

ALERT

New Quality Management Standards for Accounting Firms



March 5, 2021

Quick Facts

- Earlier this month, the American Institute of Certified Public Accountants' (AICPA's) Auditing Standards Board (ASB) issued exposure drafts of three interrelated quality management standards applicable to all certified public accountant (CPA) firms performing audits, reviews and other assurance and related assurance services under U.S. auditing and attestation standards
- A firm's system of quality management (previously referred to as quality control) is critical to proactively managing risk and reducing the frequency and severity of litigation and claims
- When effective, these standards will add increased complexity to compliance with professional standards and will expose firms that fail to comply to increased scrutiny from external stakeholders and provide another source of potential liability
- The quality management standards include new requirements for CPA firms and the effort necessary to comply with the new standards will be substantial; firms that have not yet done so should assess their readiness and begin implementation efforts in the near term
- The Lemme Accounting Firm Risk & Quality Management Consulting team can assist your firm in preparing for implementation of the new quality management standards

Issuance of Proposed Quality Management Standards

Following the issuance of new quality management standards by the International Auditing and Assurance Standards Board (IAASB) at the international level in September 2020, the Assurance Standards Board (ASB) issued drafts of proposed standards related to a firm's system of quality control and the performance of assurance engagements under U.S. auditing and attestation standards. In the interests of convergence, the ASB's standards as proposed largely mirror the standards issued by the IAASB. In fact, the ASB used the IAASB standards as the starting point for the proposed U.S. standards - included among the [meeting materials from the January 2021 ASB meeting](#) are redline versions marked against the IAASB's issued standards. Comments on the exposure drafts are due to the ASB by June 11, 2021.

Key Elements of the Quality Management Standards for Accounting Firms

The new standards use the term quality management in place of the term quality control used in the existing U.S. and International quality control standards. Under the [Proposed Statement on Quality Management Standards \(SQMS\) 1, A Firm's System of Quality Management](#) and recently issued [ISQM1, Quality Management for Firms That Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements](#), a firm's system of quality management is comprised of eight highly integrated components:

1. The firm's risk assessment process
2. Governance and leadership
3. Relevant ethical requirements
4. Acceptance and continuance of client relationships and specific engagements
5. Engagement performance
6. Resources
7. Information and communications
8. The monitoring and remediation process

Most of these eight components carry the same name or were adapted from existing terminology in the AICPA's existing [QC section 10, A Firm's System of Quality Control](#). The most notable new component is the firm's risk assessment process, designed to focus a firm's attention on those risks that may have an impact on engagement quality. The risk assessment process requires (1) that a firm establish quality objectives for each component except the monitoring and remediation process, (2) identify and assess risks to the achievement of those objectives (quality risks), and (3) design and implement responses to address identified quality risks.

The standards prescribe certain quality objectives for different components while leaving it to a firm to identify the specific quality risks and determining appropriate quality responses to those risks. The proposed Safety and Quality Management System (SQMS) also identifies several specifically required responses including the establishment of policies and procedures associated with identifying and addressing threats to compliance with ethical requirements; responding to breaches of ethical requirements; and receiving, investigating and resolving complaints and allegations regarding compliance with professional standards, firm policies and other applicable legal and regulatory requirements.

Another new component, Information and Communication, recognizes the importance of two-way communication throughout the firm and encourages firms to be transparent to external stakeholders about their system of quality management. Many larger firms have already taken steps to address such public interest concerns through audit quality transparency reports, many of which now identify specific audit quality indicators (AQIs) monitored by the firm. Examples of common AQIs found in transparency reports include internal and external inspection results, ratios of technical experts to client service partners and professionals, and average annual workloads and training hours by level.

The monitoring and remediation component considers the results of the firm's risk assessment process and places greater emphasis on the monitoring of the system of quality management as a whole as opposed to just the inspection of completed engagements. Of note is the new requirement for root cause analysis of identified deficiencies, a now common practice for Public Company Accounting Oversight Board (PCAOB)-inspected firms that may be newer to firms not serving public issuer clients. The proposed standard also discusses the impact of external inspections and peer review on the monitoring activities of the firm. As to external inspections, the proposed SQMS clearly states that external inspections may identify deficiencies in the system of quality management and may inform the nature, timing and extent, but are not a substitute, for the firm's internal monitoring activities. As to peer review, the proposed SQMS indicates that because the objectives are similar, an AICPA peer review may substitute for the inspection of some or all completed engagements for the period subject to review.

Evaluating the System of Quality Management and Documentation Requirements

The quality management standards require a formal evaluation of the firm's system of quality management undertaken as of a point in time at least annually by the individuals assigned ultimate responsibility for the system of quality management – which the standards require to be either the firm's CEO, managing partner, or, if appropriate, managing board of partners (or respective equivalents). The proposed SQMS prescribes the possible conclusions that may be reached and the expected response to identified deficiencies. The proposed SQMS does not require a firm to obtain an independent review of its system of quality management nor does it preclude a firm from doing so.

In what has drawn comparisons to Sarbanes-Oxley requirements for their public clients, firms will be required to prepare documentation of their system of quality management sufficient to (a) support a consistent understanding of quality management by personnel, (b) support the consistent implementation and operation of the quality responses, and (c) provide evidence of the design, implementation, and operation of the responses to support the evaluation of the system of quality management by the individuals assigned ultimate responsibility. This would include documentation of the individuals assigned ultimate responsibility and accountability for quality as well as individuals assigned operational responsibility for different aspects of quality management. It would also include documentation of the firm's quality objectives, quality risks, the firm's responses, and how those responses address the quality risks. Additional documentation requirements include the monitoring and remediation activities and related communications, network services and requirements (where applicable) and the basis for the conclusions reached regarding the effectiveness of the system of quality management.

