ISQM 2–IESBA-Specific Issues and Recommendations

Introduction

1. Some respondents to the IAASB’s December 2015 Invitation to Comment Enhancing Audit Quality in the Public Interest: A Focus on Professional Skepticism, Quality Control and Group Audits questioned whether the global auditing or ethics and independence standards should clarify issues relating to the engagement quality reviewer’s (EQR) objectivity. Specifically, it was pointed out that some jurisdictions require firms to establish mandatory “cooling-off periods”\(^1\) for individuals previously involved in the audit engagement, in particular engagement partners.

2. At the September 2017 joint IAASB-IESBA meeting, the IAASB and the IESBA established a Joint Working Group (JWG) to explore how best to address issues relating to the objectivity of the EQR in support of the IAASB’s Quality Control project. In particular, the JWG was asked to consider:

   (a) Whether, and if so how, the provisions\(^2\) in the International Code of Ethics for Professional Accountants (including International Independence Standards) (“the Code”) should clarify the requirements that apply to EQRs with respect to compliance with the fundamental principle of objectivity. There were also questions about whether more explicit provisions are needed in the Code.

   (b) Whether there should be a specific requirement in the Code, or in the IAASB’s International Standards, to address the situation of an individual who was previously involved in the audit engagement stepping into an EQR role.

JWG Recommendations and Feedback from the September 2018 Meetings

3. At their September 2018 meetings, the IAASB and the IESBA considered the JWG’s recommendations. The JWG recommended a multi-faceted approach to deal with the issue, with actions to be taken by both the IAASB and the IESBA. The JWG proposed text for inclusion in both the IAASB’s standards and the Code, involving:

   • Establishing a new requirement in proposed ISQM \(^3\) for firms to establish policies or procedures that prohibit, or limit the eligibility of, individuals who served as the engagement

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1 In the context of this paper, the term “cooling-off period” relates to the period of time when an individual who had previously been involved in the audit, including in the role of the engagement partner, would not be eligible to fill the role of the EQR.

The International Independence Standards in the IESBA Code includes a different description of “cooling-off period” in relation to long association of personnel with an audit client (see Section 540, Long Association of Personnel (Including Partner Rotation) with an Audit Client, paragraphs R540.5, R540.11 to R540.13).

The IESBA Code notes that a familiarity threat to independence might be created as a result of an individual’s long association as an audit team member with the client, the client’s operations, senior management, or the financial statements (see paragraph 540.3 A1).

2 Section 120, The Conceptual Framework and Section 300, Applying the Conceptual Framework – Professional Accountants in Public Practice

3 Proposed International Standard on Quality Management (ISQM) 1, Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements
partner for certain engagements to act as an EQR (see paragraph 5 below).

- Including in the newly proposed IAASB standard (ISQM 2⁴) eligibility requirements for the EQR. In particular, the EQR would be required to address threats to objectivity that might be created by previous involvement in the audit engagement.
- Including examples in the Code (i.e., Section 300) to assist the EQRs in identifying threats to compliance with the fundamental principle of objectivity.
- Commissioning IAASB and IESBA Staff to prepare a joint Staff Publication or FAQ to help users better understand the enhanced provisions relating to the objectivity of the EQR. This material would reflect the enhancements in the IAASB’s revised Quality Control standards and the IESBA’s revised and restructured Code.

4. With respect to the recommendations described in the first two bullets in paragraph 3, the JWG believed that ISQM 1 should include application material to illustrate the specific threats to objectivity that may arise, and provide specific examples for how firms may tailor their policies or procedures to address those threats.

5. At its September 2018 meeting, the IAASB agreed to relocate the material that was included in proposed ISQM 1 related to engagement quality reviews. References to the firm’s policies or procedures that address the EQR’s objectivity, including limitations on eligibility and threats to objectivity, will now be included in proposed ISQM 2.

