. These include:

    (a) Transparency reporting;

    (b) Engagement partner performance and rewards, and engagement partner competency and human resources; and

    (c) Consideration of the effect of changes to the International Ethics Standards Board for Accountants (IESBA) *Code of Ethics for Professional Accountants* (the Code).

    Accordingly, although **Agenda Item 6–A** may include matters related to these topics, the QCTF needs to further consider how to address them in the context of the feedback from respondents to the Invitation to Comment (ITC), *Enhancing Audit Quality: A Focus on Professional Skepticism, Quality Control and Group Audits*. The QCTF also recognizes that conforming amendments to the other engagement standards may be necessary, and is further considering how these will be addressed in conjunction with the ISA 220[2] Task Force.

3. Over recent months, the QCTF has been encouraged to consider the length of the application material presented to the IAASB in the June 2017 working draft. In developing **Agenda Item 6–A**, the QCTF agreed that it would be useful to include all guidance which the QCTF considers useful, however it is recognized that certain guidance may not be necessary for the application of the standard and may be better placed in a separate publication (see paragraphs 97–99). These paragraphs are marked in "grey text" in **Agenda Item 6–A.** In considering **Agenda Item 6–A**, the IAASB is asked to consider whether the application material provided is appropriate and whether the application material highlighted in "grey text" should be located in a separate publication or retained in the standard.

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

[2] International Standard on Auditing (ISA) 220, *Quality Control for an Audit of Financial Statements*

Summary of June 2017 IAASB Discussions – Overall Comments

4.   An overview of the IAASB's discussions has been included in the various sections of this paper relevant to the respective topics. The overall discussions of the IAASB have highlighted:

   (a)   Overall support for the proposed direction in relation to Proposed ISQC 1 (Revised).

   (b)   The importance of outreach with a variety of stakeholders.

   (c)   Exploring the development of a publication to accompany the ED that would provide additional guidance and examples in relation to the implementation and application of the revised standard.

   (d)   Keeping the standard principles-based and the importance of recognizing small and medium sized practices (SMPs) and other types of organization, other than firms, for example, through more conditional requirements, better signposting or clarifying how a system of quality management can be scaled according to the circumstances of the firm.

   (e)   The need to remain focused on why the changes are in the public interest and how they are expected to improve audit quality.

Summary of Consultative Advisory Group (CAG) Feedback

5.   The QCTF presented a working draft of Proposed ISQC 1 (Revised) to the CAG at its September 2017 meeting. An overview of the CAG's feedback has been included in the various sections of this paper relevant to the respective topics. In addition to certain members expressing support for the proposed direction, the CAG discussed the application of the standard by SMPs, the importance of developing guidance to support the application of the standard and addressing other types of engagements in Proposed ISQC 1 (Revised).

Summary of Outreach Feedback

6.   Since the June 2017 and August 2017 IAASB discussions, the QCTF has undertaken various outreach, including:

   (a)   A two-day workshop with representatives of the Global Public Policy Committee (GPPC), that was observed by a representative of the International Forum of Independent Audit Regulators (IFIAR) Standards Coordination Working Group, as well as the Secretary General of the Public Interest Oversight Board;

   (b)   A one-day workshop with representatives of the Forum of Firms (FoF);

   (c)   A half-day workshop with members of the International Federation of Accountants (IFAC) SMP Committee;

   (d)   A teleconference with representatives of IFIAR; and

   (e)   A webcast aimed largely at SMPs.

For the purposes of this outreach, participants were provided with a working draft of Proposed ISQC 1 (Revised), which comprised the version presented to the IAASB in June 2017 that was updated to reflect the August 2017 proposals and various other revisions to address certain of the IAASB's comments. The working draft was not provided for the purposes of the SMP webcast. The QCTF is

in the process of arranging outreach with public sector constituents. The QCTF is also considering further outreach in 2018 as the ED is progressed.

7. The feedback from the outreach with the GPPC, FoF, SMP Committee and the webcast has been included in the various sections of this paper. A summary of the feedback from the IFIAR representatives will be presented to the IAASB at the December 2017 meeting. The QCTF has addressed certain feedback, however there are matters that the QCTF has yet to consider and will do so in conjunction with the feedback from further outreach that has not yet taken place.

8. In general, outreach participants were supportive of the revised, scalable approach to managing quality. Participants further commented as follows:

   (a) The changes may not change behavior in some circumstances, since firms may recourse to a "standard" system of quality management obtained from a network or third party service provider. However, the revised standard may cause the firm to reflect on why they have implemented policies and procedures, and assess if they remain appropriate.

   (b) More flexible requirements could create expectation gaps between firms and regulators, however others shared different views that a more principles-based approach is necessary to support scalability.

   (c) There were views that the proposals did not seem reflective of the circumstances of SMPs. It was further noted that a more burdensome system of quality management could have the unintended consequence of negatively affecting engagement quality as firms would need to allocate resources to support the system, reducing available resources for engagements.

   (d) Accompanying guidance will be extremely important in order to support implementation. A participant also encouraged the IAASB to be innovative in their presentation of the standard, to facilitate an improved understanding of the requirements.

   (e) The effective date will need to be well considered, since it will take time for firms to develop their systems.

Task Force Views

9. The QCTF has considered the above feedback and particularly noted the differing views regarding keeping the standards scalable to accommodate a wide variety of firms, while at the same time addressing concerns that more flexible requirements may generate expectation gaps. The QCTF remains of the view that a scalable approach to the management of quality is necessary to accommodate the wide variety of firms, and prescriptive requirements would result in this objective not being met. The QCTF considered how the scalability of the standard could be improved and:

   (a) Has reorganized the standard with a simpler and clearer structure, which the QCTF believes will reduce expectation gaps and more evidently demonstrate the scalability of the standard (see paragraphs 23–28).

   (b) Has introduced a new section in the introduction, "Considerations in Relation to the Size and Complexity of the Firm", that aims to clarify, upfront, how the standard may be applied to different firms. The QCTF has focused this section on all ranges of firms (i.e., size and complexity of the firm), rather than only SMPs, given the difficulty in defining SMPs and to further emphasize the scalability of the standard to a wide variety of firms.

The QCTF has also considered whether any of the requirements could be conditional, but agreed that the requirements would, in general, be applicable to all firms, although applied proportionately in the context of the firm's circumstances. Furthermore, paragraph 19 of **Agenda Item 6–A** highlights that any requirements that are not relevant need not be complied with, for example, performance evaluations in the case of a sole practitioner.

10. The QCTF considered the comments regarding how the proposals would impact firms. The QCTF noted that the impact on the firms may vary, for example:

 (a) Some firms may already have enhanced their system of quality management beyond what is required under extant ISQC 1, including having introduced a risk-based approach, and therefore the perceived impact of Proposed ISQC 1 (Revised) may not be significant. This may be the case for firms located in jurisdictions that have, for example, audit firm governance codes, or enhanced audit regulation or inspection regimes. As a result, firms may have enhanced their system of quality management to address jurisdictional requirements.

 (b) The policies and procedures implemented by some firms under extant ISQC 1 may not change significantly given that many aspects of the extant standard, including the elements, have been retained in Proposed ISQC 1 (Revised).

 (c) Some firms, for example smaller firms, may continue to adopt a simplistic approach to their system of quality management and therefore the perceived impact may not be significant.

11. Despite the varying impact on firms, the QCTF remains of the view that a risk-based approach to the management of quality is a logical and sensible approach and will create benefit for firms through, for example:

 (a) Improving the interrelationship of the various aspects of the firm's activities that are currently in place.

 (b) Improving the firm's process for setting up its system of quality management and focusing more on areas of higher assessed quality risks, while implementing responses that are proportionate to their assessed significance.

 (c) Promoting the sustainability of quality by, for example, reducing the extent of shortcomings through a proactive and continuous management of quality and increased use of ongoing monitoring activities.

 (d) Improving the connection between firm level quality management and the management of quality at the engagement level as a result of the proposed enhancements to ISQC 1 and ISA 220.

12. The QCTF also noted the views that firms may adopt a "standard" system obtained from a network or third party service provider. Paragraphs 75–83 further discuss the use of networks and third party service providers.

13. The QCTF acknowledged the requests for additional guidance to support implementation and will continue to consider the development of such guidance (see paragraphs 97–99).

Matter for IAASB Consideration

1. In light of the feedback from the various outreach activities, is the IAASB of the view that Proposed ISQC 1 (Revised) provides appropriate scalability for a wide range of firms?

Reasonable Assurance

Summary of June 2017 IAASB Discussions

14. At its June 2017 meeting, the IAASB discussed:

    (a) Clarifying the meaning of reasonable assurance, including how it relates to the assessment of the system of quality management.

    (b) The use of the term "reasonable assurance" in each element. In this regard it was noted that "reasonable assurance" is used within each element of extant ISQC 1, however Proposed ISQC 1 (Revised) does not use this term within each component, and therefore it could be perceived that the robustness of the standard has been diluted.

    (c) Clarifying what would be considered a "deficiency", a "deficiency in the system of quality management" and the varying levels of severity of deficiencies, and how these are considered individually and in aggregate.

