

1 July 2019

Willie Botha
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International Auditing and Assurance Standards Board
545 Fifth Avenue, 14th Floor
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USA

Dear Willie,

IAASB Exposure Draft –ISQM 1

Thank you for the opportunity to comment on this Exposure draft. We submit the feedback from the New Zealand Auditing and Assurance Standards Board (NZAuASB) to the specific questions raised in the consultation paper in the attachment.

The External Reporting Board (XRB) is a Crown Entity responsible for developing and issuing accounting and auditing and assurance standards in New Zealand. The XRB's outcome goal is to contribute to the creation of dynamic and trusted markets through the establishment of an accounting and assurance framework that engenders confidence in New Zealand financial reporting, assists entities to compete internationally and enhances entities' accountability to stakeholders. The NZAuASB has been delegated responsibility by the XRB for developing and issuing auditing and assurance standards.

In formulating this response, the NZAuASB sought input from a wide range of targeted New Zealand constituents. A joint webinar was held with the Auditing and Assurance Standards Board of Australia to provide an overview of the proposals. Four half day workshops targeting sole practitioners and smaller practices were held around New Zealand, specifically aimed at exploring the scalability of the proposals. Small and medium practices and the public sector were well represented at these workshops. A separate roundtable discussion was held to seek feedback from the larger firms.

Fundamentally, the NZAuASB supports a risk-based approach to enhancing quality management by firms. However, the NZAuASB is concerned that the proposals in ED ISQM 1 will be challenging to implement in practice. Even for the larger firms and network firms, we have been told that the proposals will be resource intensive and costly to implement – even if the firm is already managing its business using a risk management approach.

Many of those participating in our outreach, especially those from smaller practices and sole practitioners questioned the benefit of transitioning to the new standard. Acceptance of the new standard and its benefits in the public interest is obviously an important element in its implementation. We consider there is a strong need to more clearly demonstrate and articulate the benefits of the proposed quality management approach, and explicitly weigh these against the cost to implement. We think it is likely to benefit implementation of the standard in our jurisdiction if the standard (or the Basis for Conclusions) then articulates the benefits and explains how they have been weighed against the costs of transition and implementation.

As New Zealand's national standard setting board, the NZAuASB also supports the standard stating the objective of the firm as being to design, implement and operate a system of quality management which, as a key contributor to audit quality, is in the public interest. Capturing this notion is critically important, especially in the current global environment where, in many jurisdictions, there are perceptions of inadequate audit quality and insufficient means of measuring quality in a comprehensive way (including at the firm and

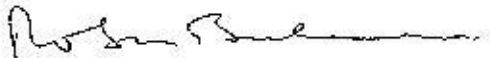
engagement level). A strong and measurable system of quality management at both the firm and engagement level has an important part to play in restoring trust in the value of audit.

Key messages for the IAASB to reflect upon in finalising the proposals include:

- The length and density of the material. This is a major point of concern and may be a barrier to effective application of the standard. We encourage a review of the drafting conventions used in the exposure draft, to ensure that the requirements are clear and the application material will assist practitioners (rather than for example repeating requirements or justifying the requirement).
- The extent of prescription in the standard. As we comment in the detailed submission, the combination of risk management with compliance seems to result in a hybrid that is likely to undermine the real benefits of the risk-based approach. We encourage the IAASB to reconsider the inclusion of prescriptive requirements.
- The large cost and resourcing needed to implement these proposals. We raise with the IAASB for consideration the benefit of developing a tool such as a “thinking list” of common quality risks (in the form of a generic list of common risks that practitioners can consider as applicable to their circumstances when undertaking the risk assessment and add to as appropriate) within the standard and/or develop illustrative documentation to assist practitioners to implement the proposals. We consider this may help to mitigate the large cost and resourcing burden without detracting from the benefits of a risk-based approach.

Should you have any queries concerning our submission please contact either myself at the address details provided below or Sylvia van Dyk (sylvia.vandyk@xrb.govt.nz).

Yours sincerely,



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Chairman

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Submission of the New Zealand Auditing and Assurance Standards Board

IAASB Exposure Draft – ISQM 1

I Overall Questions

- 1) Does ED-ISQM 1 substantively enhance firms' management of engagement quality, and at the same time improve the scalability of the standard?**

Response:

The NZAuASB considers that a risk-based approach to quality management should substantively enhance firms' management of engagement quality. The Board has been advised that many of the mid and larger tier firms in New Zealand already apply a quality risk management approach, with some variation in practice; and that the proposals largely codify what is being applied as best practice.

