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**Re: IAASB Exposure Draft: *Proposed International Standard on Quality Management 1 (Previously International Standard on Quality Control)***

Further to our covering letter, please find below the BDO International (BDO) comments in respect of the aforementioned standard (ED-ISQM 1).

While we are supportive of the proposed new approach to quality management, there are a number of matters that we would like to bring to the IAASB's attention for further consideration:

- **Inconsistent messaging**

The IAASB's approach to communicating the new suite of quality management standards has been comprehensive; however, some of the implied messaging has been that the changes in the standards are merely to reflect how well-run firms operate at present or to encapsulate existing practices. This contrasts with regulatory comments in various jurisdictions, which when combined with early indications from firm-pilots, have led to a heightened expectation about the need for significant changes (specifically in the area of monitoring activities). As a result, this has led to concerns about mixed messages and what exactly the expectations are in respect of implementation efforts by firms.

- **Potential for scope confusion**

ED-ISQM 1 applies to '*...firms performing audits or reviews of financial statements, or other assurance or related services engagements.*' During our internal and external discussions, it has become clear that there is some confusion about the scope of the standard regarding the extent to which it applies to:

- a) Larger audit firms - which may be structured via a holding entity with various operational entities and service lines and whether the proposed quality management approach would apply across firms or across all operational entities and service lines.
- b) Individuals who may not be 'professional accountants' but who may still perform roles within the range of engagements listed in ED-ISQM 1.

While we acknowledge that further clarification is provided in the ED-ISQM 1 objective section, the way paragraph 4 is drafted within the scope section has the potential to raise more questions than it answers.

## Overall Questions

- 1) Does ED-ISQM 1 substantively enhance firms' management of engagement quality, and at the same time improve the scalability of the standard? In particular:
  - (a) Do you support the new quality management approach? If not, what specific attributes of this approach do you not support and why?
  - (b) In your view, will the proposals generate benefits for engagement quality as intended, including supporting the appropriate exercise of professional skepticism at the engagement level? If not, what further actions should the IAASB take to improve the standard?
  - (c) Are the requirements and application material of proposed ED-ISQM 1 scalable such that they can be applied by firms of varying size, complexity and circumstances? If not, what further actions should the IAASB take to improve the scalability of the standard?

**Part (a)** Yes, on balance, and after reviewing the significant matters outlined in the ED-ISQM 1 explanatory memorandum, we take the view that the proposed new standard has the potential to enhance firms' management of engagement quality and to generate benefits for engagement quality. We also agree with the IAASB's ED-ISQM 1 focus of requiring firms to have as a foundation an effective system of quality control which can respond to a rapidly changing business environment and the need for firms (of all types) to lead in the area of audit quality.

We further support the notion that strengthening how firms approach quality, particularly in the context of audit & assurance, is in the public interest and support the emphasis in ED-ISQM 1 on a change in mindset away from compliance-driven approaches to one which further enables firms to focus on audit quality.

### *Potential advantages of the proposed Quality Management Framework (QMF)*

- This new approach will likely cause firms and networks to redirect resources towards certain areas of risk within a system of quality management, rather than maintain a system of quality control that complies generically with standards but may not otherwise ensure sufficient audit quality within a firm.
- The overall approach is clear, well laid out and unambiguous in terms of the components it is designed to cover.
- The proposed 'Firm's risk assessment process' presents in a logical manner the steps that decision-makers should be undertaking to establish quality objectives, identify & assess quality risks, and design & implement their responses.
- By providing quality objectives (at a minimum level) across most component areas, the IAASB has also given a steer to firms of all shapes and sizes about the starting point for the given framework while maintaining a risk-based approach.
- The approach also has the potential to provide more focus on quality at the engagement level - resulting in better connection between firm-level 'quality' measures and the day to day experience of engagement teams. This should help support an appropriate level of professional skepticism being applied at the engagement level.

### *Potential risks of the proposed QMF*

In our covering letter<sup>1</sup> we outlined four thematic areas of concern relating to: streamlining the standards to improve implementation, promoting a more consistent approach, effectiveness of the proposed approach, and providing for a successful implementation. In addition, we have specific concerns that:

- As currently presented, this enhanced set of requirements (especially when compared to extant ISQC 1), combined with the potential impact on many areas of cross-firm functional departments and the integrative nature of the proposed QMF components, is likely to place a high burden on firms (and networks).
- While there is the potential for this standard to enhance firms' management of engagement quality, the likelihood of success may be jeopardised by a need for additional engagement and firm-level resources, a significant increase in planning time by key decision-makers (on an ongoing basis) combined with a standard that is much longer.
- Whether in totality this package of proposed changes is likely to lead to increased quality is debatable, and can really only be confirmed by successful design, piloting and implementation.

**Part (b)** Yes, the proposed changes do, in our view, have the potential to generate the engagement quality benefits outlined in the explanatory memorandum. Had the IAASB focused solely on revising ISQC 1 then there might have been a danger that the focus of revision would be targeted only at firm decision-maker levels. However, by presenting the planned reforms as part of the issuance of new standards such as ED-ISQM 2 and/or revisions through ED-220, this provides for a more comprehensive impact across individual engagement leaders as well as firm leadership responsibilities.

We agree with the IAASB that having in place an appropriate system of quality management within a firm can help support the exercise of professional skepticism at the engagement level. This is particularly true in areas such as the impact of tone at the top (set by leadership at firm and engagement levels), an emphasis on the importance of cultural factors and prioritising resources appropriately to ensure sufficient time, knowledge and experience on each engagement.