Summary of Outreach Feedback

15. Participants discussed:

    (a) The firm's evaluation that it has reasonable assurance regarding the achievement of the objective of the system of quality management, in particular what is needed to support the evaluation.

    (b) The importance of clarifying a deficiency versus other shortcomings in the system, and encouraged the QCTF to consider the IFIAR definition of deficiency.

Task Force Views

"Reasonable Assurance" in Respect of Each Component

16. The QCTF considered how the concept of reasonable assurance is applied in the COSO Internal Control – Integrated Framework,[3] which explains that reasonable assurance is attained when:

    (a) Each of the five components of internal control and the relevant principles are present and functioning; and

    (b) The five components are operating together in an integrated manner.

    The COSO Integrated Framework does not require the organization to obtain reasonable assurance in relation to each component.

17. The QCTF is of the view that it would not be appropriate to require firms to obtain reasonable assurance in relation to each component of Proposed ISQC 1 (Revised), since:

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[3] Committee of Sponsoring Organizations of the Treadway Commission (COSO), *Internal Control – Integrated Framework*

(a)   Similar to the COSO Integrated Framework, all of the components are interrelated and affect each other (i.e., they do not operate in isolation and the components overlap in many areas). The QCTF noted that the elements under extant ISQC 1 are more disaggregated.

(b)   Each component individually would not provide the firm with reasonable assurance in relation to the overall objective of the system of quality management.

(c)   In applying each ISA, the auditor is not expected to obtain reasonable assurance in relation to the objective of each standard; it is the collective work that provides the auditor with reasonable assurance.

A Deficiency in the System of Quality Management and Circumstances when a Deficiency May Result in the Firm Not Achieving Reasonable Assurance

18.   The QCTF agreed that a "deficiency in the system of quality management" would be analogous to an "internal control deficiency" under the COSO Integrated Framework[4] (see paragraph 17(b) of **Agenda Item 6–A**). The QCTF further noted that the COSO Integrated Framework defines a "major deficiency",[5] and explains that:

(a)   A major deficiency exists when management determines that a component and one or more relevant principles are not present or functioning or that components are not operating together; and

(b)   When a major deficiency exists, the organization cannot conclude that it has met the requirements for an effective system of internal control.

19.   The QCTF noted that the framework established in the COSO Integrated Framework for evaluating deficiencies is useful, in particular the concept of a major deficiency. The QCTF debated how this concept could be introduced in Proposed ISQC 1 (Revised), since it would be useful in promoting consistency across firms in evaluating the firm's system of quality management. The QCTF noted that the components of the standard would need to be established at the appropriate level of granularity, i.e., at the level at which a major deficiency would be considered to exist. The QCTF agreed that a breakdown in any of the following aspects of the system of quality management would in most cases be considered a major deficiency:

(a)   The quality management process (QMP);

(b)   Governance and leadership;

(c)   Information and communication;

(d)   Relevant ethical requirements;

(e)   Acceptance and continuance of client relationships and specific engagements;

(f)   Resources;

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[4]   An internal control deficiency is defined as "a shortcoming in a component or components and relevant principle(s) that reduces the likelihood that the entity can achieve its objectives."

[5]   A major deficiency is defined as "an internal control deficiency or combination of deficiencies that severely reduces the likelihood that the entity can achieve its objectives." The COSO Integrated Framework further adds that "a major deficiency exists in the system of internal control when management determines that a component and one or more relevant principles are not present or functioning or that components are not operating together".

(g)   Engagement performance; and

(h)   The monitoring and remediation process.

20.   Accordingly, in order to align the approach for assessing a deficiency with the COSO Integrated Framework, the QCTF agreed that all of the above areas should be standalone components in Proposed ISQC 1 (Revised). Establishing the above areas as standalone components:

(a)   Addresses various concerns from the IAASB and outreach regarding the importance of the elements;

(b)   Provides a clearer linkage with Proposed ISA 220 (Revised), which has retained the elements from extant ISA 220 (referred to as sections in relation to Proposed ISA 220 (Revised)); and

(c)   Allows for the concept of a "major deficiency" to be introduced in Proposed ISQC 1 (Revised)

21.   Proposed ISQC 1 (Revised) includes a framework for assessing whether the firm has reasonable assurance that the overall objective of the system of quality management has been achieved (see paragraphs 17(b), 17(k), 55, 58 and A2–A5 of **Agenda Item 6–A**). This framework comprises:

Step 1:   Establishing whether a shortcoming in the system of quality management is a deficiency.

Step 2:   Evaluating whether a deficiency, or a combination of deficiencies, results in the overall component not operating effectively, i.e., the deficiency, or a combination of deficiencies, is so significant that it is considered to be a major deficiency.

When the firm has determined that a major deficiency exists, until such time as the major deficiency has been remediated, the firm may not have reasonable assurance that the objective of the system of quality management has been met. Paragraph 61 of **Agenda Item 6–A** requires the firm to promptly communicate major deficiencies to the persons assigned ultimate and operational responsibility for the system of quality management, who are required to monitor the effectiveness of remedial actions planned and implemented to address such deficiencies. Given the recognition in the standard that the firm may not have reasonable assurance until the major deficiency is remediated, it encourages firms to take immediate action to reduce the severity of the major deficiency and eventually fully remediate it.

22.   The QCTF noted that under the COSO Integrated Framework, a major deficiency automatically results in the organization concluding that it has not met the requirements for an effective system of internal control. However, the QCTF is of the view that a major deficiency would not automatically result in the firm's system of quality management not providing the firm with reasonable assurance that the overall objective of the system of quality management has been achieved in all cases.

Revised Structure of Proposed ISQC 1 (Revised)

23. Establishing separate components as proposed in paragraph 19 results in a structure that is different from the structure previously presented to the IAASB. The previous components of governance and leadership, information and communication and the QMP have been retained, however monitoring and remediation has been separated from the QMP and introduced as a new component in order to emphasize that monitoring and remediation applies to all of the components, including the QMP. Furthermore, the remaining elements of extant ISQC 1 have been introduced as components, i.e., relevant ethical requirements, acceptance and continuance, resources and engagement performance.
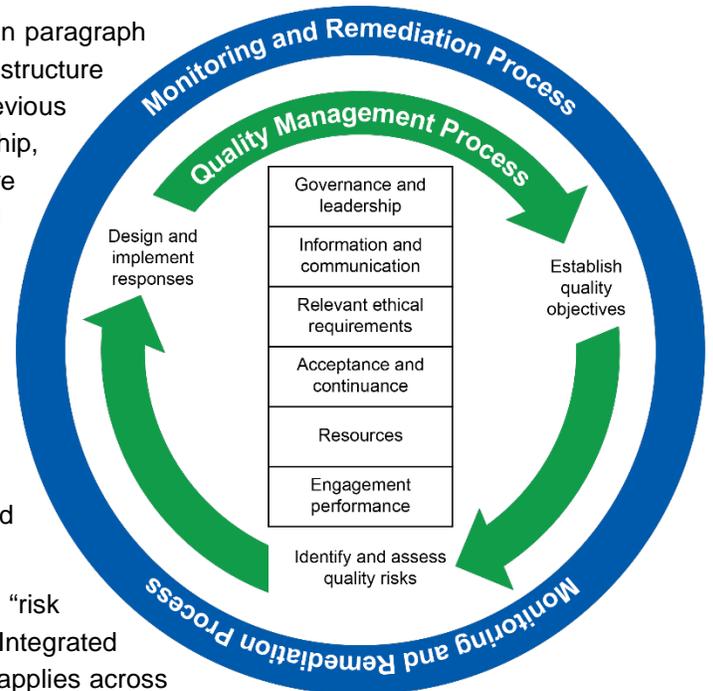
24. The QCTF noted that the QMP is similar to the "risk assessment" component in the COSO Integrated Framework, i.e., it is a separate component that applies across the other components. The QCTF further agreed that it is necessary for the QMP to be a standalone component since a deficiency in this process could constitute a deficiency in the system of quality management.

25. The QCTF debated the relationship between the QMP and the other various components. The QCTF is of the view that establishing objectives, identifying and assessing risks and designing and implementing responses is a process that should be applied by the firm in relation to its governance and leadership and information and communication, as well as the other components of relevant ethical requirements, acceptance and continuance, resources and engagement performance.

26. The QMP and monitoring and remediation components have been established in Proposed ISQC 1 (Revised) as processes with specific requirements. In this regard, the QCTF do not propose that a firm needs to establish quality objectives, quality risks and responses in relation to these two components as the proposed requirements are considered sufficiently comprehensive to drive the desired behavior. Deficiencies in these components would be identified through measuring a shortcoming against the requirements and determining whether the requirement has been met (see paragraph A7 of **Agenda Item 6–A**). For the purposes of driving consistency in determining whether a deficiency is a major deficiency, each of these components includes a component objective.

27. In addition to the reasons explained above regarding why the QMP should not be applied to the monitoring and remediation component, the QCTF is also of the view that doing so:

    (a) Would be unreasonably complicated and difficult for firms to implement in practice;

    (b) May blur the distinction between a response to a quality risk (e.g., a detection control) and a monitoring activity; and

    (c) Could result in it not being clear that monitoring is intended to be a process that provides an objective evaluation of the remaining components of the system of quality management.

