Quality Management (QM) Projects International Ethics Standards Board for Accountants (IESBA) Coordination

Objective of Agenda Item

The objective of this Agenda Item is to provide an overview of the coordination activities with the IESBA regarding the projects on proposed ISQM 1,1 ISQM 2,2 and ISA 220 (Revised)3 and the matters of a significant nature discussed with IESBA as part of the coordination.

Coordination Activities with IESBA

1. The Quality Control Task Force (QCTF), ISA 220 Task Force (TF) and ISQM 2 Task Force (TF) (QM Task Forces) have engaged in various coordination activities with representatives and staff of the IESBA over the life of the three QM projects. Feedback from the coordination activities with IESBA was presented to the IAASB at its March, June and September 2018 meetings.

2. In the fourth quarter of 2018, various coordination was undertaken with the IESBA including:
   (a) A teleconference of the Chairs of the QM Task Forces, the IESBA Liaison Member and staff.
   (b) Frequent liaison and teleconferences between IAASB Staff and the IESBA Staff.
   (c) Offline comments provided by IESBA representatives and staff on the drafts of the standards at various points.
   (d) A meeting and activities of the Joint Working Group (JWG), dealing with the question of objectivity of the engagement quality (EQ) reviewer in proposed ISQM 2.

The comments from the representatives and staff of the IESBA generally related to providing clarity on the understanding and application of the IESBA Code, perceived inconsistencies with wording or concepts in the IESBA Code or suggestions to improve the understandability of the standards from an ethics or independence perspective. Many of the comments have been discussed by the respective Task Forces and incorporated into the draft standards, as applicable, taking into consideration broader stakeholder input and direction from the IAASB.

3. This paper provides an overview of the following matters of a significant nature that IESBA representatives identified in their most recent review of the proposed standards, and the IAASB or Task Force perspectives on these matters:
   (a) Proposed ISQM 1: Independence considerations in a network context.
   (b) Proposed ISQM 1 and ISQM 2: Entities of significant public interest versus public interest entities (PIEs).

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1 Proposed International Standard on Quality Management (ISQM) 1 (Previously International Standard on Quality Control 1) (Revised), Quality Control for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance Engagements or Related Services Engagements
2 Proposed ISQM 2, Engagement Quality Reviews
3 Proposed International Standard on Auditing (ISA) 220 (Revised), Quality Management for an Audit of Financial Statements
Proposed ISQM 2: Threats to the objectivity of the EQ reviewer, including the cooling-off period for an engagement partner to be able to act as the EQ reviewer on an engagement.

This paper also highlights the comments from IESBA representatives regarding assigning responsibility for independence to an individual in the firm.

4. At its December 2018 meeting, the IESBA will receive an update on the coordination activities, including an outline of the significant matters highlighted above. The Chairs of the QM Task Forces will attend the session (in person or via teleconference) to provide further context and explanations regarding these matters.

**Matters of a Significant Nature**

*Independence Considerations in a Network Context*

5. The independence provisions of the IESBA Code (the Code) includes various provisions that relate to the firm’s network or other firms within the firm’s network. IESBA representatives in their most recent review of Agenda Item 2–A of the IAASB’s December 2018 meeting raised concern that proposed ISQM 1 does not appropriately address independence considerations in a network context. Accordingly, IESBA representatives made various suggestions in relation to proposed ISQM 1, including:

(a) An additional requirement in paragraph 59 of proposed ISQM 1 (the networks requirements and networks services section) for the firm to understand the independence requirements applicable to the network that could affect the firm’s system of quality management, and the network’s compliance with such independence requirements.

(b) In the context of the monitoring and remediation process, where the network performs monitoring activities relating to the firm’s system of quality control (paragraph 61), considering whether there is adequate recognition of the need for the firm to have access to relevant monitoring reports and other information of the network given that non-compliance with independence standards could be created by another entity within the network.

(c) Reconsidering some of the application material, for example:

(i) Highlighting that the illustrative responses in the application material in paragraph A67 of proposed ISQM 1 (responses for information and communication and resources) may also apply to the network.