We note that ED-ISQM 1 emphasises the importance of professional skepticism at the engagement level (paragraph 7 and 36(b)) and we also support the references made in ED-220 via explanation of potential impediments to the exercise of professional skepticism (as well as engagement partner actions). We note that unlike ISQC 1, ED-ISQM 1 specifically requires greater exercise of professional judgement in applying the requirements of the new standard (specifically by firm and engagement decision-makers). We fully support this approach as it assists in ensuring that the identification of quality risks (and the responses that flow from them) are tailored to the nature of the firm and its engagements.

There is a danger that the proposed QMF approach leaves the engagement quality of a firm (and the level of professional skepticism applied by its professionals) entirely up to the operating effectiveness of each firm's quality management. One consideration could be to include in the

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<sup>1</sup> Relating to 'Explanatory Memorandum - *The IAASB's Exposure Drafts for Quality Management at the Firm and Engagement Level, Including Engagement Quality Reviews*'

application guidance (or as Frequently Asked Question (FAQ)) examples of how key areas of the components could directly or indirectly support application of professional skepticism by engagement teams.

**Part (c)** With respect to ‘scalability’, while we acknowledge the IAASB has improved the overall scalability of the proposed standards through inclusion of implementation materials referencing scalability scenarios for smaller firms, and the notion that there may be fewer additional quality objectives that need to be identified, the set-up and implementation of a QMF is likely to be a heavy burden for many smaller firms. Additional or existing resources will need to be directed to support training, tools modifications, set up of new processes and testing of the system.

For many firms, especially those without access to a network-provided set of resources or with limited availability of local risk management expertise, one of their challenges is likely to be the initial thoughtful identification and assessment of quality risks in response to the quality objectives. For firms of this nature there may be difficulty in deciding (a) where to start and (b) how to assess which quality risks are likely to have a ‘*reasonable possibility*’ of occurring.

Potential options for the IAASB to consider to support all, and in particular these users of ED-ISQM 1, could include:

- Provision of supplementary implementation support materials including mini examples which outline from a sole practitioner or small and medium-sized practice (SMP) perspective the types of quality risks that they identified in response to the quality objectives for a firm of their size. While this option does pose a danger that individuals and firms adopt the specific examples wholesale (even when not relevant) at least it provides a starting point for decision-makers to commence putting the QMF into practice.
- Another option could be to bring the diagrams, which have helpfully been included in the explanatory memorandum (specifically on pages 13, 15 and 24), alive through mini video examples to explain how a decision-maker in an SMP context put these into practice in their firm given a specific set of facts and circumstances.

**2) Are there any aspects of the standard that may create challenges for implementation? If so, are there particular enhancements to the standard or support materials that would assist in addressing these challenges?**

Yes. As previously noted in our answer to Question 1 above, one of the biggest challenges for firms of all sizes will be the need to invest time and resources in setting up a QMF that is appropriate to the nature, facts and circumstances of each firm. The amount of time and expertise needed to properly implement the objective/risk/response approach and to test the effectiveness of responses, is likely to be extensive. We also note that the unclear scope of ED-ISQM 1 may cause issues in respect of to which parts of a firm the standard applies.

In our view ED-ISQM 1 does a reasonable job of highlighting in the explanatory memorandum those areas of quality objectives (for example, ‘Leadership and governance’) that can result in a set of actions that may be simplified for a smaller firm. One option to help firms - especially those that do not have an extant risk management team or experience in this area - could be to develop an example timeline (from standards approval by the PIOB, through to effective date and highlight typical activities that those in leadership roles could focus on to put in place a

successful QMF). This could also emphasise to firms the need to fully test and pilot a QMF so that it meets their firm's needs.

There may also be an implementation challenge where individuals with operational responsibilities are informed they have to change their processes and procedures but do not understand the bigger picture of *why*, from a quality management perspective, they have to change their approach. Perhaps one way of enhancing this understanding is to provide a scenario in implementation materials that describes how multiple individuals (some audit, some non-audit) work together to fulfil the requirements of ED-ISQM 1.

The inclusion of a risk assessment process at the core of the ED-ISQM 1 approach may present certain new challenges for implementation - specifically when identifying and then assessing quality risks. While ED-ISQM 1 provides a helpful steer to users (see ED-ISQM 1 Explanatory Memorandum paragraphs 31-35) this does on balance appear to be limited and generic in how individuals should then apply the requirements set out in ED-ISQM 1 paragraphs 26-31. There is also a danger that this valuable content is left in an historic document when users in future years are focused only on the published standards. While the draft FAQs (specifically responses to questions 4-7) do provide additional guidance to users, we believe that this is likely to be one of the more challenging areas of implementation for firms of all sizes and types. Having more detailed implementation materials related to performing and documenting risk assessment will be helpful to ensure that firms and regulators are more commonly aligned in their views and expectations.

Finally, the concept of 'network communications' may need more guidance to enable networks of all sizes to conceptualise and operationalise the potential impact of what is intended by ED-ISQM 1 (the phrase '*less sophisticated than in larger firms*' is not entirely helpful). This may be an area where additional implementation materials - with examples of networks of different sizes (whether operating at international, regional or national levels) may help users envisage what is intended.

**3) Is the application material in ED-ISQM 1 helpful in supporting a consistent understanding of the requirements? Are there areas where additional examples or explanations would be helpful or where the application material could be reduced?**

Yes, on balance, and subject to our comments below, we found the application guidance to be helpful to support a consistent understanding of the requirements in ED-ISQM 1. The significant increase in the application guidance sections of ED-ISQM 1 versus extant ISQC 1 may of itself be indicative of an overly complex proposed set of requirements.