28. Applying the QMP to all of the remaining components, with the exception of monitoring and remediation:

    (a) Emphasizes the scalability of the components that were previously outside of the QMP (outreach feedback highlighted a perceived lack of scalability in relation to governance and leadership);

    (b) Allows the standard to be developed in a more consistent manner, i.e., across each of the components the same process applies, that creates repetition in the components and therefore is clearer and simpler to understand;

    (c) Improves the linkage across the components, for example, a response in relevant ethical requirements may be designed to address a quality risk in relation to governance; and

    (d) Promotes a more proactive, risk-based approach to addressing the components that were previously outside of the QMP.

The Frequency of the Firm's Evaluation of its System of Quality Management

29. The QCTF debated the frequency with which the firm should evaluate whether its system of quality management provides it with reasonable assurance that the overall objective has been met. The QCTF agreed that:

    (a) It would not be appropriate to prescribe a "point in time" assessment, since the system of quality management is a continual, dynamic process tailored for the firm's circumstances. Through its monitoring activities, which may be ongoing or periodic, the firm would identify a deficiency at a point in time, and it would be determined at that point in time whether the deficiency is a major deficiency and accordingly whether the firm has reasonable assurance regarding the overall objective. Establishing a "point in time" assessment could discourage firms from assessing and addressing deficiencies as and when they are identified. Furthermore, the impact of changes to the firm's circumstances are required to be considered as set out in paragraph 24 of **Agenda Item 6–A** (i.e., changes in the firm's circumstances could affect what is needed to achieve reasonable assurance, however since these are considered as part of the continual process, there is not a need for a point in time assessment).

    (b) A "point in time" assessment may imply that the firm evaluates the effectiveness of the system for a past period. The QCTF questioned the value of such an assessment, noting that the objective of the system is to detect, correct and prevent deficiencies. The QCTF is of the view that the assessment of reasonable assurance is an ongoing assessment of whether the system continues to detect, correct and prevent deficiencies on an ongoing basis, rather than just a historical "look-back" of whether it provided reasonable assurance for a past period.

    (c) The requirement for the firm to communicate on a timely basis, but at least annually, information about the results of the firm's monitoring and remediation that is relevant to personnel in the firm would drive the firm to evaluate the system of quality management at least on an annual basis. Paragraph 61 of **Agenda Item 6–A** also introduces a requirement for more timely communication of major deficiencies to firm leadership, in order that these are promptly addressed and remediated.

Application material has been included to explain the concept of the firm's evaluation of whether it has reasonable assurance regarding the overall objective (see paragraphs A2–A5 of **Agenda Item 6–A**).

Matters for IAASB Consideration

2.   The IAASB is asked to share their views regarding:

(a)   The proposed components of the system of quality management and how they are interrelated.

(b)   Whether the concept of a major deficiency is useful in providing a framework for the firm in determining whether it has reasonable assurance that the overall objective has been met.

(c)   Whether the concepts of a deficiency in the system of quality management and major deficiency are appropriately defined and established.

(d)   The proposal of the QCTF with respect to a point in time assessment, i.e., that it is not appropriate to prescribe a point in time assessment, as this is implicitly addressed through evaluating deficiencies as they are identified.

Objective of Proposed ISQC 1 (Revised)

Summary of June 2017 IAASB Discussions

30.   At its June 2017 meeting, the IAASB discussed the objective of the standard, noting that it was similar to extant ISQC 1, and expressed mixed views regarding whether it should be revised to reflect a notion of quality.

Summary of Outreach Feedback

31.   Participants noted that despite the extent of change in the standard, the objective remained consistent and:

(a)   Expressed mixed views about reflecting a notion of quality in the objective, although agreed that the objective implies a "compliance" mindset, and this could be improved.

(b)   Encouraged the QCTF to keep the objective focused on the outcome of the system.

Task Force Views

32.   In considering the revisions to the objective, the QCTF:

(a)   Reflected upon the intended objective of this project, noting that the purpose was to revise the approach to quality control in order to address specific issues and concerns with extant ISQC 1.[6]

(b)   Considered whether it would be possible for the objective to reflect a notion of "improvement of quality." However, the QCTF agreed that this would result in an objective that would not meet the key principles of an objective, i.e., something that is measurable, observable, attainable

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[6]   See, for example, paragraph 64 of the ITC and paragraphs 22 and 30–33 of the project proposal.

and relevant. The QCTF further noted that quality is a complex subject and there is no definition or analysis of it that has achieved universal recognition.[7]

    (c)   Noted that the term "compliance" in the objective could create a misconception that the firm needs to do the minimum necessary to comply with the standard, instead of applying the spirit of the standard that encourages firms to design and implement a system of quality management that proactively manages quality. The QCTF also noted that the term "maintain" is intended to convey that the firm needs to proactively manage the system.

    (d)   Considered terminology used in other standards, for example, ISA 700 (Revised)[8] uses the phrase "conducted in accordance with the ISAs" and ISA 200[9] notes that "the ISAs, taken together, provide the standards for the auditor's work in fulfilling the overall objectives of the auditor."

33.   The QCTF agreed that the phrase "the firm and its personnel *comply with* professional standards and applicable legal and regulatory requirements" should be replaced with the phrase "the firm and its personnel *fulfill their responsibilities* in accordance with professional standards and applicable legal and regulatory requirements." The QCTF agreed that "fulfill" better articulates that the firm and its personnel are expected to do more than the minimum, i.e., complying with the spirit and the letter of professional standards and applicable legal and regulatory requirements. This is further supported in paragraph 3 of **Agenda Item 6–A** which provides an enhanced explanation of the objective.

34.   In addition to the considerations above, the QCTF debated the meaning of the term "reports issued by the firm or engagement partners", i.e., whether this is intended to cover all reports issued by the firm (including transparency reports), all reports issued in relation to engagements or only the engagement report (i.e., the opinion, conclusion, report of factual findings etc.). The QCTF agreed that the meaning is intended to cover all reports issued in relation to engagements and will further consider how the objective relates to firms' transparency reports when the QCTF presents this topic to the IAASB.

Matters for IAASB Consideration

3.   Does the IAASB support the objective of Proposed ISQC 1 (Revised)?

4.   Does the IAASB agree with the conclusion of the QCTF that all reports issued in relation to engagements are covered by the meaning of the term "reports issued by the firm or engagement partners"?

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[7]   See, for example, Appendix 1 of *A Framework for Audit Quality: Key Elements that Create an Environment for Audit Quality,* which states that "the term "audit quality" is frequently used in debates among stakeholders, in communications of regulators, standard setters, audit firms and others, and in research and policy setting. Audit quality is a complex subject and there is no definition or analysis of it that has achieved universal recognition."

[8]   ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*

[9]   ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*

QMP

Summary of June 2017 and August 2017 IAASB Discussions

35. The IAASB discussed the QMP at its June 2017 meeting and August 2017 teleconference and supported the overall approach, including the granularity of the prescribed quality objectives and quality risks presented in August 2017. The IAASB discussions also included:

    (a) Exploring how to retain the elements from extant ISQC 1.

    (b) Clarifying the relationship between the quality objectives, including how they interrelate with the other components of Proposed ISQC 1 (Revised) (i.e., governance and leadership and monitoring and remediation) and clarifying circumstances when it may be appropriate to establish additional quality objectives.

    (c) Improving the linkage between the quality risks and responses in Proposed ISQC 1 (Revised) and Proposed ISA 220 (Revised).

    (d) Establishing an appropriate "threshold" in relation to the identification and assessment of quality risks and considering how the "threshold" and identification of quality risks relates to deficiencies in the system of quality management and the overall objective of the standard (i.e., "reasonable assurance").

    (e) The operation of the proposals in the circumstance of a network of firms and the impact of alternative delivery models[10] on the quality risks and responses in the standard.

    (f) Specifically addressing the quality of professional judgments at the engagement level and the processes needed to support the professional judgments within the QMP, as well as capturing professional skepticism in the quality objectives and quality risks.

Summary of Consultative Advisory Group (CAG) Feedback

36. The CAG feedback included:

    (a) Support for establishing minimum quality objectives and quality risks with various suggestions for additional quality risks that could be included.

    (b) Exploring how the requirements could be developed in a more positive manner.

Summary of Outreach Feedback

37. Feedback from outreach participants included the following:

    (a) Participants emphasized the importance of the elements in extant ISQC 1 and how these are currently understood and used.

    (b) In practice firms may identify and assess quality risks differently and therefore the standard needs to be clear about how this should be operationalized, including placing appropriate focus on areas of more significant quality risk.

    (c) There were varying views regarding the required quality risks:

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[10] An expression intended to cover terms such as "firm shared service centers," "centers of excellence," "on-shoring," "offshoring," or "outsourcing."

(i)   On the one hand, participants encouraged the QCTF to be less prescriptive with the quality risks, noting that it adds confusion, does not appear to be scalable and may drive a checklist-based approach. It was suggested that these could instead be articulated as objectives.

(ii)   However, others expressed support for more prescriptive quality risks in order to eliminate uncertainty that could arise regarding what quality risks should be identified.

Participants also commented that the manner in which the risks are drafted is difficult to understand (i.e., in a negative manner).

(d)   Participants sought clarity regarding the reassessment of the QMP, i.e., how frequently this would need to occur.