(ii) Reconsidering whether it is appropriate to characterize the network or network firms as “external parties” (paragraph A148).

**The Approach to Networks in Proposed ISQM 1**

6. In the Invitation to Comment (ITC), the following key public interest issues were identified in relation to networks:

(a) Undue reliance on network requirements or network services (e.g., network policies or procedures, a network methodology or network-developed software);

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4 *International Ethics Standards Board for Accountants’ International Code of Ethics for Professional Accountants (Including International Independence Standards)*

5 *Invitation to Comment, Enhancing Audit Quality in the Public Interest*
(b) Transparency of the network structure and operations, including the relationship between the network and the network firms; and

(c) Consistency of engagement quality across networks.

7. Taking into consideration respondents’ views, the IAASB developed new requirements in proposed ISQM 1 to address circumstances when the firm uses network requirements or network services in its system of quality management (paragraphs 59 to 64 of proposed ISQM 1). In doing so, the IAASB recognized the need for the requirements to be adaptable for various network structures, and for the requirements to be applied in circumstances when the firm uses services provided by other organizations or structures within a network (e.g., a cluster of firms within the network or another network firm). The requirements in proposed ISQM 1 have been designed to place the onus on the firm to determine that the network requirements or network services are appropriate for the firm’s system of quality management, thereby ensuring that the firm retains responsibility for its own system.

8. In developing these proposals, the IAASB debated whether it would be appropriate for the standard to impose requirements on networks directly. However, the IAASB concluded that doing so would restrict the adaptability of the requirements in light of varying network structures and use of services from other organizations or structures within a network. The IAASB also was concerned that doing so would reduce the responsibility of the firm for its system of quality management, and that networks are generally not subject to regulatory inspections or overseen by audit oversight authorities.

9. Nevertheless, the IAASB is of the view that the proposed new requirements will have an implicit effect on the network. For example, the requirements would likely:

(a) Create the need for increased communication and transparency between the network and network firms.

(b) Drive consistency across the network because the network would seek ways to effectively and efficiently manage requests from all of its network firms.

Network Independence

10. Network independence is addressed in proposed ISQM 1 as follows:

(a) Paragraph 36(a) requires the firm to identify the relevant ethical requirements and determine the applicability of the relevant ethical requirements to the firm, its personnel and others, including, as applicable, the network, network firms, personnel in the network or network firms, or service providers. Paragraph A69 highlights that the applicability of the relevant ethical requirements to others (i.e., the network, network firms, personnel in the network or network firms, or service providers) depends on whether the relevant ethical requirements contain specific provisions addressing others, and how the firm uses others in its system of quality management. It provides a further example specific to networks, i.e., that relevant ethical requirements may include requirements for independence that apply to network firms or employees of network firms.

(b) The remaining requirements of paragraph 36 require the firm to establish policies or procedures to address threats to compliance with relevant ethical requirements and breaches of the relevant ethical requirements. Given that there may be relevant ethical requirements applicable to the network that affect the firm (identified by the firm as part of complying with
paragraph 36(a)), such policies or procedures would need to address the network’s compliance with independence requirements.

11. The IESBA views were considered in view of the requirements and application material already included in proposed ISQM 1. In the view of the QCTF, the provisions in the standard addressing network independence are consistent with the provisions in paragraph 21 of extant ISQC 1 (the provisions in extant ISQC 1 have been adapted given the new risk-based approach), and have been further enhanced from extant ISQC 1 because they are more explicit about how the network may be subject to relevant ethical requirements. Accordingly, it was considered that it would not be necessary to include a specific requirement addressing network independence because it is already addressed through the principles-based requirements of the standard, and the new more explicit application material.

12. Furthermore, the QCTF believes that:

(a) It would not be appropriate to deal with network independence in network requirements and network services because this section is dealing with the issue of undue reliance on network requirements or network services. The network would be required to comply with independence requirements irrespective of the nature and extent of network requirements and network services provided to the firm (e.g., if the network provides no network requirements or network services, the independence provisions of the Code still apply).