Feedback from the September 2018 Meetings

6. The IESBA and IAASB generally supported the JWG’s recommendations and commented as follows:

IESBA Meeting

- The IESBA should provide input on any new material that is developed to clarify how EQRs are to comply with the fundamental principle of objectivity.
- The Code should continue to be principles-based with respect to the determination of objectivity of EQRs, and should not include a requirement for a cooling-off period. There was also a view that the revised provisions for identifying, evaluating and addressing threats in the conceptual framework already provide appropriate guidance as they are principles-based and scalable.
- The IESBA supported the recommendation for having additional application material in the Code, by way of illustration to help EQRs identify threats. However, IESBA members emphasized the need to maintain an appropriate balance between audit-specific and non-audit examples in Part 3 of the Code, which applies to all professional accountants in public practice. Therefore, they suggested that the Code should include only one EQR-related example versus the four presented.

IAASB Meeting

- Some IAASB members highlighted the importance of proportionality when establishing eligibility requirements for EQRs, in particular with respect to provisions relating to objectivity.

⁴ Proposed ISQM 2, Engagement Quality Reviews
Those members noted the need to achieve the right balance in the standard, and emphasized the need for proposed ISQM 2 to be operable by all firms irrespective of their size. With respect to small and medium practices, there was a request to consider situations when an individual external to the firm might be used as an EQR.

- The IAASB supported the JWG recommendations regarding how to address the cooling-off period in ISQM 1 and ISQM 2.

**JWG Decisions Post-September 2018**

7. Since the September 2018 meetings, the JWG met once via teleconference to consider the feedback from the IAASB and IESBA meetings, and to determine a way forward. Among other matters, the JWG concluded that:

- The Explanatory Memorandum (EM) accompanying the exposure draft (ED) of proposed ISQM 2 should include a specific request to respondents for input on whether proposed ISQM 2 appropriately addresses the matter of cooling off as an eligibility requirement for the EQR (e.g., where an individual has served previously as an engagement partner on the same engagement) and what additional provisions should be established in the Code.

- The EM will provide a useful vehicle to communicate what actions each Board has taken or plans to take. In particular, the EM could include:
  
  o A discussion about whether a specified “cooling-off period” should be established for situations in which a former engagement partner steps into an EQR role.
  
  o A discussion of any proposed application material being considered for inclusion in the Code in response to the JWG’s recommendation.
  
  o A question to solicit stakeholders’ views about the proposed application material in ISQM 2 and whether any other consequential or conforming amendments need to be made to the Code in light of proposed ISQM 2.

- The IAASB and IESBA Liaisons and Staff will progress coordination activities leading up to the Boards’ December 2018 meetings and the release of the ISQM 2 ED. The JWG will then reconvene in 2019 to consider the feedback on the ED.

8. The JWG believes that the responses to questions in the EM about what should be included in the Code would provide advance input to the IESBA and could inform the IESBA’s future standard-setting activities with respect to clarifications about how EQRs are to comply with the fundamental principle of objectivity.

9. IESBA representatives noted the JWG’s recommendation and also believe that the EM to the ISQM 2 ED should explain, in general terms, how EQRs should identify, evaluate and address threats to compliance with the fundamental principle of objectivity. In particular, IESBA representatives believe that it would be helpful if the EM:

- States in an explicit manner that threats might be created when an individual who was previously involved in an audit engagement (whether as the engagement partner or as another member of the engagement team) is appointed as the EQR, and that those threats should be evaluated and addressed in accordance with the provisions in the Code.
Indicates that the IESBA believes that the nature of the previous role an individual served on the audit engagement (e.g., as an engagement partner versus another role on the engagement team) influences the level of the threat(s) to compliance with the fundamental principle of objectivity when the individual assumes the role of EQR on the engagement.

Consideration of IESBA-Specific Matters

10. During the session, the IESBA representatives will brief the Board on their feedback to the IAASB representatives on proposed ISQM 2, two of which are significant matters and are described below. The IAASB representatives will have an opportunity to explain the Task Force’s and the IAASB’s thinking regarding the approach taken in proposed ISQM 2 on those matters.