Task Force Views

Threshold for Identifying and Assessing Quality Risks

38.   In debating how to establish a threshold for identifying and assessing quality risks, the QCTF considered how a quality risk and a deficiency in the system of quality management are related in the context of reasonable assurance. The QCTF noted that, throughout the IAASB's International Standards and in the COSO Integrated Framework, reasonable assurance is linked to the concept of reducing risk to an acceptably low level. Applying this concept to quality risks would result in the firm excluding those quality risks where the likelihood that the quality risk will occur or the impact of the quality risk if it did occur is at an acceptably low level. The QCTF agreed that this is a well-established and understood concept, and would form an appropriate basis for the threshold for identifying and assessing quality risks.

39.   Accordingly, the QCTF has introduced the concept of "clearly trivial quality risks," which is the threshold below which the quality risks need not be identified and assessed. The concept of clearly trivial is described in paragraph A17 of **Agenda Item 6–A**.

Reassessing the Quality Objectives, Quality Risks and Responses

40.   A fundamental principle of the QMP is that the firm evaluates its system in response to information that may indicate that deficiencies exist, or that the firm's circumstances have changed. The QCTF recognized the IAASB feedback to more clearly highlight the continual nature of a system of quality management and the firm's consideration of the quality objectives, quality risks and responses in response to various information. Furthermore, feedback from outreach highlighted the need to clarify the expectation regarding when a firm may need to reevaluate its quality objectives, quality risks and responses, as it was noted that it could be impracticable to expect firms to do so on a continual basis.

41.   The QCTF have therefore introduced a new requirement for the firm to determine whether the quality objectives, quality risks and responses remain appropriate when there are changes relevant to the system of quality management (see paragraph 24 of **Agenda Item 6–A)**. Furthermore, in performing the root cause analysis, paragraph 57 of **Agenda Item 6–A** requires the firm to determine whether the root cause(s) indicates that there is a deficiency in the design or operation of the firm's quality management process that may include inappropriate quality objectives, quality risks and responses. The QCTF is of the view that these requirements clearly establish the expectation of the frequency of the firm's reevaluation and is scalable as it only comes into operation when these events occur (i.e., there is a change in circumstance or a deficiency).

Quality Management (Firm Level): Considerations in Relation to the Draft Exposure Draft of Proposed ISQC 1 (Revised)
IAASB Main Agenda (December 2017)

Policies or Procedures

42.   In previous discussions with the IAASB (December 2016 and June 2017), the QCTF proposed introducing the concept of "responses to quality risks" in order to improve the scalability of Proposed ISQC 1 (Revised) and provide flexibility for firms in choosing the nature of the response to quality risks, i.e., whether the firm chooses policies, procedures, processes or other methods as a response. Paragraph A18 of **Agenda Item 6–A** further explains this concept. The QCTF recognizes that in its recent discussions in relation to ISA 315 (Revised),[11] the IAASB concluded that "policies and procedures" includes any actions that may be taken, which may be different from how policies or procedures are articulated in Proposed ISQC 1 (Revised). The QCTF has yet to consider the impact of this revised thinking on Proposed ISQC 1 (Revised), as well as how this cascades down to the engagement level (the QCTF recognize that Proposed ISA 220 (Revised) conitnues to use the term "policies and procedures"). In particular, given that the COSO Integrated Framework has been used as a guideline in the development of Proposed ISQC 1 (Revised), the QCTF needs to consider how the use of "policies and procedures" in the context of "control activities" under the COSO Integrated Framework, relates to the use of "responses" and "policies or procedures" in Proposed ISQC 1 (Revised). In doing so, the QCTF will remain focused on ensuring that the scalability of the revised standard is clear.

Matters for IAASB Consideration

5.   The IAASB is asked to share their views regarding whether:

   (a)   The proposed threshold for identifying and assessing quality risks is appropriate and will result in a consistent interpretation of the extent of quality risks that need to be identified and their specificity.

   (b)   The requirement for the firm to determine the continued appropriateness of the quality objectives, quality risks and responses is clear and practicable.

6.   The IAASB is asked to share their views regarding the application material supporting the QMP component, in particular whether it supports locating the "grey text" application material in a separate publication and whether any other application material not marked "grey text" should also be located in such publication.

General Matters Relating to the Components

Structure of the Requirements in the Components

43.   The QCTF noted varying inconsistencies in the requirements for each component previously presented to the IAASB, for example, some components had principles and specific requirements while others had required quality objectives and quality risks. The QCTF agreed that in order to keep the standard understandable and practicable, the requirements for each component would need to be established in a consistent manner that also reflects the application of the QMP. Accordingly, with the exception of the QMP and the monitoring and remediation process, each of the components has been established with:

   (a)   A component objective.

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[11]   ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

Agenda Item 6
Page 14 of 33

(b)   Required quality objectives.

(c)   A requirement for the firm to establish quality risks in relation to the component.

(d)   Required responses, or a requirement for the firm to establish responses in relation to the component

Component Objectives, Required Quality Objectives, Quality Risks and Responses

44.   The QCTF concluded that each component should have a component objective, i.e., a criteria for determining whether or not a deficiency results in the component being effective and therefore whether the firm has a major deficiency. The QCTF noted that this is essential in supporting a consistent evaluation across firms of whether a deficiency is a major deficiency. A component objective has been established in relation to the QMP and the monitoring and remediation process.

45.   The QCTF is of the view that the component objectives need to be measurable, observable, attainable and relevant, i.e., not too vague such that the firm never identifies a major deficiency and not too aspirational such that the firm is not able to achieve reasonable assurance. The QCTF noted that the quality objectives previously presented to the IAASB in relation to relevant ethical requirements, engagement acceptance and continuance, resources and engagement performance are in fact component objectives. Therefore, new component objectives have been established for the remaining components.

46.   Given that the quality objectives previously presented to the IAASB are now component objectives, the QCTF noted that it would be necessary to establish more granular quality objectives for each component that support the overall component objective. Furthermore, more granular quality objectives would help provide a consistent basis for the firm to determine whether it has a deficiency, i.e., a quality objective is not met. The QCTF noted that in August 2017 the IAASB largely supported the level of granularity of the required quality objectives and quality risks, however outreach feedback highlighted varying views regarding the appropriateness of the granularity of the required quality risks and concerns that the requirements were not obviously scalable. The QCTF further observed that in establishing more granular quality objectives, there would be significant overlap between the required quality objectives and the required quality risks. Accordingly, the QCTF has converted the required quality risks previously presented to the IAASB into required quality objectives. The QCTF is of the view that this approach:

(a)   Retains the robustness of extant ISQC 1 as the level of granularity remains the same as previous proposals.

(b)   Improves consistency in the structure and layout of the standard, and its understandability.

(c)   Improves the scalability of the standard, i.e., the standard is clear about what the outcome needs to be through the quality objectives, and the firm determines how that is achieved.

(d)   May improve firm behavior as it reduces the risk that firms may adopt a checklist-based approach in applying the standard.

47.   The required quality objectives in relation to each of the components represent what is required to be achieved in order that the component objective is met (i.e., the QCTF is of the view that all quality objectives applicable to all firms have been identified in the standard). Nevertheless, circumstances specific to the firm may drive the need for additional quality objectives to be identified in order that the component objective is met. This is established through the requirement in paragraph 23(a) of

Agenda Item 6–A, which links the establishment of the quality objectives to the achievement of the component objective, taking into consideration the circumstances of the firm.

48.   The QCTF noted that there would no longer be required quality risks within the components, which may create the perception that the firm is able to overlook this step. Furthermore, only certain components would have required responses. Therefore, in order to echo the QMP within the components, a requirement has been included in each component for the firm to identify and establish quality risks and design and implement responses.

Matters for IAASB Consideration

7.   The IAASB is asked to share their views regarding:

  (a)   The structure of each component and whether it is appropriate.

  (b)   The proposal to convert the required quality risks as previously presented to IAASB into required quality objectives, i.e., that each component no longer has required quality risks.

  (c)   Whether the required quality objectives in relation to each component represent what is required to achieve the component objective, i.e., that these are complete in terms of the quality objectives that would be relevant to all firms in achieving the component objective.

Governance and Leadership, including Organization, Culture and Strategy

Summary of June 2017 IAASB Discussions

49.   At its June 2017 meeting, the IAASB generally supported the proposals in relation to this component and suggested various enhancements to the requirements. The IAASB further discussed:

  (a)   The relevance of governance principles in the context of the scope of Proposed ISQC 1 (Revised), as well as the relevance to SMPs, and cautioned the QCTF to not inappropriately extend the principles to firms' commercial considerations.

  (b)   The appropriate use of the term "governance" or clarity as to what it relates to.

  (c)   The interaction between Proposed ISQC 1 (Revised) and jurisdictional requirements relating to the governance of firm.

  (d)   Different types of firm structures, and how this could be recognized, including leadership structures.

  (e)   The responsibilities of firm leadership and what they are reasponsible for.

  (f)   The responsibilities of a person within firm leadership for independence and whether these should extend to relevant ethical requirements.

  (g)   Various aspects of the proposals in relation to whistleblowing, including the appropriate use of the term and the placement in the standard.