(b) The requirements of proposed ISQM 1 should focus on what the firm needs to obtain from the network, and the proposed standard directly addresses the need for communication between the network and the firm as follows:

(i) Paragraph 43(c) requires the firm to establish policies or procedures that address the nature, timing, extent and content of communication with external parties, and specifically indicates in subparagraph (ii) that the policies or procedures should address communication with the network.

(ii) Paragraph A203 addresses obtaining information from the network about deficiencies identified in another network firm’s system of quality management that affects the firm, for example, when the other network firm is a component auditor.

(c) The network does not form part of the firm’s system of quality management. While the firm may use network requirements or network services in its system of quality management, the firm retains full responsibility for its own system. When the firm uses network requirements or network services, the firm is required to determine the effect of the network requirements or network services on the system, and that they are appropriate for the firm’s system. If the network were considered to be part of the firm’s system of quality management, it would imply that the firm is responsible for the network (including all aspects of the network, such as governance and leadership of the network).

Entities of Significant Public Interest Versus PIEs

13. The Code defines the term “public interest entity” and uses it in the independence provisions. IESBA representatives suggested that, for purposes of proposed ISQM 1 and ISQM 2, the category of entities described as PIEs in the Code should be used in place of “entities that the firm determines are of significant public interest.” It was argued that this would avoid inconsistency between the proposed standards and the Code. It was also noted that the Code already provides guidance as to
general criteria (including those in the proposed ISQM 1 and ISQM 2) by which firms could determine whether to treat other entities as PIEs.

14. The IAASB has had numerous discussions over the years relating to whether the standards should refer to, or define, “public interest entity.” Prior to discussions in relation to the quality management standards, the IAASB most recently debated this point in connection with the auditor reporting standards, and whether to extend the requirement to communicate key audit matters to entities other than listed entities. At that time, and consistent with previous discussions, the IAASB determined not to refer to or define the term in its standards because there is no universally accepted definition of PIEs across jurisdictions. Instead, the IAASB agreed to refer to “entities that may be of significant public interest” and provide high-level guidance regarding the characteristics of such entities. This guidance has been consistently used across the suite of IAASB standards (e.g., ISA 700 (Revised)\(^6\) and ISA 260 (Revised)\(^7\)).

15. The suggestion to extend the requirement for the performance of EQ reviews beyond listed entities was explored in the ITC, and included various options as to how this could be achieved (e.g., establishing additional criteria for engagement selection, incorporating a risk-based approach or requiring an EQ review for entities of particular public interest or PIEs). Respondents overall supported strengthening the requirements for entities that should be subject to an EQ review, noting concerns that the extant standard was not effective in leading firms to select entities other than listed entities. However, in general, respondents did not support extending the requirements for an EQ review to PIEs or entities of particular public interest, citing similar reasons that had been expressed in connection with other IAASB projects as noted in paragraph 14 (i.e., different definitions of PIE in various jurisdictions, which could lead to inconsistencies in application of the requirements, or unintended consequences could arise from imposing burdensome requirements on certain small, less complex entities that fall under the definition of PIE in a particular jurisdiction).

16. Recognizing the challenges in requiring EQ reviews for engagements for PIEs, the IAASB nonetheless believed it was important to respond to comments from certain stakeholders, particularly regulators, to extend the requirement for an EQ review to more engagements beyond audits of listed entities. Accordingly, the IAASB concluded that it would be most appropriate for an EQ review to be performed for entities that the firm determines are of significant public interest (see paragraph 40(e)(ii) in Agenda Item 4-C). The related application material (paragraph A103) describes the characteristics of such entities using wording consistent with other references in the ISAs. These characteristics also reflect engagements for which there would likely be quality risks, thereby creating an appropriate link between the EQ review (a response) and the quality risks.

17. Proposed ISQM 1 also includes the concept of “entities that may be of significant public interest” for similar reasons as set out above, i.e., to embed a focus on areas where quality risks may arise. In the view of the QCTF and ISQM 2 TF, the use of “entities that the firm determines are of significant public interest” and “entities that may be of significant public interest” throughout proposed ISQM 1 (including paragraph 40(e) and related application material in Agenda Item 4-C) remains appropriate.