That being said, we do support:

- Alignment with the IT-related concepts included within the application material to ensure consistency with ED-315 (A124-A131);
- Inclusion of application material that provides more explanation about the characteristics of public interest entities (which we acknowledge has often been an area of difference across jurisdictions) (A101-A107); and
- Clarity about how a firm may go about determining the length of an inspection cycle, including when a different length of cycle may be appropriate within the same firm (A169-A169).

Other areas that may benefit from further exploration via implementation support, include:

- Monitoring techniques (in areas such as audit quality indicators and evaluation of professional skepticism) and how this might be achieved when operationalised in a sole practitioner or SMP context.
- Extending the list in paragraph A4 to include root cause analysis and also the determination of any remedial actions. Both areas are inherently based on the need to exercise professional judgement and by including them in this list it further highlights the importance of these concepts emphasised in other parts of ED-ISQM 1.
- Including examples of firms applying a QMF during a period of change to support paragraph 6 (such as firm mergers, firm acquisitions, provision of new assurance service lines, changes in key personnel).
- Including examples of some potential positive behaviour within paragraph A123.
- Providing clarity about what is meant in paragraph 67 (c) (i) about ‘*evidence of the monitoring activities performed...*’ and the extent of the required documentation.
- Including explicit reference to a firm’s technical specialists (such as accounting or auditing experts who may operate in firm’s technical departments) as part of paragraph 38 (f) and (g) and associated application guidance.
- Further clarification about the objectivity of those performing the monitoring (see paragraph 46 (b) and A171).
- Adding to the set of FAQs and converting this content into a more user-friendly format (such as short videos) that may have greater impact/accessibility for users.

#### Specific Questions

##### 4) Do you support the eight components and the structure of ED-ISQM 1?

We fully support seven out of eight components in the system of quality management that need to be addressed in ED-ISQM 1. Specifically, we support:

- Inclusion of a new component ‘**Information and communication**’ - extant ISQC 1 does not address broader considerations surrounding information and communication which are likely to be critical within firms, offices, business units and engagement teams and potentially across networks too. The emphasis in ED-ISQM 1 on the need for two-way communication is also welcome - including the responsibility of all personnel for communication.
- Greater focus on ‘**Monitoring and remediation process**’ as opposed to the previous ‘monitoring’ component in extant ISQC 1. As noted in our Invitation to Comment response, reinforced by the explanatory memorandum for ED-ISQM 1, this has been an area where ISQC 1 was in need of some modernisation.

With respect to the new *Information and communication* component we support the IAASB’s decision not to prescribe ‘with whom’ communication should take place and the type of information that should be obtained, generated and communicated. We take the view that the new requirements outlined in paragraphs 40-41 provide sufficient content such that firms can still tailor the method and nature of information and communications that they need to share.

This will also likely assist with scalability issues - particularly in those firms that are sole practitioners or SMPs. Inclusion of paragraph 40 (c) and the emphasis on the impact of a firm's culture on successful communication is particularly welcome.

While we understand that firms are not required to organise their quality management systems according to these discrete segments we note that ED-ISQM 1 intends that the 'Firm's Risk Assessment Process' component is to be '*...applied to the other seven components...*' as part of a firm's systems of quality management. This raises concerns about whether this particular component is actually in fact a component on its own or whether it would be more appropriate, and less confusing for firms who are unfamiliar with quality management frameworks, to posit this as an overarching rather than component-level concept. We note that the diagram on page 7 implicitly reinforces our initial concern.

- 5) **Do you support the objective of the standard, which includes the objective of the system of quality management? Furthermore, do you agree with how the standard explains the firm's role relating to the public interest and is it clear how achieving the objective of the standard relates to the firm's public interest role?**

Yes, we are broadly supportive of the objective of ED-ISQM 1.

Specifically, we are supportive of the clarification provided in the objective (over and above what is stated in extant ISQC 1) that the system of quality management is directed towards '*audits or reviews of financial statements, or other assurance or related services engagements performed by the firm...*' as this provides much needed confirmation to stakeholders and firm management as to which service lines are likely to be subject to the ED-ISQM 1 requirements. This confirmation was absent, as per our earlier comments, in the scope section. We also support linking the objective with other public interest concepts such as '*social responsibility*' (in paragraph A26).

We also support the extension of part (a) to include '*...and conduct engagements in accordance with such standards and requirements...*' on the basis that this emphasises the importance of behavioural changes as it applies to engagements. The clarification in part (b) towards '*engagement reports*' rather than just '*reports*' in extant ISQC 1 is also a welcome change. We also continue to support ED-ISQM 1's emphasis on '*reasonable assurance*' rather than '*absolute assurance*' which acknowledges there are potential limitations of all systems of quality management and that uncertainties and risks may exist that cannot be predicted.

In consideration of whether ED-ISQM 1 explains the connection between the public interest and the objective of the standard, we believe that paragraph 7 is both necessary and sufficient although as currently drafted it implies a more generic rather than firm-specific role.

Specifically, we:

- Do not have a strong preference either way for including or excluding a reference to the public interest within the objective statement. We recognise the challenge of including a concept that could be open to misinterpretation (such as through inadvertent measurement of a concept which is itself difficult to define). As a consequence, we support the IAASB's decision not to specifically reference the public interest within the requirement. There is a danger that doing so encourages inclusion of the public interest in all objectives and requirements to the extent that it becomes meaningless.