More work needs to be done to improve the scalability of the standard. Feedback from the New Zealand constituency indicates that, for small to medium-sized practices and sole practitioners (together in this submission described as SMPs), both the cost to transition to the new requirements and ongoing cost to apply the proposed approach will be significant and may not significantly improve engagement quality if such firms are unable to appropriately resource meeting the requirements.

We expand on these points in the specific questions below.

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?**

Response:

Yes, the NZAuASB supports the new quality management approach. The risk-based approach proposed in ED ISQM 1 aligns with other well-established frameworks, for example the ISO 9000 series of standards on quality management and ISO 31000 standard on risk management.

The proposals will be beneficial if practitioners focus efforts on quality, and continuously think about how to improve quality. However, the NZAuASB is concerned that the extensive use of prescription in the standard will detract from achieving those benefits. Effective management of engagement quality should involve a methodology by which firms and practitioners focus on identifying and managing risks, rather than complying with checklists of quality requirements.

The extensive prescription of the proposals suggests that the IAASB's approach is, in effect, a hybrid of risk-based quality management and prescribed procedures, with requirements to apply risk assessment and mitigation techniques while retaining a level of prescription (largely from the extant standard) which has the potential to predetermine outcomes in relation to specific risks. In other words, the standard may be viewed as taking a risk-based plus checklist approach; the NZAuASB is concerned that overly prescriptive objectives may hinder the proper application of a true risk-based approach.

Most notably, we are concerned the proposed quality objectives are too granular. This was also the view of most New Zealand practitioners we spoke to. We recommend that the proposals be enhanced by lifting the quality objectives to a less granular level. This is further explored in response to question 6(b).

(b) In your view, will the proposals generate benefits for engagement quality as intended, including supporting the appropriate exercise of professional scepticism at the engagement level? If not, what further actions should the IAASB take to improve the standard?

Response:

The NZAuASB considers the proposals will generate benefits and should assist to focus practitioners on the importance of quality at both the firm and the engagement level. The NZAuASB is also supportive of the emphasis on professional scepticism in the proposals.

However, the benefits for engagement quality will not be achieved if the requirements cannot be appropriately and effectively applied. Feedback from the New Zealand constituency indicates that the practical implementation of the proposals will be challenging, resource intensive, and therefore costly. The NZAuASB urges the IAASB to take further actions to address these challenges, both in the requirements and application guidance and in providing support for implementation.

From our targeted outreach it became clear that implementation support will be needed to assist, especially for SMPs. Feedback from SMPs was that the need to identify risks will be time consuming for individual practices. It was observed that many of the risks would be identical for such firms. Practitioners saw little value in requiring each firm to identify similar risks.

We raise with the IAASB for consideration the benefit of developing a “thinking list” of standard types of quality risks, that firms and practitioners could consider for their circumstances and be required by the standard to add to as appropriate. We do not think of this approach as creating a “checklist”. To the contrary, we have in mind a description of the generic types of risks to engagement quality which could be identified and assessed by each firm when it is undertaking its assessment of risks in relation to the quality objectives, having regard to its own circumstances as the standard contemplates.

To further assist in implementation, there may also be benefit in extending that type of generic risk approach by developing a matrix of the quality objectives which could be mapped to common quality risks and responses. This guidance could be provided by the IAASB, or others, as part of the implementation approach.

In considering such an approach, the NZAuASB encourages the IAASB to specifically consider the implications of the quality management approach, and the requirements of the standard, for sole practitioners. This should be addressed in application material, and in other ways that enable a consistent and effective approach by SMPs to implementing the standard.

The NZAuASB also emphasizes the need for ongoing support by professional accounting bodies and others to assist over the transition period. However, we have heard concerns from practitioners that any guidance developed should be consistent with the principles of

the standard (when it is finalised) rather than establishing a professional body's (or regulator's) own interpretation of the standard. A co-ordinated effort at an international level may be the best way to develop this support.

- (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?**

Response:

Building on the response to question 1(b), the NZAuASB considers that many aspects of the ED will be challenging for SMPs and are not scalable. Whilst in principle, the risk assessment process will enable the firm to adjust the risk response according to its size and nature, the detail and prescriptiveness of the application material will make it difficult for SMPs to understand and apply the fundamentals of the risk-based approach throughout the requirements.

