

AGENDA PAPER

Item Number: 5
Date of Meeting: 4 March 2021
Subject: Project update on Quality Management Standards (ISQM 1 & 2/ ASQM 1 & 2)

<input checked="" type="checkbox"/> Action required	<input checked="" type="checkbox"/> For discussion	<input type="checkbox"/> For noting	<input type="checkbox"/> For information
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Purpose

To:

- a) update the Board on the release of the International Standards on Quality Management (ISQM 1 and 2);
- b) update the Board on discussions with the AUASB Technical Staff on local adoption via ASQM 1 and 2 and the impact on APESB pronouncements;
- c) present to the Board options for managing APESB pronouncements impacted by the release of ISQM 1 and 2; and
- d) obtain direction from the Board on the preferred option for revision of impacted APESB pronouncements.

Background

In February 2019, The IAASB announced that it would be seeking public comment on three interrelated standards that address quality management.

- 1) ISQM 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Statements and Other Assurance and Related Services Engagements* (ISQM 1);
- 2) ISQM 2 *Engagement Quality Reviews* (ISQM 2)
- 3) ISA 220 *Quality Management for an Audit of Financial Statements* (ISA 220)

After a lengthy consultation process, the new standards were issued in December 2020, in part to replace ISQC 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Statements and Other Assurance and Related Services Engagements* (ISQC 1).

ISQM 1 and 2 change the way accounting firms are expected to manage quality for audits, reviews, other assurance related engagements, and other related services.

ISA 220 addresses the engagement partner and engagement team's responsibilities for quality management for an audit of financial statements, which is not within the mandate of the APESB.

Refer to Agenda Item 5(a) for the chronology of milestones and links to relevant resources.

Key Considerations

The IAASB issued the final pronouncements for [ISQM 1](#) and [ISQM 2](#) in December 2020. The operative date of both standards is December 15, 2022, which is when the system of quality management (SQM) is to be designed and implemented, and the evaluation of the SQM is required annually thereafter.

Currently, ASQC 1 and [APES 320 Quality Control for Firms \(APES 320\)](#) are based on extant ISQC 1. The requirements and application material are predominately similar between the standards; however, the scope and application are different as APES 320 applies to all services provided by Firms. In contrast, ASQC 1 exclusively applies to audit and assurance services. Without a significant expansion of APES 320, the consistency between requirements and application material in ISQM 1 and APES 320 will cease. However, this also presents an opportunity for the APESB to amend and enhance APES 320 to focus on non-assurance services.

APES 320 would be significantly impacted by the revised ISQM 1 and 2 if the APESB adopted them in full. Refer to agenda paper 5 (b) for a high-level comparison of the extant and new standards. APES 325 *Risk Management for Firms* (APES 325) may also require consequential amendments due to the changes in the ISQM standards, which will need to be considered when reviewing APES 320.

AUASB Technical Staff have indicated that no compelling reasons have been identified to justify the AUASB not adopting the International Standards (noting the AUASB's different mandate to the APESB). Should the AUASB support the Technical Staff view, the international standards will be fully adopted and receive the force of law under ASA 101 *Preamble to Australian Auditing Standards*. It is likely that the operative date of ASQM 1 and 2 (as issued by the AUASB) will be January 2023.

APESB Technical Staff consider there to be two options for revision to APES 320:

- Option 1: Full harmonisation between ISQM 1, 2 and APES 320 via the inclusion of all requirements and application material from ISQM 1 and 2 in APES 320
- Option 2: Harmonisation between fundamental components of ISQM 1 and APES 320 by aligning the elements in APES 320 to the components in ISQM 1 and removal of existing Audit and Assurance related materials from APES 320. The removal of Audit and Assurance related material will result in ISQM 2 not being incorporated in APES 320.

Option 1 *Full harmonisation between ISQM 1, 2 and APES 320*

The objective of Option 1 is to retain full consistency between APES 320 and ISQM 1 and 2.