Summary of CAG Feedback

50.   In addition to commenting on transparency reporting, the CAG feedback included the following:

(a) The possible difficulty of applying the proposals given their generality and improving the requirements regarding firm culture, including how the firm's culture and business model may impact quality and the responsibility of all individuals within the firm for quality.

(b) Improving the emphasis of, and using the reference to, the firm's "public interest role".

(c) A proposal to include certain governance principles from other jurisdictional audit firm governance codes.

(d) Concerns regarding the practicality of undertaking performance evaluations of firm leadership, particularly in the public sector.

Summary of Outreach Feedback

51. Feedback from outreach participants included the following:

(a) Mixed views regarding the applicability of the governance principles to SMPs.

(b) The need for clarity regarding certain governance principles, in particular the principle relating to consideration of the needs of stakeholders.

(c) Emphasis that firms have varying leadership structures, and therefore the need for flexible requirements for whom within firm leadership assumes responsibility. Participants also questioned the practicality of the requirement for leadership to have the appropriate experience, knowledge and capacity to assume the assigned responsibilities, as well as having an understanding of Proposed ISQC 1 (Revised).

(d) Concern regarding the practicality of undertaking performance evaluations of firm leadership, and in the case of SMPs it was noted that it is not practicable to link the results of the performance evaluations to remuneration.

Task Force Views

52. As noted previously, the QCTF is of the view that applying the QMP to this component improves the scalability of the component, thereby addressing concerns regarding the applicability of the governance principles to a variety of firms. In addition, the QCTF considered various revisions to this component as a result of the restructure of the components and to address the feedback from the IAASB, CAG and outreach. These revisions include:

(a) Clarifying the objective in relation to the culture of the firm, and emphasizing that all firm personnel have a responsibility for quality (see paragraph 27(a) of **Agenda Item 6–A)**. Furthermore, the application material in paragraph A29 of **Agenda Item 6–A** clarifies the meaning of the attributes of professional values, ethics and attitudes that has been derived from International Education Standard (IES) 4.[12] The QCTF notes that the term "culture" has been removed from the responsibilities of those assigned ultimate responsibility for the system of quality management as it is not possible for leadership to action culture, rather this is established through their consistent actions and behaviors that promote quality over an extended period of time (see paragraph 29(a)(i) of **Agenda Item 6–A)**.

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[12] IES 4, *Initial Professional Development-Professional Values, Ethics, and Attitudes (Revised)*

(b)   Clarifying the objective in relation to the consideration of the firm's stakeholders in the firm's decision making, removing the references to "public interest" (this was encouraged by the IAASB in June 2017), and improving the linkage with the strategy of the firm. In refining this requirement, the QCTF considered the IFAC policy position paper,[13] as well as other publications regarding public interest[14] (see paragraph 27(b) and 29(a)(ii) of **Agenda Item 6– A).**

(c)   Introducing resources as one of the overarching objectives of governance and leadership, similar to other governance codes (see paragraph 27(c) of **Agenda Item 6–A)**.

(d)   More explicitly highlighting that law or regulation may contain requirements relating to the governance and leadership of the firm that need to be taken into consideration by the firm (see paragraph 27(e) of **Agenda Item 6–A)**.

(e)   Improving the flexibility of the requirement for who within the firm may be assigned ultimate responsibility and accountability for the system of quality management by aligning the requirement more closely to extant ISQC 1 (see paragraph 29(a) of **Agenda Item 6–A)**. The QCTF noted the concerns from outreach regarding the sufficient and appropriate experience, knowledge and capacity of such individuals, however agreed that this is appropriately qualified in the standard as it aligns the experience, knowledge and capacity to the role. Application material has been included to clarify this and further explain that such individuals may be supported by others within the firm, as appropriate (see paragraph A42 of **Agenda Item 6–A)**.

(f)   Clarifying that the person(s) within the firm with ultimate responsibility and accountability are responsible for the system of quality management (see paragraph 29(a) of **Agenda Item 6– A)**. This was in response to varying views regarding what such individuals should be responsible for, and given the scope of Proposed ISQC 1 (Revised), the QCTF determined that it would be appropriate to relate this to the system of quality management.

(g)   More explicitly requiring the firm to assign operational responsibility for the system of quality management, and better differentiating between these individuals and the person(s) assigned ultimate responsibility and accountability for the system of quality management (see paragraph 29(b) of **Agenda Item 6–A)**. The standard emphasizes that in some cases the same individual may be responsible for both (see paragraph A43 of **Agenda Item 6–A)**.

(h)   Clarifying the requirement related to the performance evaluations of firm leadership, i.e., that the firm responds to results that are both positive and negative (see paragraphs 29(c) and A48 of **Agenda Item 6–A)**.

53.   As noted in the introduction of this paper, the QCTF has yet to consider matters related to engagement partner performance and rewards, and engagement partner competency and human resources. As part of this consideration, the QCTF will consider the requirement relating to the performance evaluations of firm leadership and the feedback from the CAG and outreach in this regard.

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13   IFAC Policy Position Paper #5, *A Definition of the Public Interest*

14   For example, the Institute of Chartered Accountants in England and Wales publication, *Acting in the Public Interest: A Framework for Analysis*

54. Given the concerns raised in various outreach forums, the QCTF has improved the requirement in paragraph 18 of **Agenda Item 6–A** that addresses the responsibility of firm leadership for understanding Proposed ISQC 1 (Revised). In this regard, the QCTF has clarified that instead of having an understanding of the entire text of Proposed ISQC 1 (Revised), firm leadership should have an understanding of Proposed ISQC 1 (Revised) relevant to their responsibilities.

55. The QCTF considered the suggestion from the IAASB to identify a person within leadership to be responsible for ethical requirements, rather than limiting this to independence. The QCTF noted that the ITC proposals in this regard had specifically addressed a responsibility for independence, which was generally supported by respondents to the ITC, and in previous discussions with IESBA Staff, it was indicated that responsibility for independence is largely the concern shared by regulators. As a result, the QCTF proposes that this requirement should remain focused on independence matters (see paragraph 37(a) of **Agenda Item 6–A**).

Matters for IAASB Consideration

8. The IAASB is asked to share their views regarding the proposed requirements and application material in relation to this component.

9. Does the IAASB agree with the QCTF's conclusion that Proposed ISQC 1 (Revised) should prescribe identifying a person within leadership to be responsible for independence (i.e., instead of ethical requirements more broadly)?

10. The IAASB is asked to share their views regarding the application material supporting the component of governance and leadership, in particular whether it supports locating the "grey text" application material in a separate publication and whether any other application material not marked "grey text" should also be located in such publication.

Information and Communication

Summary of June 2017 IAASB Discussions

56. At its June 2017 meeting, the IAASB generally supported the proposed direction in relation to this component, however noted that the proposals were too conceptual and needed to be further elaborated. The IAASB further discussed:

   (a) Emphasizing the two-way nature of communication and improving the interrelationship with ISA 220.

   (b) Focusing on the purpose of the information and the decisions being made based on that information.

   (c) Addressing "external parties" separately, in addition to various other enhancements.

   (d) Identifying circumstances when the manner in which information is communicated needs to be systematic.

Summary of Outreach Feedback

57. Feedback from outreach participants included the following:

(a) Improving the clarity of the requirements addressing external parties, and considering how this relates to ISA 600.[15] Participants also noted that it would be inappropriate to introduce requirements that result in a more onerous requirement for component auditors within a network versus those outside of a network.

(b) The need to take into consideration confidentiality restrictions imposed by law or regulation.

Task Force Views

58. The QCTF has made various revisions to this component in response to the feedback and as a result of the restructure of the components, and also considered the principles in relation to information and communication in the COSO Integrated Framework. Furthermore, the QCTF:

(a) Explored the IAASB's suggestion to elaborate the requirements with a focus on the purpose of the information and the decisions being made based on that information. However, in doing so, the QCTF identified that this approach resulted in specific requirements that were repetitive of the requirements in the various other components. In addition, given the nature of this component, the QCTF is of the view that such an approach would be contradictory to a principles-based approach that is needed to support a scalable application to a wide variety of circumstances. The QCTF has instead included application material that provides an explanation of the type of information that may be used within the firm, and the parties who may be using it (see paragraphs A51–A56 of **Agenda Item 6–A**), however seeks the IAASB's views as to whether such material is meaningful in the standard and should be retained.

(b) Noted that the various components include specific circumstances when information needs to be communicated, however it would be inappropriate to specify how such information should be communicated as this would result in a prescriptive, non-scalable approach.

(c) Included a requirement for the firm to communicate to engagement teams responses that need to be implemented at an engagement level (see paragraph 33(b) of **Agenda Item 6–A**). This echoes the requirement in paragraph 17 of extant ISQC 1 and improves the linkage with proposed ISA 220 (Revised).

(d) Has explained the need for two-way communication and the types of information that may be communicated in paragraphs A51–A55 of **Agenda Item 6–A.**

(e) Noted that communication exchanges with external parties may be subject to confidentiality restrictions under law or regulation (see paragraph 31(c) of **Agenda Item 6–A**).

Matters for IAASB Consideration

11. The IAASB is asked to share their views regarding information and communication, including whether the proposals appropriately emphasize two-way communication.