To address the lack of scalability, the NZAuASB encourages the IAASB to refine its drafting approach to reduce the length of the proposed requirements and application material. The length and density of the proposals is a barrier to its readability and understandability and therefore its effective application. The potential implementation challenges are seen to be more difficult for SMPs that do not have the level of technical support at their disposal. The density of the standard will only add to the resourcing burden.

For example, the introduction is lengthy and repeats the standard. While this may be useful initially, it will be less so as firms familiarise themselves with the changes. This overview of the standard could be positioned outside of the standard as a type of "At a Glance" summary.

The NZAuASB considers the following actions could help to reduce the length and enhance the clarity of the proposals:

- Remove all non "shall" statements from the requirements, and if necessary moved to application material to ensure that the drafting conventions of the clarity project are retained.
- Separate "shall" statements into separate requirements, i.e., ensure that requirements are short and to the point, rather than embedding multiple requirements within one requirement paragraph.
- Start with the small and simple, and add to the requirements and application material to address the more complex, rather than the other way around.

Some specific suggestions are included by way of an appendix to our overall responses.

In addition, the NZAuASB considers the documentation requirements may be overly onerous. More guidance on what and how to document may help to alleviate concerns and improve documentation to better demonstrate the application of professional judgement. For example, the proposals recognise that SMPs especially may have a less formal system of quality management. However, it is unclear how less formal approaches will be documented to demonstrate compliance to the regulators. The IAASB should be mindful that the purpose of enhanced documentation should focus on improving quality in

the public interest, and providing clarity for both firms and regulators to guide the approach to file review.

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?

Response:

Yes, the NZAuASB considers there are three aspects that create significant challenges for implementation:

- The prescriptive, overly granular quality objectives;
- The requirement for each firm to identify quality risks;
- The requirement to document the quality objectives and then map the quality risk and responses to those risks.

The granularity and prescriptiveness of the quality objectives is of particular concern, and in the NZAuASB's view undermines the benefits of the risk based approach. As noted in our response to question 1(a) above, this seems to result in a hybrid type of risk-based/checklist approach to quality management. The intended application of the risk-based approach may be undermined if the objectives are too prescriptive.

From our targeted outreach, practitioners were also concerned that overly granular objectives that are outcome based will carry the risk that regulatory focus will be unduly on the outcomes (which should be matters for the firm to identify) rather than the quality management process adopted by the firm (which is the appropriate focus of regulatory oversight). The NZAuASB agrees there is some force to this point, which underlines the importance of striking the right balance between principle and prescriptiveness. We would like to see this balance addressed before we need to consider the standard's adoption in our jurisdiction. In the Board's view, the ED does not strike that balance effectively, and this has implications for the prospects of the standard achieving measurable improvements to engagement quality.

The NZAuASB also foresees significant implementation challenges in terms of linking the required responses to the prescribed objectives. We ourselves found this difficult to achieve when preparing for our workshops with the New Zealand constituency. We noted many of the required responses relate to more than one objective and create something of a "spiderweb" of objective, risk and response. We consider this likely to be time consuming and challenging for firms to implement in practice.

The NZAuASB also considers the standard should be clearer about what a firm should do if it does not link a required response to any risk. As noted in the response to question 1(b), practitioners involved in our targeted outreach questioned the value of requiring each firm to perform this exercise for common risks and responses. This supports the suggestion of a "thinking list" of generic risks which SMPs could use to identify their own firm-specific risks that are relevant to their circumstances. This could be supplemented by guidance about the requirement for each firm to identify additional risks where necessary.

The targeted outreach also identified the requirement to document the objective, risk and response as likely to be onerous and time consuming. We were told that implementation

guidance to illustrate how such documentation could be prepared would be well received, noting the need for flexibility in the approach, and recognising that the guidance may have to demonstrate a multiple of ways that this could be achieved.

Practitioners raised concern that meeting this documentation requirement may not have any benefit for quality, and instead just become a compliance exercise. We consider there is a balance between the benefit of documentation, and evidencing what has been done, against the cost to do so. Where documentation can assist the firm in developing and confirming the risk assessment, we consider the discipline of documentation may add to the robustness of a firm's system. However, we are concerned that documenting this "spiderweb" of objective, risk and response will be resource-intensive – both when initially implementing the requirements and on an ongoing basis.

As noted earlier, we recommend that the IAASB review the level of detail throughout the proposals, with a view to removing any overly prescriptive requirements and application material that does not demonstrably drive implementation of the relevant requirement to achieve improved engagement quality.