By including all requirements from ISQM 1 and 2 to APES 320, the standards will remain consistent, allowing professional accountants offering assurance services to refer to either APES 320 or ASQM 1 and 2. APES 320 is likely to expand from 29 pages to over 100 pages in content primarily due to the significant increase in application material from extant ISQC 1 to ISQM 1 and the addition of ISQM 2. To address differences in drafting conventions between the IAASB and the APESB, ISQM 1 and 2 would need to be significantly amended to address terminology and structure inconsistencies.

APES 320 applies to a significant proportion of firms offering non-assurance services. Incorporating ISQM 1 and 2 to APES 320 is likely to cause substantial disruption to small and medium practices (SMPs), particularly those only offering non-assurance services. Retaining consistency between ISQM 1, 2 and APES 320 will result in firms being required to undertake extensive updates to their systems of quality management with limited evidence available to support the benefit of such extensive revisions.

ISQM 1 and 2 have been developed to ensure systems of quality management for audits of public interest entities (PIEs) are consistently applied. The risk level addressed by ISQM 1 and 2 is unlikely to be relevant and scalable to non-assurance engagements. APES 320 addresses risk via included requirements under each element. ISQM 1 and 2 address the scalability of scope and application by not prescribing requirements. However, this results in firms needing to establish their quality risks and responses to address prescribed quality objectives.

Option 1 will arguably provide some benefit to firms offering both assurance and non-assurance services due to the consistency achieved via harmonisation of APES 320 and ISQM 1 and 2. However, this benefit is reduced by the requirement to consider matters that are not relevant to non-assurance divisions within the firm. No tangible benefit will be provided to firms offering only assurance services as these firms could refer exclusively to ASQM 1 and 2.

For a significant proportion of firms who only offer non-assurance services, Option 1 may result in substantial disruption due to firms' need to address the significant additional requirements and application material. Any perceived benefits to the public interest may be outweighed by the additional cost to implement such changes.

Full harmonisation between ISQM 1, 2 and APES 320 will result in key concerns expressed in APESB's submission to the IAASB not being addressed in the revised APES 320. In its submission, the APESB formed the view that the ISQM proposals were not commercially viable for sole practitioners and SMPs and will likely result in assurance and related services being redirected to larger firms with extensive resources.

APESB Submission Recommendations	Outcome in ISQM 1 and 2
Scalability of the proposals and the use of professional judgement.	Scalability addressed by not defining the requirements to address quality objectives resulting in firms being required to determine their own quality risks and responses (Paragraph 17 and 18 of ISQM 1 Basis for Conclusions)
Evidence of nexus between identified deficiencies and the proposals.	Not addressed.
Cost-benefit analysis from the practitioner's perspective.	Not addressed.
The ability to use elements of the existing quality framework.	While some elements are common between the extant framework and the new framework, extensive revisions require a re-write of systems of quality management. The IAASB has not produced any mapping between ISQC 1 and ISQM 1 and 2, likely due to the changes being too significant.

APESB Submission Recommendations	Outcome in ISQM 1 and 2
Excessive volume of application material.	Application material has increased from 75 paragraphs to 259 paragraphs.
Subjectivity and the regulator's or monitoring body's perspective.	Not fully addressed. Subjectivity addressed in part in Paragraphs 40 and 41 of Basis of Conclusions. The monitoring body's perspective was not addressed.
Consistency with the requirements and terminology of the IESBA's International Code of Ethics for Professional Accountants (including International Independence Standards) (the IESBA Code).	Addressed in part.

Option 2 *Harmonisation between fundamental components of ISQM 1 and APES 320 and removal of Audit and Assurance related materials and non-adoption of ISQM 2 materials.*

The objective of Option 2 is to design a solution that provides the greatest benefit to the public interest while creating the least disruption for firms. Considering that the IAASB has presented no evidence to suggest that the current quality management framework is deficient (especially for related services and non-assurance services), the impost on firms is the most relevant consideration.

As ASQM 1 and 2 will only apply to Audit and Assurance firms/divisions, there is an opportunity for the APESB to develop a specific quality management standard for firms providing non-assurance services while retaining the key objective of maintaining consistency with the firm level components of the quality management standard.