12. The IAASB is asked to share their views regarding the application material supporting the component of information and communication, in particular whether it supports locating the "grey text" application material in a separate publication and whether any other application material not marked "grey text" should also be located in such publication.

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[15] ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

Ethical Requirements, Engagement Acceptance and Continuance, Resources and Engagement Performance

59. Since the previous discussions with the IAASB in June and August 2017, the QCTF has made various enhancements as follows:

    (a) Clarification of the requirements in relation to these components, and reorganizing the requirements according to the revised structure.

    (b) Introducing new requirements addressing intellectual resources and technological resources. The application material in this regard further explains considerations for the firm when using resources obtained from third party service providers, including a network firm. In developing the requirements and application material, the QCTF considered how the COSO Integrated Framework addresses technology.

    (c) Improving the linkage of the component engagement performance with Proposed ISA 220 (Revised).

    (d) Including the application material in extant ISQC 1 in relation to these elements, appropriately tailored to cater for the quality management approach.

60. As highlighted in the introduction, the QCTF has yet to consider the effect of changes to the IESBA Code as a result of various projects that have been recently completed. The QCTF also still needs to consider how to address engagement partner performance and rewards, and engagement partner competency.

Matters for IAASB Consideration

13. The IAASB is asked to share their views regarding these components, including with respect to the new additions in relation to technological and intellectual resources.

14. The IAASB is asked to share their views regarding the application material supporting these components, in particular whether it supports locating the "grey text" application material in a separate publication and whether any other application material not marked "grey text" should also be located in such publication.

Monitoring and Remediation

Summary of June 2017 IAASB Discussions

61. At its June 2017 meeting, the IAASB supported the proposed direction in relation to this component. In addition to various suggestions for clarification, the IAASB discussed:

    (a) Incorporating an evaluation of the effectiveness and the design of the system in monitoring and remediation.

    (b) The assignment of responsibilities for monitoring activities, clarifying who in the firm is responsible for assessing the system of quality management overall and having appropriate reporting lines of communication within the firm for those performing monitoring activities.

    (c) The need for additional material to explain how this component would apply to SMPs.

    (d) The various types of monitoring activities and the difference between monitoring activities and review-type activities under the QMP.

(e)   The cyclical inspection of engagement partners.

(f)   The root cause analysis, including focusing on more important deficiencies, recognizing that in some instances a "root cause" may not exist and improving the emphasis on understanding engagements that went well.

(g)   Monitoring being a continous process and the consideration of the quality objectives, quality risks and responses in response to findings from monitoring activities.

(h)   The communication, noting restrictions imposed by law or regualtion and the frequency of communication.

Summary of CAG Feedback

62.   In addition to general support for the proposals, the CAG discussed:

(a)   Clarifying what the monitoring and remediation should address, i.e., the system or engagements.

(b)   Undertaking point-in-time assessments, including long-term periodic reviews as to whether the system addresses the firm's circumstances.

Summary of Outreach Feedback

63.   Feedback from outreach participants included the following:

(a)   The challenge for SMPs to comply with the monitoring and remediation requirements, given the limited resources and possibility of "self-review".

(b)   Improving the focus on various types of monitoring activities that monitor firm-wide controls and not only engagement inspections. Participants also suggested following a more risk-based approach in relation to engagement inspections.

(c)   Clarifying what is expected in terms of monitoring the monitoring activities (participants noted that this seemed circular).

(d)   Clarifying the difference between monitoring activities and detection controls (i.e., review-type activities under the QMP), and how detection controls may affect the nature, timing and extent of monitoring activities.

(e)   Improving the emphasis on ongoing monitoring activities and clarifying the frequency of monitoring.

(f)   The perception that a root cause analysis appears to be a rigorous process. Participants noted that in practice, the root cause analysis is not performed across all deficiencies and it is useful when performed for engagements that went well. Participants raised concern that undertaking a root cause analysis across all deficiencies could result in deferring timely remediation of more significant deficiencies.

(g)   Clarifying the requirements in relation to communication, for example, what is relevant to the particular audience and the granularity of information to be communicated.

Task Force Views

64. As highlighted in paragraphs 18–22, the QCTF has clarified the concept of a deficiency, and introduced the concept of a "major deficiency". These concepts were largely derived from the COSO Integrated Framework, however the QCTF had considered various other literature in debating these concepts, including:

    (a) The use of the terms "deficiency in internal control" and "significant deficiency in internal control" in the ISAs. The QCTF is concerned that the use of the term "significant deficiency" in Proposed ISQC 1 (Revised) would create confusion with how the term is used in the ISAs.

    (b) How ISAE 3402[16] uses the term "deviation."

65. The QCTF has introduced requirements, based on the definitions of deficiency and major deficiency, which establish the framework for evaluating shortcomings in the system of quality management (see paragraphs 55 and 58 of **Agenda Item 6–A)**. Using this framework may assist the firm in establishing whether it has reasonable assurance in relation to the achievement of the overall objective. As discussed in paragraph 29, the QCTF is of the view that a prescribed point-in-time assessment is not appropriate.

Monitoring the Monitoring and Remediation Component

66. The QCTF agreed that in monitoring of the system of quality management, the firm would also need to determine that the component "monitoring and remediation" is appropriately designed, implemented and operated. Without an effective monitoring process, the firm would not be able to determine whether deficiencies exist. Nevertheless, the QCTF recognize that in practice this may be challenging to implement, i.e., firms may be unclear about how they can "monitor their monitoring". The QCTF noted that this could be accomplished in a variety of ways including through:

    (a) Understanding external information, for example, the results of external inspections may identify deficiencies and the firm may consider why their monitoring activities did not identify such deficiencies.

    (b) A root cause analysis, for example, in some instances deficiencies may arise from ineffective monitoring.

    (c) An evaluation by firm leadership of the monitoring activities.

    (d) Monitoring activities that monitor the monitoring activities. In some cases, these monitoring activities may be designed to monitor multiple components of the system of quality management (e.g., engagement inspections).

67. Paragraph 51 of **Agenda Item 6–A** emphasizes that the monitoring activities need to include monitoring of the monitoring and remediation process and includes application material to explain the types of activities that may be undertaken in order to fulfill this requirement.

Engagement Inspections

68. The QCTF debliberated how to improve the scalability of the requirement for the cyclical inspection of engagement partners. The QCTF agreed that it would not be appropriate to establish a conditional

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[16]   ISAE 3402, *Assurance Reports on Controls at a Service Organization*

requirement, since all engagement partners across the firm performing engagements under the IAASB Standards should at some point be subject to inspection. However, the QCTF agreed that more emphasis could be placed on the firm adopting a risk-based approach to determining the cyclical inspection and the selection of engagements, and that the application material which suggests a three year cycle should be deemphasized, given that this is interpreted as a rule in practice (see paragraphs 53 and A131–A132 of **Agenda Item 6–A)**.

Monitoring Activities versus Responses

69.   The QCTF noted the comments from the IAASB and outreach regarding clarifying the difference between monitoring activities and responses designed as detection controls. The QCTF agreed that:

(a)   Detection controls are a response to a quality risk(s) and would be designed to prevent deficiencies in the system of quality management. Therefore, when a failure is identified by a detection control, the failure could not be considered a deficiency, since the purpose of the detection control is to detect the failure and correct it. This would be an important point of distinction between monitoring activities and responses designed as detection controls.

(b)   It may be beneficial for firms to deploy resources in performing detection controls, as this may prevent deficiencies from occurring in the first place. The existence of detection controls could affect the nature, timing and extent of monitoring activities, however would not entirely eliminate them.

(c)   Aspects of an activity may be designed as a monitoring activity and other aspects may be a response designed as a detection control. For example, as part of a pre-issuance review designed as a detection control, the firm may inspect whether the engagement quality control review has been undertaken in accordance with the firm's policies or procedures that has been designed as a monitoring activity.

70.   The QCTF has included application material in paragraph A125 of of **Agenda Item 6–A** to clarify the above thinking.

Root Cause Analysis

71.   The QCTF noted the concerns regarding the lack of clarity in relation to which deficiencies should be subject to a root cause analysis and the need to focus on more important deficiencies. Given the new definition of deficiencies, the QCTF is of the view that this creates an appropriate threshold for those matters that should be subject to the root cause analysis, i.e., it would not be all shortcomings identified, it would only be those shortcomings that are considered deficiencies.

72.   The QCTF further recognizes the association of the term "root cause analysis" with a rigorous process. In June 2017, the QCTF had proposed an alternative term as the QCTF was concerned that stakeholders may perceive it as a rigorous process that needs to be applied to all deficiencies. Nevertheless, the QCTF noted the IAASB's recommendation to use the term "root cause analysis". The QCTF is of the view that this requirement is appropriately scalable as it bases the extent of the root cause analysis on the nature of the deficiencies, including their perceived severity (see paragraph 57 of **Agenda Item 6–A).** Furthermore, the application material further emphasizes the scalability of this requirement (see paragraph A141 of **Agenda Item 6–A)**.