- Note that the public interest goes beyond mere compliance with professional standards (and thus the stated objective of ED-ISQM 1) and rests on other variables such as culture, values, day to day actions and individual behaviours. Given the importance attached to these attributes we believe there is a case for making a reference to these aspects in the objective or associated application guidance.

6) Do you believe that application of a risk assessment process will drive firms to establish appropriate quality objectives, quality risks and responses, such that the objective of the standard is achieved? In particular:

- Do you agree that the firm's risk assessment process should be applied to the other components of the system of quality management?
- Do you support the approach for establishing quality objectives? In particular:
  - Are the required quality objectives appropriate?
  - Is it clear that the firm is expected to establish additional quality objectives beyond those required by the standard in certain circumstances?
- Do you support the process for the identification and assessment of quality risks?
- Do you support the approach that requires the firm to design and implement responses to address the assessed quality risks? In particular:
  - Do you believe that this approach will result in a firm designing and implementing responses that are tailored to and appropriately address the assessed quality risks?
  - Is it clear that in all circumstances the firm is expected to design and implement responses in addition to those required by the standard?

**Part (a)** Yes, in our view, *successful* application of a risk assessment process should enable firms to establish appropriate quality objectives, quality risks and responses. As ED-ISQM 1 sets out very clearly the starting point for a set of quality objectives within each of the components (and to an extent prescribes a set of responses), the real challenge for firms (and networks) will be (a) determining additional quality objectives that apply to their facts and circumstances, (b) identifying additional resources to successfully implement a risk assessment approach and (c) setting up processes, documentation and review tools.

In our view a dynamic risk assessment process is critically important to provide for a successful system of quality management and we do support having this apply across the other components (although, see our response to Question 4 above). The elements of '*establish quality objectives*', '*identify and assess quality risks*' and '*design and implement responses*' within this process appear to be logical and have applicability across each component. We also support the flexibility provided to firm decision-makers as outlined in A48 that the risk assessment process may be applied individually to each component, or the process may be applied to individual business units or service lines. A risk-based application allows firms to tailor their systems of quality control to allocate resources to areas of greatest risk to achieving the quality objectives.

**Part (b)** The approach for determining quality objectives (as set out in paragraphs 27-30 of the ED-ISQM 1 Explanatory Memorandum) appear to be clear. We encourage the IAASB to capture this content (particularly the diagrams and supporting material) within further implementation



materials (either in slide decks, videos, or ‘how to’ concepts within FAQs). We also acknowledge the additional clarification contained within FAQs 3 and 4 on the concept of a risk assessment process.

With respect to the quality objectives outlined in paragraphs 23, 32, 34, 36, 38, 40 and 42 of ED-ISQM 1, we are broadly supportive of the nature and extent of these objectives - recognising that they are designed to be outcome-based with the ability of the firm to determine how they may be achieved. While we support the emphasis placed on culture, leadership and assignment of roles in other requirements, we note that these are all described in terms of ‘the firm’ within paragraph 23. This could give the impression that leadership qualities at the engagement level are not as important in driving quality. We also note that it might help to be more explicit about ‘who’ is responsible for the risk identification and assessment process.

Yes, we believe it is clear both within ED-ISQM 1 (paragraphs 10 and 26) and the accompanying explanatory memorandum that firms need to establish additional quality objectives beyond those set out in the standard to achieve the objective of the standard. We also note that the concept of additional quality objectives is reinforced by FAQ 3 in the example implementation materials.

**Part (c)** We support the approach adopted by the IAASB regarding the identification and assessment of quality risks and specifically the application guidance in paragraph A54. We also support the emphasis in ED-ISQM 1 for firms to use a process or threshold to identify and then assess quality risks as this leads to firms adopting a more consistent approach to risk identification and assessment. We also note that this threshold approach is in alignment with ED-315 which should aid users. While we can understand the IAASB’s decision not to provide a set of quality risks as part of the requirements - by providing quality objectives and a set of prescribed responses - the IAASB has implicitly identified some of the potential quality risks that could affect a firm. Whether this is intended or not, it may at least help firms to identify some initial quality risks before going on to develop a more customised and tailored set specific to their facts and circumstances. While we note the rationale for not including required responses for ‘Acceptance and continuance of client relationships and specific engagements’ and ‘resources’ this could lead to inconsistency in how firms respond to these components while also implying that these two areas are of lesser importance relative to the other components.

Additional implementation materials would be helpful in the following areas:

*Risk Identification*

- Risk identification is fundamental to the effectiveness of this process and is a process that could be easily challenged; therefore, further insights with respect to the extent of risk identification, including documentation expectations, would be helpful to ensure that firms and regulators of firms will be more commonly aligned in their views of the requirements.

*‘Individually and in combination’ and ‘significant impact’ concepts*

- The proposed standard uses these terms with respect to assessing risks. While these terms appear to have clear meanings in every day usage, application of these terms within the context of a risk assessment framework may vary among firms without additional guidance, including what support may be necessary to evidence. We recognise that some guidance has been provided in the draft FAQs (specifically number 7) however this is likely to be an area that requires more guidance.

**Part (d)** We support the need to design and implement responses to quality risks. This requirement ensures that firms take responsibility to create tailored responses to the assessed quality risks that they face. We also agree that ED-ISQM 1 is clear that firms have to design and implement responses in addition to those required in the standard.

**7) Do the revisions to the standard appropriately address firm governance and the responsibilities of firm leadership? If not, what further enhancements are needed?**

Yes, we are generally supportive of the quality objectives relating to firm governance and the responsibilities of firm leadership. We believe that by specifically addressing firm governance - in contrast to extant ISQC 1 - this ensures that ED-ISQM 1 provides sufficient prominence to this critical aspect of quality management.

