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July 1, 2019

Mr. Willie Botha
Technical Director
International Auditing and Assurance Standards Board
529 5th Avenue
New York, NY 10017

GAO's Response to the International Auditing and Assurance Standards Board's February 2019 Explanatory Memorandum, *The IAASB's Exposure Drafts for Quality Management at the Firm and Engagement Level, Including Engagement Quality Reviews*, and Exposure Draft, Proposed International Standard on Quality Management 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*

Dear Mr. Botha:

This letter provides GAO's response to the questions in the explanatory memorandum, *The IAASB's Exposure Drafts for Quality Management at the Firm and Engagement Level, Including Engagement Quality Reviews*. This letter also provides GAO's response to the exposure draft, Proposed International Standard on Quality Management 1 - *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*. GAO promulgates generally accepted government auditing standards, which provide professional standards for auditors of government entities in the United States.

We support the International Auditing and Assurance Standards Board's (IAASB) efforts to strengthen quality control and management for audits. Overall, this effort should lead to audits and reports that are consistently of high quality. We believe that there are opportunities to strengthen the standard, especially as it concerns scalability for small- and medium-sized governmental audit organizations. Our responses to the IAASB's questions are in the enclosure to this letter.

Thank you for the opportunity to comment on these important issues. If you have questions about this letter or would like to discuss any of the matters it addresses, please contact me at (202) 512-3133 or dalkinj@gao.gov.

Sincerely yours,

A handwritten signature in black ink, appearing to read 'James R. Dalkin', with a stylized flourish at the end.

James R. Dalkin
Director
Financial Management and Assurance

Enclosure

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Enclosure: Responses to Explanatory Memorandum and Exposure Draft Questions

Explanatory Memorandum, *The IAASB's Exposure Drafts for Quality Management at the Firm and Engagement Level, Including Engagement Quality Reviews*

Overall Questions

1) Do you support the approach and rationale for the proposed implementation period of approximately 18 months after the approval of the three standards by the Public Interest Oversight Board? If not, what is an appropriate implementation period?

We do not believe that 18 months will provide sufficient time for affected entities, especially small- and medium-sized governmental audit organizations, to prepare to implement these standards. For many audit organizations, the proposed quality management standards will require substantial revisions to their quality management systems. These audit organizations will then need additional time to evaluate and refine the revised systems to ensure that they develop and implement proper monitoring and remediation processes. We believe that the International Auditing and Assurance Standards Board (IAASB) should consider at a minimum a 24-month period for implementation of the standard, with the possibility of deferring full implementation for another 12 months, to allow audit organizations to evaluate and refine their revised quality management systems.

2) In order to support implementation of the standards in accordance with the IAASB's proposed effective date, what implementation materials would be most helpful, in particular for SMPs?

We are not providing comments relating to implementation materials.

General Questions

In addition, the IAASB is also seeking comments on the general matters set out below for all three EDs:

(a) Developing Nations—Recognizing that many developing nations have adopted or are in the process of adopting the International Standards, the IAASB invites respondents from these nations to comment on the proposals, in particular, on any foreseeable difficulties in applying it in a developing nation environment.

We are not providing comments relating to developing nations applying the proposed standard.

(b) Public Sector—The IAASB welcomes input from public sector auditors on how the proposed standards affect engagements in the public sector, particularly regarding whether there are potential concerns about the applicability of the proposals to the structure and governance arrangements of public sector auditors.

As indicated in individual responses to the questions below, we have concerns about the applicability and scalability of the proposals to the structure and governance arrangements of many public sector auditors, especially smaller governmental audit organizations. As mentioned in our May 2016 response to the December 2015 invitation to comment entitled *Enhancing Audit Quality in the Public Interest*, a significant number of engagements that occur in the U.S. public

sector are performed by small- and medium-sized practitioners (SMP), so the effect of these changes on SMPs directly and indirectly affects the public sector audit practice.

(c) Translations—Recognizing that many respondents may intend to translate the final ISQMs and ISA for adoption in their own environments, the IAASB welcomes comment on potential translation issues respondents may note in reviewing the proposed standards.

We are not providing comments relating to potential translation issues.

International Standard on Quality Management 1 - *Proposed Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*

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?

We support the new quality management approach. A risk-based approach to quality management should permit firms and government audit organizations to focus on engagement risk areas that may be unique to the environments in which they conduct engagements. The new approach should permit firm management to allocate more time to areas with higher risks to engagements.

(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?

We believe that the proposals will generate many of the intended benefits, including an appropriate exercise of professional skepticism at the engagement level.

(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?

We believe that much of the proposed International Standard on Quality Management 1 (ED-ISQM 1) is scalable. However, certain requirements may prove difficult or overly complex for small- and medium-sized governmental audit organizations. For example, paragraph 24c requires a firm to include, as a response to risk, policies or procedures for dealing with complaints and allegations about the quality of the firm or its personnel. Paragraph A47 notes that a smaller firm may use a service provider, such as legal counsel or a consultant, to fulfill this role. However, this could be cost prohibitive for small governmental audit organizations. Similarly, paragraph 46b requires firms to establish policies or procedures that prohibit engagement team members or the engagement quality reviewer from performing an internal inspection on an engagement. Small governmental audit organizations, such as those with only two or three auditors, may find it difficult to adhere to this requirement.