Cooling off Period

11. Subsequent to the JWG teleconference post-September 2018 IESBA meeting, the ISQM 2 Task Force decided to develop new application material to provide guidance with respect to a cooling-off period for situations in which a former engagement partner steps into an EQR role as follows:

A5. Relevant ethical requirements or law or regulation may establish requirements for a cooling-off period during which individuals are prohibited from serving as the engagement quality reviewer for engagements for which they previously served in another role(s). For example, the IESBA Code contains prohibitions, for audits of public interest entities, on individuals acting in any of the following roles, or combination of such roles, for a period of more than seven cumulative years, with a minimum cooling-off period of two years:

- The engagement partner;
- The individual appointed as the engagement quality reviewer; or
- Any key audit partner role.

A6. An individual who has served as the engagement partner is not likely to be able to perform the role of the engagement quality reviewer immediately after ceasing to be the engagement partner because it is not likely that the threats to the individual’s objectivity with regard to the engagement and the engagement team can be reduced to an acceptable level. In recurring engagements, the matters on which significant judgments are made and the facts and circumstances around those significant judgments are not likely to vary to a degree such that an objective evaluation of those judgments can be made by the individual who served as the engagement partner in the immediate previous period. Accordingly, this ISQM requires the firm to establish policies or procedures that limit the eligibility of individuals as engagement quality reviewers who previously served as engagement partner, for example, by establishing a specified cooling-off period during which the engagement partner is precluded from being appointed as the engagement quality reviewer. Determining a suitable cooling-off period depends upon the facts and circumstances of the engagement. In the case of an audit of financial statements of a listed entity, it is unlikely that an
engagement partner would be able to act as the engagement quality reviewer until two subsequent audits have been conducted.

**Threats to Objectivity of EQRs**

12. The ISQM 2 Task Force has included the following requirement and application material in proposed ISQM 2 to assist EQRs in identifying threats to compliance with the fundamental principle of objectivity:

16. The engagement quality reviewer shall:

   …

   (c) Comply with:

   (i) Relevant ethical requirements, including that threats to objectivity of the engagement quality reviewer related to the engagement or the engagement team do not exist, or have been reduced to an acceptable level; (Ref: Para. A14–A17)

**Threats to the Objectivity of the Engagement Quality Reviewer (Ref: Para. 16(c)(i))**

A16. Threats to the engagement quality reviewer’s objectivity may arise in the following circumstances:

- A familiarity, self-review or self-interest threat may arise when the engagement quality reviewer was recently consulted on matters of significant complexity or judgment in the engagement.

- A familiarity or self-interest threat may arise when the engagement quality reviewer is a close or immediate family member of the engagement partner or another member of the engagement team, or through close personal relationships with members of the engagement team.

- An intimidation threat (either implicit or explicit) may arise when pressure is exerted on the engagement quality reviewer (e.g., when the engagement partner is an aggressive or dominant individual, or the engagement quality reviewer has a reporting line to the engagement partner).

- A self-review or self-interest threat may arise when the engagement quality reviewer was recently a member of the engagement team.

13. Given the addition of new paragraph A16 in proposed ISQM 2 that discusses the types of threat that might be created in different situations, including when an individual moves from being recently a member of the engagement team to an EQR role, IESBA representatives believe it is no longer necessary to include a specific example of threat to objectivity in the Code to address the situation of an engagement partner moving into an EQR role.
Matters for IESBA Consideration

1. IESBA members are asked:

   (a) For views on the approach taken in paragraphs A5-A6 in proposed ISQM 2 regarding the matter of “cooling off,” in particular to address the situation of an individual moving from engagement partner directly into an EQR role.

   (b) For views on the paragraph regarding identification of threats to objectivity (A16 in proposed ISQM 2), and in light of that ISQM 2 guidance, whether they agree that it is unnecessary to add illustrative example(s) of threats that might be created in a situation involving an engagement partner moving to an engagement quality reviewer role?