We believe that as currently constructed, the requirements set out in ED-ISQM 1 are relatively clear and allow flexibility for firms to determine how their system of quality management can meet the objective. In addition, we support the prioritisation accorded to this specific component - as the first of the eight components and the overriding emphasis to consider impact that the tone at the top of a firm (or an engagement) might have through cultural, ethical or decision-making influences. We also note, and support, inclusion of the impact of a firm's strategic actions (including financial and operational decisions). This inclusion is particularly important from a public interest perspective.

However, we feel that additional guidance relating to the following may assist users:

- *Scalability*: although there are some example situations in the ED relating to small firms (e.g. paragraphs A28, A32, A37, A42), the examples are quite brief and additional guidance is needed. Further, the separate document on Draft Examples is a good start in demonstrating scalability but we believe that more than three scenarios are needed.
- *Roles and responsibilities*: It may be helpful, perhaps as part of further FAQ development, to provide examples of a range of different scenarios when individuals have ultimate responsibility as compared to operational responsibilities.

**8) With respect to matters regarding relevant ethical requirements:**

- (a) Should ED-ISQM 1 require firms to assign responsibility for relevant ethical requirements to an individual in the firm? If so, should the firm also be required to assign responsibility for compliance with independence requirements to an individual?**
- (b) Does the standard appropriately address the responsibilities of the firm regarding the independence of other firms or persons within the network?**

We acknowledge the importance that ethical behaviour, independence and objectivity play in our profession and the impact it can have on stakeholders. These are areas that are particularly important given the complexity of regulatory rules and standards that can apply within a jurisdiction and across transnational audits.

While it is important that responsibilities are assigned to appropriate individuals within firms, we would not support a prescriptive approach if it inhibited the flexibility afforded to firms to operationalise or structure roles and responsibilities accordingly.

In our view, as outlined primarily in application guidance, ISQM 1 does appropriately address the responsibilities of the firm regarding the independence of other firms or persons within the network.

**9) Has ED-ISQM 1 been appropriately modernized to address the use of technology by firms in the system of quality management?**

Given the digital transformation that has occurred within the auditing profession, we remain supportive of steps taken by the IAASB in ED-ISQM 1 to reflect how technology is being used to support performance of engagements and operation of quality management in firms' systems.

We support the principles-based approach that the IAASB has adopted in requirement paragraph 38(e). In our view, this requirement provides sufficient flexibility for firms of all sizes through use of the word '*appropriate*'. This, when combined with the application guidance in paragraphs A124-A131 acknowledges different extant usage of technology (both in terms of engagement team performance and supporting the system of quality management) while also not inhibiting future technological innovation in these areas.

We also agree that data management and interrogation is likely to be an essential element to an effective monitoring program; therefore, maintenance of an information system that supports a system of quality management (paragraph 40) is imperative.

**10) Do the requirements for communication with external parties promote the exchange of valuable and insightful information about the firm's system of quality management with the firm's stakeholders? In particular, will the proposals encourage firms to communicate, via a transparency report or otherwise, when it is appropriate to do so?**

Yes, we believe the requirements for communication with external parties may promote the sharing of information about the firm's system of quality management with the firm's stakeholders. The information that is suggested to be included in such reports as identified in paragraph A150 is clear and relevant. The example of a transparency report as a form of communication is useful as there are several examples firms can look to and is highly relevant given increasing usage of these types of reports across different jurisdictions. However, there is a danger that its very inclusion could lead to a lack of perceived flexibility in the standard (i.e., often these examples can become a rule of thumb or presumption and may result in a loss of flexibility as to the nature, timing and extent of appropriate communications in different jurisdictions).

We do note and are supportive of the flexibility that has been embedded within requirement 41 (c), (i). This is particularly important so as not to restrict the requirements only to information provided by a transparency report, but also to enable other means of valuable and insightful information (such as website information) to be considered. Whether the requirements as set out in ED-ISQM 1 are likely to encourage firms to start to use transparency reporting or otherwise is debatable. However, the potential increase in communication of information about a firm's system of quality management, whether through a transparency report or other means, is in the public interest as it would enable external parties to have more information when making decisions about a firm.

- 11) Do you agree with the proposals addressing the scope of engagements that should be subject to an engagement quality review? In your view, will the requirements result in the proper identification of engagements to be subject to an engagement quality review?

Yes, we believe that the proposals in ED-ISQM 1 addressing the scope of engagements that should be subject to an engagement quality review are appropriate. We agree that audits of financial statements of listed entities and entities that the firm determines are of significant public interest should capture the majority of engagements where quality issues could have a significant impact on the public. We also believe that paragraph 37(e)(iii) is broad enough to capture other engagements where an engagement quality review is either required by law or regulation, or where the firm believes that an engagement quality review is an appropriate response to a quality risk identified under the new QMF in ED-ISQM 1.

While there is no clear definition of '*significant public interest*' in ED-ISQM 1, we believe that the guidance in paragraph A102 on determining whether an entity is of significant public interest is helpful because it provides factors to take into account but it is not prescriptive, thereby allowing professional judgement to be applied. We agree with the terminology used (i.e., an entity of significant public interest), rather than using the term '*public interest entity*' which is not consistently defined.

The examples provided in paragraph A104 regarding engagements with assessed quality risks, and the guidance in paragraphs A106 and A107 on public sector entities are also very useful.