We believe that the IAASB should provide additional, specific application guidance that discusses how small governmental audit organizations can comply with these requirements, for example, by adopting alternative procedures that accomplish the overall goal.

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?

The concept of developing a risk-based approach to quality management is a significant shift for the auditing profession. While most governmental audit organizations may conclude that establishing quality objectives is straightforward, they could face more challenges in identifying and assessing quality risks. However, the standard focuses substantially on establishing quality objectives and provides relatively little application guidance on identifying and assessing quality risks. Therefore, we believe that additional application guidance or publications that discuss quality risks in more detail could prove useful, especially to small- and medium-sized governmental audit organizations.

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?

We suggest that additional application material be added to help government audit organizations apply the standards, particularly to address scalability, as noted in our response to 1c above.

Specific Questions

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

We support the concepts covered in the eight components of ED-ISQM 1. We appreciate that firms are not required to organize their quality management systems to follow the eight-component structure, as long as all requirements within the standard are met.

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?

We support the objective of the standard, including the objective of the system of quality management. With regard to the standard explaining the firm's role relating to the public interest, we believe that the language in the proposed standard is sufficient. The references in paragraph 7 and application guidance in paragraph A2 link the standard's objective to the firm's public interest role.

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:

(a) Do you agree that the firm's risk assessment process should be applied to the other components of the system of quality management?

We note that under the Committee of Sponsoring Organizations of the Treadway Commission's (COSO) *Internal Control- Integrated Framework*¹ and GAO's adaptation of the COSO framework for the government environment, *Standards for Internal Control in the Federal Government*,² the control environment component, which most closely aligns to the governance and leadership component of ED-ISQM 1, has a pervasive effect on the overall system of internal control and is the foundation for an internal control system. We do not believe that governance and leadership of a firm should be exempt from the scrutiny of a risk assessment. However, if the governance and leadership of a firm is deficient, it is less likely that the firm will initiate an effective risk assessment process and meet the quality management objectives. This risk may be heightened for governmental audit organizations, for which there may be no separation between governance and leadership and the individual who is assigned responsibility for the quality management system.

(b) Do you support the approach for establishing quality objectives? In particular:

i. Are the required quality objectives appropriate?

We believe that the quality objectives are appropriate.

ii. Is it clear that the firm is expected to establish additional quality objectives beyond those required by the standard in certain circumstances?

We believe that the standard clearly states that a firm or audit organization is expected to establish additional quality objectives beyond those the standard requires when necessary.

(c) Do you support the process for the identification and assessment of quality risks?

We believe that the process for identifying and assessing quality risks is appropriate for the revised quality management framework.

(d) Do you support the approach that requires the firm to design and implement responses to address the assessed quality risks? In particular:

i. 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?

We support the approach that requires a firm to design and implement responses to address the assessed quality risks. Under this approach, it is more likely that a firm will design and implement responses that are tailored to the particular assessed quality risks.

ii. Is it clear that in all circumstances the firm is expected to design and implement responses in addition to those required by the standard?

¹Committee of Sponsoring Organizations of the Treadway Commission, *Internal Control – Integrated Framework* (New York: American Institute of Certified Public Accountants, 2013).

²GAO, *Standards for Internal Control in the Federal Government*, GAO-14-704G (Washington, D.C.: September 2014).

We believe that it is clear that in all circumstances the firm is expected to design and implement responses to assessed quality risks in addition to those that ED-ISQM 1 requires.

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

We believe that ED-ISQM 1 appropriately addresses firm governance and the responsibilities of firm leadership.

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?

We believe that the final ISQM 1 should not dictate precisely how firms meet the requirements related to relevant ethical requirements, including independence. Firms should be given latitude to determine, based on their individual structures and situations, whether a single individual should be assigned responsibilities for these duties or if another method is more efficient and effective for ensuring that the firm adheres to the underlying principles.

(b) Does the standard appropriately address the responsibilities of the firm regarding the independence of other firms or persons within the network?

We are not providing comments related to 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?

We are not providing comments related to the use of technology by firms in the system of quality management.

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?

We believe that the requirements for communication with external parties about a firm's quality management system are not easily addressed. We note that paragraphs A142 and A153 mention that laws or regulations may either specifically require transparency reports or prohibit communication with external parties concerning a firm's quality management system. It is also unclear with whom small- and medium-sized governmental audit organizations that do not perform engagements of public interest entities should communicate. Finally, producing transparency reports or similar external reports, if not required by applicable law or regulation, could place an undue demand on the limited resources of small- and medium-sized governmental audit organizations.

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?

We suggest that the IAASB consider reordering paragraph 37(e) to help clarify which engagements should be subject to an engagement quality review. Specifically, we suggest the following:

- (e) Establishing policies or procedures addressing engagement quality reviews in accordance with ISQM 2 and that require an engagement quality review for
 - (i) audits of financial statements of listed entities;
 - (ii) audits or other engagements for which an engagement quality review is required by law or regulation;
 - (iii) audits of financial statements of entities that the firm determines are of significant public interest; and
 - (iv) audits or other engagements for which the firm determines that an engagement quality review is an appropriate response to assessed quality risks, based on the reasons for the assessments given to those risks.