73.   An improved emphasis on engagements that went well has been included in paragraph A137 of **Agenda Item 6–A.**

Other Considerations

74. The QCTF considered the various other comments from the IAASB, CAG and outreach and:

    (a) Agreed that the scalability of this component is evident throughout, for example (i) in designing monitoring activities that take into consideration a variety of factors that may impact the nature, timing and extent of the monitoring activities; (ii) improving the scalability of the requirement to perform engagement inspections; and (iii) undertaking the root cause analysis according to the nature or severity of the related deficiencies.

    (b) Noted the improved emphasis on monitoring each of the components in paragraphs 50 and 51 of **Agenda Item 6–A**, as well as designing the nature, scope and frequency of the monitoring activities. The QCTF is of the view that this emphasizes the focus on monitoring the system, not engagements, and the fact that monitoring activities may comprise activities other than engagement inspections.

    (c) Has emphasized the need for an appropriate combination of ongoing and periodic monitoring activities in paragraph 52 of **Agenda Item 6–A**.

    (d) Given the suggestion to clarify who in the firm is responsible for assessing the system of quality management overall, the QCTF have included a requirement for the firm to promptly communicate a major deficiency to the person(s) assigned ultimate responsibility and accountability and the person(s) assigned operational responsibility for the system of quality management (see paragraph 61 of **Agenda Item 6–A).** Furthermore, this requirement implicitly replaces the need for the firm to undertake a point in time assessment, i.e., firm leadership would be immediately aware of when the system potentially does not provide reasonable assurance.

    (e) Improved the clarity of the requirements in relation to communication, including circumstances when communication may be restricted by law or regulation (see paragraph 60 of **Agenda Item 6–A)**.

Matters for IAASB Consideration

15. The IAASB is asked to share their views regarding the proposed requirements in relation to this component.

16. The IAASB is asked to share their views regarding the application material supporting this component, in particular whether it supports locating the "grey text" application material in a separate publication and whether any other application material not marked "grey text" should also be located in such publication.

Networks

Summary of June 2017 IAASB Discussions

75. At its June 2017 meeting, the IAASB supported the proposed direction in relation to how networks would be addressed and further discussed:

    (a) Keeping the approach principles-based.

    (b) The practical implications of the proposals, including how the firm would evidence and document its considerations of the network services.

(c)   Whether the approach should be applied to third party service providers.

(d)   The importance of driving quality and consistency across all firms in the network.

Summary of CAG Feedback

76.   Feedback from the CAG included the following:

(a)   More strongly emphasizing the role of networks, including in relation to the culture of the firm. There were mixed views regarding the proposed approach to addressing networks, i.e., some were of the view that there needs to be requirements for networks.

(b)   Exploring whether Proposed ISQC 1 (Revised) could address ensuring that the procedures performed by other firms as part of a group audit are undertaken in accordance with the IAASB's standards, irrespective of whether the firm is within the network or outside of the network.

(c)   Considering the use of third party service providers, i.e., outside of the network.

Summary of Outreach Feedback

77.   Feedback from outreach participants included the following:

(a)   The varying structures within networks, as it was noted that within networks there may be a group of firms that form a territorial cluster.

(b)   The importance of governance at a network level, and two-way communication between the firm and the network.

(c)   Support for the firm understanding what network services they are using. Participants sought clarity on how firms would practically demonstrate an understanding of the network services.

(d)   A recommendation to develop accompanying guidance on how firms apply Proposed ISQC 1 (Revised) in interacting with networks.

Task Force Views

78.   The QCTF reinforced their views that developing requirements for networks in Proposed ISQC 1 (Revised) is not practicable given the different types of networks and extent of services provided by the network.

79.   The QCTF considered various ways that the requirements for networks could be addressed in Proposed ISQC 1 (Revised), for example, introducing a requirement for networks within each component. However, given the broad range of services that may be provided by networks, the QCTF agreed that establishing a framework for addressing circumstances when the firm uses the services of a network is the best approach, with considerations for networks included in application material of the various components, where this is considered necessary.

80.   In developing the requirements for networks, the QCTF considered various literature, in particular ISA 402.[17] In relation to the requirements presented in paragraphs 62–66 of **Agenda Item 6–A**, the QCTF:

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[17]   ISA 402, *Audit Considerations Relating to an Entity Using a Service Organization*

(a)   Considered how to articulate the various things that may be used by the firm from the network. The QCTF noted that it would not always be responses, and that the network may provide objectives or quality risks, or it may relate to monitoring and remediation. The QCTF settled on the term "services" which is a generic term that refers to the various policies or procedures, quality objectives, quality risks or monitoring activities etc.

(b)   Agreed that it would be important for the firm to understand the expected form, timing and content of communications between the firm and the network in relation to the services provided by the network. The QCTF noted the importance of this requirement in encouraging two-way communication between the firm and the network and the firm establishing expectations for the network in what information is needed to support the system of quality management.

(c)   Noted that the monitoring of the network services may be undertaken in a variety of ways, i.e., at the network level, firm level or both. The QCTF agreed that the manner in which information about deficiencies identified from monitoring activities is obtained and shared may differ according to the level at which the monitoring activities are undertaken and accordingly has included specific requirements to address the possible alternatives (i.e., paragraphs 64 and 65 of **Agenda Item 6–A)**.

(d)   Considered how to emphasize the two-communication of information in relation to the system of quality management of other firms within the network, particularly when such information supports the firm's reliance on component auditors in the case of engagements performed in accordance with ISA 600. The QCTF agreed to include application material in this regard, with appropriate caveats and guidance to address circumstances when there may be confidentiality restrictions on sharing such information (see paragraph A162 of **Agenda Item 6–A**).

81.   The QCTF further notes:

(a)   The requirements and application material developed in relation to technological and intellectual resources, which are services commonly provided by networks (see paragraphs 43(e) and 43(f) of **Agenda Item 6–A**).

(b)   The application material that has been introduced in relation to the definition of networks to explain that other structures may exist within the network that would be treated in the same way as how the firm uses the network services (see paragraph A9 of **Agenda Item 6–A**). The use of alternative delivery models, referred to as service delivery models for the purposes of the standard, has also been emphasized in paragraph A10 of **Agenda Item 6–A.**

(c)   The application material in the governance and leadership component, highlighting the impact of the governance at a network level on the firm (see paragraph A49 of **Agenda Item 6–A**).

82.   The QCTF considered the CAG's suggestion to address how the firm ensures that the procedures performed by other firms as part of a group audit are undertaken in accordance with the IAASB's standards. The QCTF noted that the scope of Proposed ISQC 1 (Revised) is focused on the firm's system of quality management and accordingly monitoring other firms would fall outside of this scope. The QCTF is also of the view that as part of undertaking monitoring activities at the engagement level, in the case of a group audit, such activities ordinarily include an evaluation of how the engagement team has considered the work of the component auditor.

Third Party Service Providers

83. The QCTF notes that firms may use third party service providers instead of services provided by a network, for example, audit software or a methodology. While paragraphs 43(e) and 43(f) of **Agenda Item 6–A** address the use of technological and intellectual resources provided by such parties, not all services provided are addressed by ISQC 1 and it appears that the requirements are more onerous when the services are provided by the network than in the circumstance when they are obtained from a third party. The QCTF will therefore further deliberate whether there should be requirements established for circumstances when services are obtained from a third party service provider, based on the requirements that have been established for network services.

Matters for IAASB Consideration

17. The IAASB is asked to share their views regarding the proposed requirements in relation to this component.

18. Is the IAASB of the view that prescriptive requirements should be established for circumstances when services are obtained from a third party service provider, based on the requirements that have been established for network services?

19. The IAASB is asked to share their views regarding the application material supporting this component, in particular whether it supports locating the "grey text" application material in a separate publication and whether any other application material not marked "grey text" should also be located in such publication.

Documentation

Summary of September 2017 IAASB Discussions

84. At its September 2017 meeting, the IAASB supported the proposed direction in relation to this component, and noted that documentation provides the basis for the firm's reasonable assurance in relation to the overall objective of Proposed ISQC 1 (Revised). Other suggestions included:

   (a) Explaining that it supports an understanding of the basis for the firm's decisions in relation to its system of quality management;

   (b) Further emphasizing the scalability of the requirements and explaining how the documentation may vary within the firm for different types of engagements;

   (c) Considering further how external inspections are addressed in the requirements and application material; and

   (d) Considering or clarifying the use of the term sufficient and appropriate.

Summary of Outreach Feedback

85. Outreach participants noted that documentation is a key concern, since the revised approach could be burdensome to document, however participants encouraged the IAASB to be clear regarding documentation requirements in order to minimize any expectations gaps between firms and regulators.

Task Force Views

86. In restructuring the standard, the QCTF is of the view that applying the QMP to documentation would be inappropriate. Furthermore, the QCTF recognizes that placing the documentation requirements at the end of the standard is the convention used across all of the IAASB's International Standards. Accordingly, although it was previously proposed that documentation would form part of information and communication, the QCTF is now of the view that it is best placed as a discrete section at the end of the standard.

87. The QCTF has made various enhancements to the requirements and application material in order to address the IAASB's comments. In particular, the QCTF has included the term "sufficient" in the requirement in paragraph 67 of **Agenda Item 6–A** and improved the application material, in order to improve the scalability of this section.

Matters for IAASB Consideration

20. The IAASB is asked to share their views regarding the proposed requirements in relation to this component.

21. The IAASB is asked to share their views regarding the application material supporting this component, in particular whether it supports locating the "grey text" application material in a separate publication and whether any other application material not marked "grey text" should also be located in such publication.