- 12) In your view, will the proposals for monitoring and remediation improve the robustness of firms' monitoring and remediation? In particular:
- (a) Will the proposals improve firms' monitoring of the system of quality management as a whole and promote more proactive and effective monitoring activities, including encouraging the development of innovative monitoring techniques?
  - (b) Do you agree with the IAASB's conclusion to retain the requirement for the inspection of completed engagements for each engagement partner on a cyclical basis, with enhancements to improve the flexibility of the requirement and the focus on other types of reviews?
  - (c) Is the framework for evaluating findings and identifying deficiencies clear and do you support the definition of deficiencies?
  - (d) Do you agree with the new requirement for the firm to investigate the root cause of deficiencies? In particular:
    - i. Is the nature, timing and extent of the procedures to investigate the root cause sufficiently flexible?
    - ii. Is the manner in which ED-ISQM 1 addresses positive findings, including addressing the root cause of positive findings, appropriate?
  - (e) Are there any challenges that may arise in fulfilling the requirement for the individual assigned ultimate responsibility and accountability for the system of quality management to evaluate at least annually whether the system of quality management provides reasonable assurance that the objectives of the system have been achieved?

Yes, we believe that the proposals for monitoring and remediation will improve the robustness of the firm's monitoring and remediation processes. The proposed standard provides more specificity than prior standards as to the design, implementation and ongoing maintenance of a continuous improvement framework which should result in a more proactive and effective monitoring program.

- a) We believe that the proposals will improve firms' monitoring of the system of quality management as a whole and promote more proactive and effective monitoring activities, while at the same time, allowing scalability and flexibility. The examples provided in paragraph A156 are helpful in encouraging the development of innovative monitoring techniques. However, no standard can change mindsets and ultimately the behaviour of individuals who may themselves be resistant to change. This may be one of the more challenging parts of ED-ISQM 1, requiring a longer effective date period for pilots. The IAASB should continue to share implementation support which highlights innovative and proactive approaches.
- b) While the proposed standard is designed for flexibility and scalability, the retention of the cyclical inspection requirement of inspecting at least one completed engagement for each engagement partner deviates from the standard's risk-based approach. We believe that engagements should be selected primarily using a risk-based approach to ensure that sufficient evidential matter is obtained to support effectiveness of the firm's system of quality control. We do not feel that inspecting one completed engagement for each engagement partner necessarily provides representative evidence on compliance with quality objectives. However, if the requirement of one completed engagement for each engagement partner is retained, cyclical considerations should ensure that all partners are inspected within a reasonable timeframe to be determined by the firm's risk assessment.

Further, the three-year example provided in A169 may have unintended consequences in that the extant ISQC 1 included a similar three-year example in A66 which became a *de facto* requirement rather than being applied based on the factors listed in A66. Firms and regulators of firms may adopt a similar approach if such an example remains within the proposed standard's application guidance.

- c) We agree with the proposed framework for evaluating findings and identifying deficiencies and, on balance, we are supportive of the deficiency definition, although further implementation support on this area may be of benefit to users. The proposed standard in combination with the explanatory memo and application guidance provides adequate recognition that the nature and severity of findings vary and that firms should allocate resources accordingly. While consideration of inadequate design or operating effectiveness of the quality management system can highlight deficiencies, it is not clear if the firm's system of quality management should also explicitly take into account the identification and remediation of deficiencies in the quality of engagements - more clarity on this linkage in application guidance may be helpful to users.

Furthermore, while we agree with the proposed framework, we do believe that further emphasis should be placed on positive findings rather than as an optional consideration in paragraph A178.

- d) We are supportive of the requirement to investigate root causes. We do not see this as a new requirement as it was inherent within the extant requirement of performing an ongoing consideration and evaluation of the firm's system of quality control; however, providing specific emphasis in the proposed standard provides more clarity for others who may not have previously interpreted the need to perform cause analyses. We are also in agreement that there should be flexibility in the approach to performing cause analyses as the nature and severity of findings and deficiencies should drive the nature and extent of root cause analyses performed. However, supplemental implementation guidance on best practices when performing root cause analysis - particularly the extent of any analysis, application to engagement findings and the importance of having an objective mindset when performing this analysis - would be helpful to practitioners, especially those who have not performed it in the past.

As noted in part (c) above, we believe that more emphasis should be placed on evaluating positive findings as these events provide valuable insights on activities that should be replicated.

- e) The requirement for the individual assigned ultimate responsibility and accountability for the system of quality management to evaluate at least annually whether the system of quality management provides reasonable assurance that the objectives of the system have been achieved will be challenging. There will need to be a lot of data accumulated, analysed and reported up to this individual. The inter-relationships between components in the system of quality management are complex and the results of monitoring may not always identify deficiencies that exist. However, any attempt to gather this information and respond to it can only help to improve quality, so we are supportive of this requirement.

**13) Do you support the proposals addressing networks? Will the proposals appropriately address the issue of firms placing undue reliance on network requirements or network services?**

In our opinion, ED-ISQM 1 is clear that the firm is responsible for its system of quality management no matter what type of support they may receive from a network. This will be a shift in mindset for many within firms and leadership positions.

We agree with the premise that ultimately the firms are performing the engagements and should be held accountable for the effectiveness of the system of quality management. We caution, though, that such requirements should only be applied to what a firm has the ability to control. The proposed standard currently recognises that concern by focusing on how a firm responds to network requirements and the communication that must occur within a network of firms. We agree with the requirement for the firm to report any deficiencies in those services or support they find to the network for remediation. We think this focus is helpful in driving greater understanding of where and how reliance is placed on network- and firm-level resources.