\(^6\) ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*

\(^7\) ISA 260 (Revised), *Communication with Those Charged with Governance*
Threats to Objectivity of the EQ Reviewer, Including the Cooling-off Period for an Engagement Partner to be Able to Act as the EQ Reviewer

18. The ISQM 2 TF and the IAASB recognize the importance of the objectivity of the EQ reviewer, and of reducing threats to the objectivity of that individual to an acceptable level. Threats to the objectivity of the EQ reviewer are a particular concern when that individual was previously involved with the engagement, and especially when that individual most recently served as the engagement partner.

19. The topic of objectivity of the EQ reviewer, including whether a specified “cooling-off period” should be established for situations in which a former engagement partner steps into an EQ reviewer role, was discussed during the September 2017 joint IAASB-IESBA session. IAASB and IESBA members agreed to form a JWG to develop recommendations on how this issue could be addressed.

20. The various options discussed by the JWG, and the JWG’s preliminary views after considering the advantages and disadvantages of the options, were discussed by the IAASB and IESBA at their respective September 2018 meetings. See the Supplement to Agenda Item 6 of the September 2018 IAASB meeting. The recommended approach of the JWG specific to the development of the IAASB’s quality management standards included the following (references to ISQC 1 and 2 have been changed to ISQM 1 and 2, respectively):

(a) Proposed ISQM 1 should require that the firm’s policies or procedures address prohibitions or limitations on the eligibility of individuals who served as the engagement partner for certain engagements to act as an EQ reviewer. This should be supplemented by application material in proposed ISQM 1 on the threats to objectivity that may arise and examples of how policies or procedures may address it.

(b) Proposed ISQM 2 should include an eligibility requirement that the EQ reviewer is not subject to threats to objectivity related to the engagement or the engagement team that are not at, or have not been reduced to, an acceptable level. Within the context of the more general guidance on relevant ethical requirements for EQ reviewers, there should be reference to the requirement in proposed ISQM 1 for the firm to establish policies or procedures to prohibit or limit the eligibility of individuals stepping into an EQ reviewer role when they previously served as the engagement partner.

21. The ISQM 2 TF agreed with the JWG recommendations and considered them in preparing the materials for the September 2018 IAASB meeting. These points continue to be included in the draft of proposed ISQM 2 in Agenda Item 4-A for the December 2018 IAASB meeting. Specifically:

(a) Paragraph 15(c) of proposed ISQM 2 establishes a requirement for firm policies or procedures consistent with the recommendation in paragraph 20(a) above. This requirement was originally included in proposed ISQM 1, but was moved to proposed ISQM 2 based on the direction of the IAASB regarding the allocation of requirements between the two standards. Paragraph 16(c)(ii) of proposed ISQM 2 requires the EQ reviewer to comply with the related requirements established by the firm. Paragraph A6 of the application material supports the requirement in paragraph 15(c) and, indirectly, the requirement in paragraph 16(c)(ii).

(b) Paragraph 16(c)(i) requires the EQ reviewer to comply with relevant ethical requirements, including threats to objectivity, and is consistent with the recommendation in paragraph 20(b) above. Paragraph A16 in the application material relates to this requirement (see further discussion in paragraph 22).
22. Paragraph A16 of proposed ISQM 2 provides examples of threats to the objectivity of an EQ reviewer who was previously involved with the engagement team (i.e., it is intended to address more broadly threats to the objectivity of the EQ reviewer, and not only when stepping into that role after having served as the engagement partner). Accordingly, this application material is intended to support compliance with the fundamental principle of objectivity established in the relevant ethical requirements applicable to the engagement. It is not intended to be specific to the Code and, accordingly, there is no reference to the Code in paragraph A16.

23. Paragraph A6 of proposed ISQM 2 supports the requirement that relates specifically to limitations on the eligibility to be appointed as the EQ reviewer for an engagement on which the individual previously served as the engagement partner. Paragraph A6 explains that “in the case of an audit of the financial statements of a listed entity, it is unlikely that an engagement partner would be able to act as the EQ reviewer until two subsequent audits have been conducted.” IESBA representatives questioned whether this creates a de facto requirement for a “cooling-off period.”