With this change, it would be clear that engagement quality reviews are required for the scenarios depicted in (i) and (ii), and there would be some discretion for the scenarios in (iii) and (iv).

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?

We believe that the proposals should strengthen the monitoring of quality management systems, ensuring that it is appropriate for the size and complexity of the individual firms and audit organizations.

(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?

We believe that this requirement may be inconsistent with the intention to promote more proactive and effective monitoring activities discussed in question 12a. A requirement to ensure that each engagement partner has at least one completed engagement inspected on a cyclical basis may be inconsistent with the risk assessment that the firm performs. For instance, a firm may have started a new practice area that focuses on engagements with higher risk and greater inherent uncertainties. As monitoring resources are limited, a requirement to inspect at least one completed engagement for each engagement partner on a cyclical basis may divert resources that would otherwise have been devoted to monitoring engagements that posed higher quality risks. As such, we suggest that the IAASB delete this requirement.

(c) Is the framework for evaluating findings and identifying deficiencies clear and do you support the definition of deficiencies?

We suggest that the IAASB consider adding “finding” to the definitions in paragraph 19 of the ED-ISQM 1 to help ensure a consistent understanding and application of both “finding” and “deficiency” in the quality management framework.

(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?

We believe that the nature, timing, and extent of the procedures for investigating the root causes of deficiencies are sufficiently flexible.

ii. Is the manner in which ED-ISQM 1 addresses positive findings, including addressing the root cause of positive findings, appropriate?

We believe that addressing positive findings, including identifying the root causes of positive findings, in the application guidance is 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?

We agree with the requirement. However, we believe that there may be challenges to fulfilling it. In order for individuals who are assigned ultimate responsibility and accountability for a quality management system to fulfill their responsibilities appropriately, they must be able to rely on that system to provide accurate and reliable information. As reflected in our response to the first question in the explanatory memorandum, it may take more than 18 months for the audit organization’s quality management system to generate accurate and reliable information, especially if there are substantial changes to the system as a result of implementing ISQM 1. We believe that these challenges should subside as a new quality management system is evaluated and refined.

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?

We are not providing comments related to networks.

14) Do you support the proposals addressing service providers?

We are not providing comments related to service providers.

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?

We are not providing comments related to jurisdictional issues based on changing the title to ISQM.

Additional Comments and Observations

- **Specific guidance for SMPs and small- and medium-sized governmental audit organizations:** In the application guidance, there are discrete paragraphs and subsections focused on public sector auditors. We believe that the IAASB should consider providing similar discrete application guidance paragraphs for considerations specific to SMPs and small- and medium-sized governmental audit organizations (see portions of paras. A42 and A47).
- **Definition of “policies” (para. 19(t)(i)):** The definition of “policies” includes the following statement: “Such statements may be documented, explicitly stated in communications or implied through actions and decisions.” We believe that “implied through actions and decisions” should be removed. Engagement team members need to be able to access policies to be able to identify or confirm the proper response when they encounter a quality risk. In addition, written policies provide individuals performing monitoring procedures with objective criteria against which to evaluate a firm’s performance and adherence to the policies. If this phrase is retained, we suggest that the IAASB consider emphasizing, in appropriate paragraphs of the standard, the need to maintain sufficient evidence to demonstrate that the actions or decisions are the policy of the audit organization.
- **Supervision and review (para. 37(a)):** Paragraph 37(a) states, in part, that “such direction, supervision, and review is planned and performed on the basis that the work performed by less experienced members of the engagement team is directed, supervised, and reviewed by more experienced engagement team members.” We suggest that the IAASB consider whether experience is an appropriate measure for determining whether engagement team members adequately supervised work. Experience is only one driver of skill and proficiency in auditing. As such, paragraph 5.36 of the 2018 revision of generally accepted government auditing standards provides that “the audit organization should establish policies and procedures that require engagement team members with appropriate levels of skill and proficiency in auditing to supervise engagements and review work performed by other engagement team members.”³ We believe that considering the skill and proficiency of team members would more effectively achieve the objective of the requirement.
- **Monitoring activities for in-process engagements (para. 45(a)):** ED-ISQM 1 permits engagement inspections to be performed for in-process engagements as well as completed engagements. We believe that in-process reviews are part of engagement performance. Unless a firm’s established quality management process, including completion of engagement quality reviews or the equivalent, is permitted to fully function to completion, monitoring procedures such as inspections cannot determine if a potential finding or deficiency would have been rectified through the quality management process. In addition, inspecting in-process engagements could blur the distinction between quality management within individual engagements and the quality objective related to the monitoring and remediation process. Thus, we believe that permitting inspections of in-process engagements will cause additional difficulties in applying the standard.

³GAO, *Government Auditing Standards: 2018 Revision*, GAO-18-568G (Washington, D.C.: July 2018).