We believe that the requirement for two-way communication and increased transparency between networks and firms will be beneficial and will lead to overall improved engagement quality, although we accept that this is likely to be challenging in different network structures.

We understand the IAASB's decision not to include requirements specifically addressed at networks and believe that pressure from the firms will reinforce the importance of timely remediation by the network without a specific ISQM 1 requirement to do so.

However, based on paragraph 61, and the accompanying application guidance, there is the potential for users to misinterpret the extent of information they need to obtain to sufficiently perform monitoring and remediation activities (particularly across other jurisdictions or firms). More clarity on the extent of these requirements, or through different scenarios provided by way of implementation support, would be helpful.

**14) Do you support the proposals addressing service providers?**

Yes, service providers often play a critical role in managing data within a firm's system of quality management; therefore, we are supportive of the proposals to understand and assess any service providers used. As above, we agree that the firm should maintain responsibility for its system of quality management and remedy any deficiencies noted either with the service provider itself or the services provided (either through modifications at the firm, notifying the service provider and assessing their planned actions or changing service providers).

The initial challenge may be obtaining the information required from the service providers for firms to meet these requirements.

**15) With respect to national standard setters and regulators, will the change in title to "ISQM" create significant difficulties in adopting the standard at a jurisdictional level?**

While we understand the IAASB's rationale for modifying the name of the extant ISQC 1 to focus less on 'quality control' on the overarching term 'quality management' in our view, what may seem like an inconsequential change can have an unintended impact on different firms, networks and stakeholders. We believe this is an unnecessary change due to the following:

- As noted in the Explanatory Memorandum to ED-ISQM 1, in many jurisdictions professional standards must be firstly enshrined in law or regulations prior to becoming effective. Consequently, this can lead to significant delays in professional standards being adopted and implemented successfully. From a network perspective, this can cause issues in terms of timely issuance of guidance, training or support being provided to member firms and could impact adoption of the new approach.
- As a network with member firms of very different sizes, we have been supportive of the focus that the IAASB has dedicated to the concept of 'scalability' both in ED-ISQM 1 and other professional standards. However, minor wording changes for some firms can have a high impact in terms of costly modifications to legacy tools, templates and other resources. In particular, ISQC 1 because of its content and reach is referred to in many firm or network policies and/or agreements. In some respects, these minor changes can ultimately have an adverse effect on scalability and the public interest if they lead to a delay in implementation.

For the reasons outlined above, we do not feel that the benefits of the name change outweigh the time and resources that would be needed to implement the change at the firm or network level although we do understand the emphasis that the IAASB has placed on the need for ongoing 'management'.

### **Additional drafting comments:**

The following drafting points have been highlighted during our consideration of ED-ISQM 1:

#### ***‘Tone in the middle’ concept***

One area that we did think lacked clarity in ED-ISQM 1 was the ‘tone in the middle’ concept that was envisioned when the standard was first proposed for revision. Paragraph 20 ED-ISQM 1 states:

*‘The individual(s) assigned ultimate responsibility and accountability, and the individual(s) assigned operational responsibility, for the firm’s system of quality management shall have an understanding of this ISQM relevant to their responsibilities, including the application and other explanatory material, to understand the objective of this ISQM and to apply its requirements properly.’*

While the paragraph speaks to the responsibility of those assigned operating responsibility for the firm’s system of quality control there may be a need for ED-ISQM 1 to be broader, so that this is not treated as the responsibility of solely one individual or one department that is somehow apart from the business management or leadership of a firm. One option could be to improve the wording in this specific section to state:

*‘The individual(s) assigned ultimate responsibility and accountability, (including individuals with relevant leadership roles within a firm) and the individual(s) assigned operational responsibility, for the firm’s system of quality management...’*

#### ***Scalability concept***

By adopting a risk-based approach to engagement quality (recognising that there is an acceptable level of risk in any engagement), it may not be entirely appropriate to adopt the same approach for a system of quality management. Specifically, a better way of bringing in the concept of scalability may be to improve the lead-in sentence in paragraph 5 ED-ISQM 1 to state:

*‘When approaching the design, implementation and operation of the system of quality management, this ISQM requires the firm to take into account...’*

#### ***Application guidance - potential edits***

In requirement 38 (e), (notwithstanding the application guidance provided in A124-A131) there is concern that the phrase ‘enable the operation of the firm’s system of quality management’ could lead to too narrow an interpretation of this requirement (i.e., to focus only on technologies that support data capture of audit quality indicators within a firm, rather than broader use of technologies which may be used day to day by firms and teams but which in aggregate support the overall quality management of a firm). It may be helpful to provide some additional guidance or enhancements in the application guidance to highlight that this is not just tools solely developed for quality management tracking. In addition:

- Within the Introduction section the sections on scalability (paragraphs 5 and 6), the firm’s system of quality management (paragraphs 7 to 13) and networks (paragraph 14) appear to be out of order. We would ask that the firm’s system of quality management section be moved up to paragraph 4, with scalability being positioned closer to the network section.
- Paragraph 11 which introduces the concept of ‘components’ should precede or be merged into current paragraph 8 so that it’s explanation is provided in an appropriate context.



### **Objective section**

- We note that in the ED-ISQM 1 the wording part (a) of the objective refers to:  
*'The firm and its personnel fulfil their responsibilities in accordance with professional standards and applicable legal and regulatory requirements, and conduct engagements in accordance with such standards and requirements...'*

This gives rise to a question about whether the word '*applicable*' should be repositioned to say '*...all applicable professional standards and legal and regulatory requirements...*' to reflect that some professional standards may not apply in certain jurisdictions.