24. In its deliberations, the ISQM 2 TF noted that the EQ reviewer is responsible for objectively evaluating the significant judgments made by the engagement team. In the case of an audit of financial statements, significant judgments made in prior periods often affect judgments made in subsequent periods, albeit that the facts and circumstances may change over time. Accordingly, the ability of the EQ reviewer to objectively evaluate the significant judgments is affected by previous involvement with those judgments.

25. The ISQM 2 TF strongly believes that specific consideration needs to be given to establishing limitations on the eligibility of a former engagement partner to serve as an EQ reviewer. This “cooling-off period” is necessary to make sure that the EQ reviewer is in a position to objectively evaluate the significant judgments made by the engagement team as noted above. Indeed, it is this separation from the previous role as engagement partner that is necessary for the EQ review to be an appropriate response to the assessed quality risk(s) for the engagement. Accordingly, the ISQM 2 TF believes that the requirement in paragraph 15(c) of proposed ISQM 2 addresses this important point.

26. The application material in paragraph A6 is intended only to provide guidance to firms in establishing its policies and procedures for limiting the eligibility to serve as an EQ reviewer. This application material indicates only by example that this could be done by establishing a cooling-off period, and further indicates that determining a suitable period of time depends on the facts and circumstances. Nevertheless, a reference to a period of two years for audits of financial statements of listed entities has been included to support the need for an objective evaluation of the significant judgments made by the team as noted in paragraph 23 above. (It is noted that during the JWG discussions, IESBA representatives explained that a rigorous application of the Code’s Conceptual Framework should result in an appropriate response to address the threat to objectivity that arises in these circumstances, and that an outright prohibition or “cooling-off period” was therefore not necessary. The ISQM 2 TF therefore opted not to embed an explicit prohibition, and instead included it as an example in the application material.)

27. The ISQM 2 TF supports a specific requirement for a cooling-off period before an engagement partner can step into the role of EQ reviewer on an engagement, and further supports including such a requirement in the Code. However, the ISQC 2 TF also acknowledges the concerns noted by the JWG (and the specific concerns of the IESBA representatives on the JWG) and recognizes that the IESBA will be briefed on the matter at its December 2018 meeting. In addition, as noted in Agenda Item 4, consideration will be given to including questions in the ISQM 2 EM about how relevant ethical
requirements, including threats to the objectivity of the engagement quality reviewer, are addressed in proposed ISQM 2. The specific questions that may be included and how they should be formulated will be informed by discussions during the session on IAASB-IESBA coordination at the December 2018 IESBA meeting.

Assigning Responsibility for Independence

28. In the ITC, the IAASB had included a proposal to specifically require a firm to identify appropriate personnel within the firm’s leadership to be responsible and accountable for independence matters. This proposal was included in the ITC in response to calls from certain regulatory stakeholders to the IESBA to more clearly and robustly address the issue of responsibility for independence within a firm as part of its Structure of the Code project. In particular, the IESBA had noted a concern from a Monitoring Group member that the Code “lacks specificity and does not address the fundamental threat we identified of potentially having an individual in the local office tasked with resolving a local engagement team’s breach of an independence requirement. Audit firms serving the capital markets should have sufficient resources and personnel to enable issues such as these breaches to be addressed by the appropriate members of senior management most qualified to objectively deal with the breach.” Some stakeholders, including a few from the regulatory community, had encouraged the IESBA to work with the IAASB in addressing the matter.

29. Given that it was not within the remit of the Structure of the Code project to make substantive changes to the Code, the IESBA determined at the time that it should consider the matter comprehensively with the IAASB in the context of the IAASB’s project to revise ISQC 1. The IESBA had acknowledged that there would be benefit in dealing with the matter in one place rather than in two separate sets of standards. Pending further discussion with the IAASB on the matter, the IESBA determined to retain the general statement in the extant Code to the effect that firms assign responsibility for actions related to independence to an individual or a group of individuals in accordance with ISQC 1.