Quality Management at the Engagement Level

88. In developing the proposals in **Agenda Item 6–A**, the QCTF has continued to liaise with the ISA 220 Task Force, through overlap of Task Force members, various meetings and staff liaison.

89. The QCTF has considered how Proposed ISQC 1 (Revised) should emphasize the management of quality at the engagement level and, in the view of the QCTF, **Agenda Item 6–A** provides appropriate linkages between Proposed ISQC 1 (Revised) and Proposed ISA 220 (Revised). **Supplement A to Agenda Item 5** provides a further explanation of how Proposed ISQC 1 (Revised) and proposed ISA 220 (Revised) interrelate.

Professional Judgment and Professional Skepticism

90. The QCTF noted the comments from the IAASB regarding addressing the quality of professional judgments at the engagement level and the processes needed to support the professional judgments within the QMP. Furthermore, both the IAASB and CAG had commented about capturing professional skepticism within the QMP, or through the culture that creates an environment that supports and fosters the application of professional skepticism.

91. The Chair of the QCTF, Chair of the Professional Skepticism Working Group and various members of IAASB Staff met to further discuss how Proposed ISQC 1 (Revised) could address creating an environment that supports and fosters the application of professional skepticism. Matters discussed included:

(a) Using the term "professional skepticism" within the standard, which is unlikely to drive a change in behavior or mindset.

(b)   The importance of a culture of ethical values in creating an environment to support the application of professional skepticism. Furthermore, it was noted that adequate time to perform the engagement and sufficient fees may also influence the application of professional skepticism on the engagement.

(c)   The role of the engagement quality control reviewer in evaluating whether the engagement team has appropriately applied professional skepticism in relation to professional judgments, as well as the professional skepticism that should be applied by the engagement quality control reviewer in undertaking the review.

92.   In addition to these discussions, the QCTF undertook an analysis of the impediments to professional skepticism identified through the responses to the ITC,[18] and how such impediments may be addressed at the firm level. The QCTF is of the view that Proposed ISQC 1 (Revised) establishes various requirements for the firm that create an environment that supports and promotes the application of professional skepticism, including through:

(a)   The culture of the firm, including the responsibility of firm leadership for establishing and embedding the culture throughout the firm.

(b)   Emphasizing that commercial considerations should not override quality, and the importance of obtaining appropriate financial resources to support the performance of engagements.

(c)   Establishing and assigning appropriate resources, in particular human resources who have sufficient capacity, appropriate technical competence, professional skills and professional values, ethics and attitudes to perform engagements.

(d)   Undertaking performance evaluations and establishing compensation mechanisms.

(e)   Clearly establishing and communicating responsibilities in relation to direction supervision and review.

(f)   Establishing appropriate processes to address consultation and differences of opinion.

93.   Paragraph 46 of **Agenda Item 6–A** further emphasizes how judgments made by engagement teams are supported, through appropriate direction and supervision and review of work performed.

Matters for IAASB Consideration

22.   The IAASB is asked to share their views, including:

(a)   Whether Proposed ISQC 1 (Revised) appropriately addresses how a firm creates an environment that supports and promotes the application of professional skepticism.

(b)   Recommendations, if any, for how Proposed ISQC 1 (Revised) may further address professional skepticism.

Robustness

Summary of June 2017 IAASB Discussions

94.   At its June 2017 meeting, the IAASB:

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[18]   See Agenda Item 8–B of the September 2016 IAASB meeting, *Responses to Invitation to Comment—Excerpt of Impediments to Professional Skepticism and Relationship to Fundamental Principles in IESBA Code of Ethics*

(a) Expressed mixed views about whether the changes would result in the robustness of the standard being maintained, noting that the robustness of the standard is dependent on whether the proposed revisions address the issues that the project aims to address.

(b) Discussed the level of granularity of the requirements and the extent to which the extant requirements should be retained. As a result in August 2017, the QCTF presented new proposals to the IAASB to reflect how the extant requirements could be retained, including the granularity, which was supported by the IAASB.

Task Force Views

95. The initiation of the project to address ISQC 1 arose largely from feedback arising from the ISA post-implementation review, various outreach and public consultation on the IAASB's Strategy for 2015–2019 and Work Plan for 2015–2016. The ITC set out key public interest issues, i.e., what needs to be addressed in the public interest, and sought respondents' feedback on the issues identified. In general, respondents agreed with the key public interest issues identified, that included the following relevant to ISQC 1:

(a) Keeping the IAASB's standards fit for purpose, i.e.:

(i) A scalable and robust approach to quality that is fostered by proactive firm leadership and management, and becomes a pervasive aspect of the firm's culture and strategy.

(ii) Encouraging proactive quality management at the firm and engagement level.

(iii) Strengthening engagement quality control reviews and processes to respond to internal and external inspection findings.

(iv) Promoting audit quality at the engagement level in the varied and complex scenarios that arise today, and that are likely to evolve in the future.

(b) Exploring transparency and its role in audit quality, i.e., transparency reporting or other mechanisms that demonstrate the application of effective quality management.

(c) Focusing more on firms (including networks) and their internal and external monitoring and remediation, i.e.:

(i) Expected actions to remediate audit deficiencies or inspection findings.

(ii) Enhancing the requirements as to how firms communicate internally and with other network firms and how they respond to internal and external inspection findings across the network

(iii) Safeguarding against firms relying on network policies and procedures when it is not appropriate to do so.

96. In addition to the benefits highlighted in paragraph 11, the QCTF is of the view that Proposed ISQC 1 (Revised) appropriately addresses the above issues, and that the standard will enhance the robustness of firm's systems of quality management through:

(a) Its ability to accommodate a wide variety of circumstances that may arise at a firm or engagement level, thereby improving the practical application of the standard into the future.

(b)   An approach that drives the proactive and continual management of quality and drives firm leadership to own responsibility for the system of quality management and instill a culture that emphasizes the importance of quality.

(c)   Improving and promoting two-way communication within the firm and between the firm and the network, thereby supporting the improvement of quality at the engagement level.

(d)   Robust requirements addressing the responsibility of the firm in using the services provided by networks.

Matters for IAASB Consideration

23.   The IAASB is asked to share their views regarding whether the robustness of ISQC 1 has been retained and improved, in light of the key public interest issues identified in the ITC.

Length of Proposed ISQC 1 (Revised)

97.   Throughout **Agenda Item 6–A**, the QCTF has highlighted the application material that, although useful, may be placed in a separate publication (e.g., the publication discussed in paragraph 98). Eliminating this material from the proposed standard would result in a total reduction of 15 pages.

98.   The QCTF recognizes the call from outreach participants, as well as the IAASB, to develop a publication that would provide guidance on the implementation of Proposed ISQC 1 (Revised). The QCTF considered whether this publication should be developed and released with the ED, however the QCTF agreed that it would not be practicable to release the publication at the same time for the following reasons:

(a)   The development of a guide will consume significant staff and task force resources that are necessary for the purposes of finalizing all of the IAASB's current projects. The development of an additional publication within the timeframe of the ED could therefore jeopardize the overall progress of the various projects, including Proposed ISQC 1 (Revised).

(b)   Feedback from respondents to the ED may necessitate certain amendments to the proposed requirements and explanatory and application material, and therefore spending time on the development of a publication may not be the optimal use of resources, given that the underlying content may change.

(c)   The QCTF will need to coordinate with the IFAC SMP Committee regarding any publication addressing SMPs, since this committee has developed a guide on the implementation of extant ISQC 1 for SMPs. In this regard, the QCTF will further explore with the staff of the IFAC SMP Committee regarding the most efficient use of resources in developing guidance to support SMPs on the implementation of Proposed ISQC 1 (Revised).

99.   Throughout the various sections in this paper, the IAASB has been asked to consider the application material, in particular whether it supports locating the "grey text" application material in a separate publication and whether any other application material not marked "grey text" should also be located in such publication.

Appendix

QCTF Activities Including Outreach and Coordination with Other IAASB Task Forces and Working Groups

1.   The following sets out the activities of the QCTF including outreach with others and coordination with other IAASB Task Forces and Working Groups relating to the quality control project.

Task Force Activities Since Last IAASB Discussion

2.   Since the last IAASB discussion at the September 2017 IAASB meeting, the QCTF has met twice in person and held two teleconferences. The Drafting Team of the QCTF met twice in person.

Outreach

3.   Paragraph 6 of this paper sets out the recent outreach activities undertaken by the QCTF.

Coordination with Other IAASB Task Forces and Working Groups

ISA 220 Task Force

4.   Since the last IAASB discussion at the September 2017 IAASB meeting, the Chairs of the Task Forces, certain members of the respective drafting teams and staff of the respective projects held three meetings to discuss matters of mutual interest related to quality management at the firm level and quality management at the engagement level. Further coordination has also been facilitated through the overlap of Task Force members and frequent staff liaison.

Professional Skepticism Working Group

5.   The Chair of the Professional Skepticism Working Group, Chair of the QCTF, their technical advisors and staff of the respective projects held one meeting to discuss how Proposed ISQC 1 (Revised) can address matters relating to professional skepticism.