- The objective is appropriately focused on the '*firm*' and in doing so makes it clear that it has to '*...design, implement and operate...*' a system of quality management. This gives rise to a concern that in a network scenario whether this may misinform readers of ED-ISQM 1 or appear to be unnecessarily restrictive. This may be the case where the design of a consistent QMF is being led by a network with firms being encouraged to modify or tailor content during the implementation phase based on local facts and circumstances. It would be helpful for the IAASB to consider application guidance to inform readers that it could be a '*firm or network*' which may be involved in the design phase although tailoring of a QMF would be performed at the firm level.
- While we understand that the current construction of IAASB objective statements across all standards is to inform the reader that the '*objective of the firm/auditor/engagement team is to do [X]...*' - this does create an impression that the IAASB is prescribing how firms or others should run their business at a detailed level. This is an issue that had a wider impact - but in ED-ISQM 1 which is so evidently directed to working practices of firms and exercising of professional judgement - it may have been an opportunity to break with previous approaches and to focus instead of '*...the objective of firms in applying this standard...*'.

### **Unintended consequences**

- Paragraph 34 makes reference to a client's ethical values and this is further expanded upon within the appendix. It should be made clearer that there is a distinction to be made between a client's integrity and the ethical position adopted by a firm when deciding, for example, whether to audit a specific entity (perhaps because of concerns about the industry or sector within which a potential client operates). By not making this distinction it could lead to a risk of codifying a requirement for firms to adopt a statement of ethical values above and beyond those required by the IESBA<sup>2</sup> Code of Ethics.

### **Definitions**

- '*Reasonable possibility*' - in the context of the risk identification and assessment process we had views from within our network that there may be a need to provide improved clarification on the definition or intention of this concept so as to avoid an excessive number of potential risks being identified.

### **Risk assessment process**

- We would also note a concern with the wording in the final sentence in ED-ISQM 1 paragraph 10 (c) and would suggest the insertion of the word '*always*'. Without this word there is an implicit

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<sup>2</sup> International Ethics Standards Board for Accountants, *International Code of Ethics for Professional Accountants*

implication that what has been set out in the ED-ISQM 1 will never be sufficient to address all of the firm's assessed risks.

*'However, the responses required by this ISQM alone will not **always** be sufficient to address all of the firm's assessed quality risks for the quality objectives that are required to be established by this ISQM.'*

- From a drafting perspective, the construction of paragraph 26 means that effectively two requirements are contained within one requirement. This could have the unintended effect that users only read the first part of the requirement (i.e., to establish quality control objectives) and could inadvertently ignore the concept of identifying additional ones beyond those required by ED-ISQM 1. It may be helpful for the IAASB to present these as separate requirements.
- In paragraph 38 (and other parts later in ED-ISQM 1) we note the replacement of 'personnel' used in extant ISQC 1 with 'human resources'. In addition, these terms are used interchangeably within paragraph 38 without any obvious need for differentiation. We are not convinced that this change is helpful as 'human resources' or 'HR', as it's more commonly known within firms is usually a separate functional unit with a responsibility to support the business rather than those individuals who are client-facing. This could create unnecessary confusion for users and stakeholders and particularly those individuals in non-audit but operational roles.
- In paragraph 40 - while the individual elements of (a) to (e) appear to be appropriate, the ordering should be reconsidered so that the more holistic quality objective (c) is repositioned ahead of the currently drafted part (a).
- If the IAASB plans to re-use the diagrams currently included within the explanatory memorandum (which are helpful and which we would support) we would recommend including some additional shaded boxes indicating '*firm specific quality objectives*' to make it clear that additional objectives need to be identified.
- The standard makes clear in paragraphs 24, 25, 33, 35, 37, 41 and 43 of ED-ISQM 1 that the '*...firm shall include the following...*' however we disagree with the Explanatory Memorandum that this is presented 'explicitly' within the standard. When we compare how the IAASB has promoted the need to identify additional quality objectives (as part of an explicit requirement in paragraph 26) in our view, and notwithstanding FAQ 8 and the absence of example responses in the 'resources' component, the emphasis on identifying additional responses appears to be less clear. By effectively treating these two areas inconsistently it could send mixed messages to potential users. We do however note that the diagram used on page 15 of the explanatory memorandum does differentiate between 'response required by ISQM 1' and other 'responses' - which is another reason for the IAASB to embed this type of content in any future implementation support.

### **Engagement Quality Review**

- Regarding the examples of financial institutions provided in the last sentence of paragraph A102, we suggest also adding '*and other entities that hold funds in a fiduciary capacity with a broad investor base*' to capture other entities such as investment funds and mutual funds which we believe are also entities of significant public interest in most cases.

### **Monitoring and remediation**

- Paragraph 51 (b), states: '*When the report is considered to be inappropriate, consider the implications and take appropriate action, including considering whether to obtain legal advice.*'

If we read this in conjunction with the IESBA Code of Ethics, requirement 111.2 (*'A professional accountant shall not knowingly be associated with reports [...] where the accountant believes that the information: (a) contains a materially false or misleading statement, [...]'*), we would have expected the ED-ISQM 1 version to contain a much more active response, such as rectifying the report or disassociating from that report, rather than merely *'considering obtaining legal advice'*, which seems a rather passive response.

We hope that our comments and suggestions will be helpful to you in your deliberations and finalisation of the suite of quality management standards.

Please contact me should you wish to discuss any of these comments.

Yours sincerely,

BDO International Limited

Chris Smith

Global Head of Audit and Accounting