Engagement Quality Reviews

[Proposed SQMS 2, Engagement Quality Reviews](#) and [ISQM 2, Engagement Quality Reviews](#), address the appointment and eligibility of the engagement quality reviewer and that individual's responsibilities related to the performance and documentation of the engagement quality review. By moving the requirements for engagement quality reviews out of the extant auditing standards (AU-C 220/ISA 220), the standard setters have made clear that an engagement quality review can be a response to quality risks for any type of assurance engagement, not just an audit. These changes also more clearly differentiate the responsibilities of the firm from those of the engagement quality reviewer and provide clearer requirements and guidance regarding the scope, timing and documentation requirements for the reviews.

While the proposed SQMS No. 2 is in alignment with the ISQM 2, there are three issues on which the ASB is seeking comment: (1) self-inspection (the ability of an engagement quality reviewer to inspect that same engagement as part of the firm's monitoring of completed engagements, (2) the cooling-off period for an engagement quality reviewer of two years, regardless of the type of entity, when the firm has determined the review to be an appropriate response to quality risks, and (3) completion of the EQR and dating of the auditor's report and whether the EQR should be required to be completed before the report is dated rather than before the report is released.

Quality Management at the Engagement Level

The [Proposed Statement on Auditing Standards \(SAS\), Quality Management for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards](#) and [International Standard on Auditing \(ISA\) 220 \(Revised\), Quality Management for an Audit of](#)

Financial Statements address how the engagement partner leverages the firm’s system of quality management and ensures quality at the engagement level. The standards make clear the engagement partner’s responsibility for managing and achieving quality and setting the appropriate tone around ethics, values and attitudes, and expectations of team members regarding their responsibilities for quality and the importance of professional skepticism.

An interesting new element is the “stand-back requirement” requiring the engagement partner to evaluate whether they have taken overall responsibility for managing and achieving quality by evaluating whether their involvement has been sufficient and appropriate throughout the engagement and that the specific nature and circumstances of the engagement have been taken into account. Among other requirements, the proposed SAS also clarifies what the engagement partner needs to review, which are significant matters and significant judgments, and formal written communications to management and those charged with governance.

Effective Dates

The ASB has proposed the following timeline and effective dates for the proposed standards, which are generally one year later than the equivalent international standards:

- Proposed SQMS No. 1 – System of quality management designed and implemented by December 15, 2023 with the first annual evaluation required to be performed by December 15, 2024
- Proposed SQMS No. 2 – Effective for (a) audits or reviews of financial statements for periods beginning on or after December 15, 2023 (b) other assurance engagements beginning on or after December 15, 2023 (based on the earlier of date engagement is signed or when the firm begins to perform the engagement)
- Proposed QM SAS – Effective for engagements conducted in accordance with GAAS for periods beginning on or after December 15, 2023

In December 2019, the PCAOB issued a concept release – Potential Approach to Revisions to PCAOB Quality Control Standards - in which it indicated it was also considering using the ISQM 1 as a starting point, noting support for the integrated, risk-based framework and a belief that it would not be practical to require firms to comply with fundamentally different QC systems. The PCAOB received numerous comments from stakeholders and has not yet issued any further guidance or an exposure draft on the subject.

The Road Ahead

As with the implementation of Sarbanes-Oxley, the initial implementation efforts are a significant undertaking requiring the identification and commitment of dedicated resources by firms if they are to meet the requirements of the standards and the expectations of regulators and other stakeholders. The Big Four and many other large international networks and their member firms commenced their ISQM 1 implementation efforts before ISQM 1 was finalized. The network efforts are driving improvements at the international level, which, in turn, are helping to drive the implementation of ISQM 1 within the member firms. Member firms of smaller networks, however, may find that implementation efforts at the network level are only just getting underway, and many U.S. firms that are not part of networks have not yet assessed their readiness or the level of effort that will be required.

We're Here to Help

The Lemme Accounting Firm Risk & Quality Management Consulting Services Practice has extensive experience advising firms on their systems of quality management and assists firms with readiness and implementation efforts. Please contact Owen Bailitz, Principal, at owen.bailitz@lemme.com or another member of the Lemme team for no-cost discussion regarding your firm's needs.

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Appendix

Summary of Recent International and U.S. Quality Management Standards

Issued International Quality Management Standard	Proposed U.S. Quality Management Standard	Applies To
<p><u>ISQM1, <i>Quality Management for Firms That Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements</i></u></p> <p>Effective December 15, 2022</p>	<p><u>Proposed Statement on Quality Management Standards (SQMS) 1, <i>A Firm's System of Quality Management</i></u></p> <p>Proposed effective date of December 15, 2023</p>	<p>A firm's system of quality management for audits and reviews as well as other assurance or related services</p>
<p><u>ISQM 2, <i>Engagement Quality Reviews</i></u></p> <p>Effective December 15, 2022</p>	<p><u>Proposed SQMS 2, <i>Engagement Quality Reviews</i></u></p> <p>Proposed effective date of December 15, 2023</p>	<p>Audits and reviews of financial statements</p>
<p><u>International Standard on Auditing (ISA) 220 (Revised), <i>Quality Management for an Audit of Financial Statements</i></u></p> <p>Effective December 15, 2022</p>	<p><u>Proposed Statement on Auditing Standards (SAS), <i>Quality Management for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards</i></u></p> <p>Proposed effective date of December 15, 2023</p>	<p>Audits of financial statements</p>