The NZAuASB has identified the following additional implementation challenges:

- The lack of clarity of the requirement, and the absence of any examples, to assist firms to consistently distinguish between a finding and a deficiency. (Refer also to question 12(c).)
- The requirement for periodic performance evaluations of the individual assigned ultimate responsibility and accountability. (Refer also to question 7.) We consider it may be challenging for a firm, especially an SMP, to find the appropriate person to perform such an evaluation. To produce meaningful results, the evaluator would need to have the appropriate authority and be well respected within the firm, including when necessary to be able to challenge the firm's leadership. For small SMPs (including sole practitioners), the requirement may not even be capable of application.

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?

Response:

The NZAuASB notes that the requirement paragraphs mix requirements and information in the nature of application material. In addition, the NZAuASB considers the proposed application material itself could be condensed significantly by applying a "less is more" approach, ensuring that the inclusion of any application material serves the purpose of clarifying or assisting practitioners to apply the requirements.

The NZAuASB recommends that any proposed application material that has been included with the aim of justifying the approach of, or in effect repeating, a requirement should be removed. This would reduce the length of the standard; reinforce the stated aim of making the quality management approach principles-based; and improve its scalability. In overall terms, it would enhance the readability and understandability of the standard as a whole.

As mentioned above, we consider that additional application material that develops a “thinking list” of standard quality risks, that firms may consider for their circumstances would be especially useful.

As noted earlier, more specific suggestions as to where the standard could be shortened are attached by way of an appendix to this submission.

II Responses to the IAASB’s Specific Questions

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

Response:

The NZAuASB supports the eight components of the system of quality management, as part of an integrated system. Practitioners who participated in our targeted outreach found it was useful to have the components separately identified, as a useful prompt to get firms started in the process of identifying and managing risks.

That said, we have a question about the value of structuring the proposed requirements and application material around the components, given that the proposals are designed to highlight the integrated nature of the objectives and responses. For example, separating information and communication from the other components seems overly complicated, as information and communication relate to the other components.

It may be more useful to identify the required quality objectives and required responses in a more neutral manner, given that many of the responses may address multiple objectives and risks.

To address concerns of this nature, while recognising the integrated nature of the system, it may be useful for diagrams or an illustrative mapping document to be prepared (possibly separately from the standard) to show the integration while making reference to the eight components.

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?

Response:

As New Zealand’s national standard setting board, the NZAuASB supports the standard stating the objective of the firm as being to design, implement and operate a system of quality management which, as a key contributor to audit quality, is in the public interest. Capturing this notion is critically important, especially in the current global environment where, in many jurisdictions, there are perceptions of inadequate audit quality and insufficient means of measuring quality in a comprehensive way (including at the firm and engagement level). A strong and measurable system of quality management at both the firm and engagement level has an important part to play in restoring trust in the value of audit.

In particular, the NZAuASB is supportive of an objective that is focused on the process of designing, implementing and operating a system of quality management in the public

interest. In the Board's view it is essential that the standard explains clearly what the firm's public interest role is and provides clarity about the objective of quality management to be achieved. To achieve this, the NZAuASB recommends that the formulation of the objective be more explicit in linking the objective of the firm and the system of quality management to serving the public interest.

In our targeted outreach in relation to ED ISQM 1 with New Zealand firms and practitioners, we heard feedback from SMPs that the objective and scope of the standard could be clarified by expanding on what is meant by related services. It may not be clear to those unfamiliar with the IAASB terminology which of the following are within scope: agreed upon procedures, compilation work, tax services, business advisory services, etc. We recommend that this term is defined.

To ensure that the proposals, as a whole, operate in the public interest, the NZAuASB recommends:

- a clearer articulation of the cost benefit analysis of the risk-based approach to quality management, to ensure that those applying the standard can understand how the benefits outweigh the costs in the public interest. This could be of benefit both to firms and to regulators.
- Avoiding a focus on the outcome of the process. We recommend that both the objective and the requirements within the proposals should focus on the process of designing, implementing and operating a quality management system, rather than on the outcome of the process. We consider there may be unintended consequences of overly granular requirements in the proposals that focus on the outcome of the system of quality management. This is explored further in response to question 6(b).

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?