30. Respondents to the ITC expressed mixed views regarding the proposal for a requirement for the firm to identify appropriate personnel within firm leadership to be responsible and accountable for independence matters. Given the importance of independence, the IAASB agreed that proposed ISQM 1 should explicitly address responsibility for independence and therefore the standard includes a new requirement in:

(a) Paragraph 27(a)(iii) that requires the firm to assign operational responsibility for compliance with independence requirements to personnel who are appropriately qualified. Similar requirements exist for the firm to assign operational responsibility for the system as a whole and monitoring and remediation, which were adapted from extant ISQC 1.

(b) Paragraph 28 that contains qualification criteria for the individuals assigned operational responsibility for aspects of the system of quality management, including being accountable for their assigned responsibilities.

31. IESBA representatives have raised the concern that the approach in proposed ISQM 1 is too general and cursory and does not address the matter of responsibility for independence within a firm to an adequate level of specificity. The QCTF is of the view that the new requirements outlined above in proposed ISQM 1 adequately address the concerns of stakeholders because they require the firm to

8 The International Organization of Securities Commissions (IOSCO)
assign the role to an individual who is appropriately qualified, and the qualification criteria include having a direct line of communication to the firm’s chief executive officer, managing partner or managing board of partners. Furthermore, the requirements in other components of proposed ISQM 1 also contribute to addressing the issue, for example, the enhanced requirements addressing resources and information and communication. The QCTF also note that the standard has adopted a principles-based approach, and more specific requirements would be contrary to this approach and the level of specificity of other requirements in the standard.

32. During its coordination activities, IESBA representatives also suggested consideration of the need to broaden the scope of the matter to relevant ethical requirements beyond independence, i.e., to responsibility for relevant ethical requirements. The QCTF was concerned that expanding the responsibility to relevant ethical requirements could have the inadvertent effect of diluting the importance of independence. However, the QCTF has suggested in Agenda Item 2 of the December 2018 meeting that the Explanatory Memorandum explore whether this responsibility should be extended to relevant ethical requirements.

Way Forward

33. The QM Task Force’s perspectives on the significant matters have been explained above for consideration by the IAASB in the December 2018 meeting, and may lead to further changes to the standards during the December 2018 meeting or additional explanations or questions in the Explanatory Memoranda. The QM Task Forces will also consider other comments that the IESBA representatives and staff identified in their most recent review of the proposed standards that were not of a significant nature. The QM Task Forces will propose changes arising from these comments, if any, to the IAASB during the turnaround of the documents during the December meeting.

34. It is noted that as part of the coordination activities, the IESBA requested the inclusion of four additional questions in the Explanatory Memoranda as follows:

(a) Whether proposed ISQM 1 has sufficiently addressed independence considerations in a network context.

(b) Whether the various requirements and application material in proposed ISQM 1 should refer to PIEs as defined and explained in the Code, in place of “entities that the firm determines are of significant public interest” and “entities that may be of significant public interest”.

(c) Whether it is appropriate for proposed ISQM 2 to suggest a cooling off period of two years for an engagement partner to be able to act as the EQ reviewer in the application material.

(d) Whether ISQM 1 has sufficiently addressed the matter of responsibility for compliance with independence requirements within a firm, and whether the considerations should also be broadened to relevant ethical requirements.

35. The extensive coordination activities described earlier in this paper have had a beneficial impact on appropriately aligning the three QM standards with the Code and helping the representatives of both Boards to better understand the operation of the QM standards with the Code. The more recent coordination activities in anticipation of the approval of the QM standards have provided a platform to further deliberate the appropriateness of the QM standards in the context of ethical considerations, taking into account the direction provided by the IAASB based on the views of a broad range of stakeholders through responses to the ITC, discussions of the IAASB CAG, and global outreach.
Matters for IAASB Consideration

1) Does the IAASB agree with the views outlined above in response to the matters of a significant nature raised by the representatives of IESBA?

2) The IAASB is asked to share their views regarding the additional questions proposed by the IESBA representatives to be included in the explanatory memorandums.