The following key changes to APES 320 are proposed in Option 2 (and also set out in agenda paper 5(b)):

- Change the Standard's title from '*Quality Control for Firms*' to '*Quality Management for Firms*' to align terminology and definitions where appropriate.
- Change all references from '*Control*' to '*Management*' within APES 320.
- Update the scope and application of APES 320 refer Audit and Assurance practitioners to ASQM 1 and 2 for developing a system of quality management for audit and assurance engagements.
- Include a decision tree in APES 320 to assist firms to determine when to use ASQM 1, ASQM 2 and APES 320.
- Align the elements of a system of quality control (paragraph 10 of APES 320) to the 8 components of ASQM 1 by including additional components addressing '*Information and Communication*' and the '*Risk Assessment Process*' prescribed in ASQM 1. Include/adapt only relevant requirements from ASQM 1 into APES 320.
- Change APES 320, paragraph 10 (d) *Human Resources* to '*Resources*' and address human, intellectual, service providers and technology resources to align with ASQM 1. Include/adapt only relevant requirements from ASQM 1 into APES 320.
- Remove all existing paragraphs relating to Audit and Assurance services from APES 320, including most paragraphs relating to Engagement Quality Control Review.

- This also means ISQM 2 would not be required to be adopted by APESB and Engagement Quality Review requirements for non-assurance services can be retained in APES 320.

Option 2 will provide the greatest benefit to firms offering non-assurance services. The proposed changes are limited, excluding unrelated assurance services material while incorporating minimal additional requirements that further address risk. This option allows a significant proportion of content from existing quality frameworks to be used. Considering that the majority of firms in Australia do not provide assurance services, Option 2 provides substantial benefit for most firms.

For firms only providing assurance services, the correlation between the elements of APES 320 and ISQM 1 will result in these practices needing to refer only to ASQM 1. Option 2 provides benefit to practices offering both assurance and non-assurance services due to the simplicity of only minor changes required to APES 320. These hybrid practices will need to maintain a system of quality management for both assurance and non-assurance engagements that is compliant with APES 320 and ASQM 1. While the disruption associated with embedding the requirements of ASQM 1 cannot be avoided, minimal changes to APES 320 will provide benefit to these firms.

The application paragraphs have increased from 75 in ISQC 1 to 206 in ISQM 1, and a significant number of these paragraphs deal with assurance-centric matters such as external inspections, assessing and evaluating deficiencies and root cause analysis.

Option 2 aligns the two standards at a conceptual level creating consistency between the two standards while avoiding requirements that are not relevant to firms providing only non-assurance services.

APESB Technical Staff recommend Option 2. This recommendation is based on consideration of a cost/benefit analysis of implementation for Firms, in particular those who provide non-assurance services.

Way Forward

Subject to the Board's approval:

- consult with the PAOs on Option 2 in March 2021;
- prepare a proposed APES 320 Exposure Draft (and potentially APES 325 if consequential amendments are required) for approval at the June 2021 Board meeting;
- issue the APES 320 Exposure Draft by late June 2021;
- request public comments on the APES 320 Exposure Draft over a 90 day period ending late September 2021;
- review and analyse submissions received on the APES 320 Exposure Draft and consider whether any further revisions are required to APES 320 during October 2021; and
- seek approval from the Board to issue the revised APES 320 at the November 2021 Board meeting and finalise the APES 320; and
- release the revised APES 320 in December 2021 (with an effective date of 1 January 2023), allowing a year for implementation with early adoption permitted.

Staff Recommendation

The Board:

- a) note the release of ISQM 1 and 2;
- b) note Technical Staff's discussions with the Technical Staff of the AUASB;
- c) consider options presented by Technical Staff for amendments required to APES 320; and
- d) approve Technical Staff to proceed with Option 2 for proposed revisions to APES 320.

Materials Presented

Agenda Item 5 (a) Chronological background of milestones for ISQM 1 and 2.

Agenda Item 5 (b) Comparison of main components of ISQM 1 and 2 and ISQC 1/APES 320

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Date: 16 February 2021