Response:

The NZAuASB is satisfied that a risk assessment process ought, in principle, to drive a firm to establish appropriate quality objectives. Those that are well resourced to apply an intensive assessment process ought to be in a strong position to do so using the requirements of the standard. That said, the cost and effort in implementing the new approach even in large and network firms should not be underestimated. The detail and prescriptiveness of many of the proposals may well be a barrier to establishing appropriate objectives. Even for a large firm that is part of a wider network, we are concerned the objectives are overly granular and may not encourage firms to give the objectives sufficient thought. Our concern is magnified in relation to the SMP sector, which makes up the largest proportion of firms in our jurisdiction.

We are particularly concerned that a risk assessment process that requires intensive resources for a smaller firm may be overly burdensome, and therefore not result in the firm identifying appropriate objectives, risks and responses. We consider significant implementation support will be needed to assist SMPs in this task, and also to enable regulators to carry out efficient and effective file reviews.

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?

Response:

No, not necessarily. The NZAuASB considers the risk assessment process should be applied to the identified quality objectives, given that the quality risks and responses relate to the objectives rather than the components. This may assist in further emphasising the integrated nature of the risk assessment process.

The risk assessment process does not appear as relevant to the monitoring and remediation component. Rather the identification of a deficiency helps to inform the application of the risk assessment process to the other quality objectives, (i.e., to identify missing objectives, risks or responses, etc).

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

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

Response:

The NZAuASB is concerned the required quality objectives are overly granular. We encourage the IAASB to consider raising the objectives to a less prescriptive level. We consider setting the objectives at a higher level will enhance the implementation of a risk-based quality management approach. Overly granular objectives may encourage a greater emphasis on the outcome, rather than the process itself. This approach may also contribute to a checklist approach (by both firms and regulators), rather than a true risk based approach.

For example, paragraph 23 identifies very specific objectives to address the firm’s governance and leadership. The level of specificity enables some mapping between the required responses and the prescriptive objectives. This could have the unintended consequence of limiting the identification of risks. The quality objective for relevant ethical requirements could also be set at a higher level, for example, “The firm shall establish quality objectives that addresses the fulfilment of responsibilities in accordance with relevant ethical requirements”, without the prescription detailed in parts (a) to (c). If considered necessary, (a) to (c) could be built into the required responses in paragraph 33.

The NZAuASB suggests it could be clearer in the standard as to when it is expected that additional objectives are necessary. Based on the explanatory memorandum, we understand it is not expected that additional objectives are always necessary, and therefore may expect that in many cases no additional objectives would be established, especially where the objectives are very granular. However, from our targeted outreach and our own deliberations we are not confident of a consistent approach being taken in applying and regulating the approach.

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

Response:

Yes, the NZAuASB agrees in principle with the process for identification and assessment of quality risks. However, this is complicated by the inconsistency in logic, whereby the proposals include required responses with no identified risks. As mentioned above, SMPs have queried the value of requiring each individual firm to perform this process for essentially the same risks. The IAASB may consider adding a “thinking list” of common risks into the standard, based on the responses identified while still retaining the requirement for firms to identify any additional risks. This may also enhance the scalability of the standard.

The NZAuASB is supportive of the requirement to assess the quality risks. Assessing both the reasonable possibility of occurrence and the significance of the effect on the achievement of a quality objective is a useful way both to improve the scalability of the standard and to enhance the robustness of firm’s system of quality management. Practitioners we heard from were also supportive of this two-step approach, noting that ranking risks may prove to be a useful tool for the firm’s senior management to direct its focus on key risks.

However, concern was raised that the bar for developing a response may be set too low. The Board shares the concern. The application material in paragraph A55 states that having a reasonable possibility of occurring is when its occurrence is “more than remote”. This may imply that almost all risks require some response, which may be overly onerous on firms and direct effort away from key risks.

Practitioners noted this assessment is highly judgemental and raised concern that regulators, with the benefit of hindsight, could start to challenge a firm’s judgement and assessment about why a risk is unlikely to occur, etc. Practitioners requested that if there are key risks which firms should be responding to, it would be more helpful for the standard to identify those risks, rather than having to debate with regulators at a later stage why a risk was not identified by the firm or was assessed as a low risk not requiring a response.

While recognising the importance of a regulator being able to discuss such matters with a firm during an inspection, the Board agrees that the standard should be clear as far as possible where the responsibility lies for the relevant judgements.

(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?**

Response:

The NZAuASB considers the approach should result in a firm designing and implementing tailored responses if the intent of the standard is followed. However, the

NZAuASB is concerned with the amount of prescriptiveness here. By listing the required responses, there is a risk that the standard will encourage firms to take, or continue with, a bottom up approach using a “checkbox compliance” mentality and working backwards to identify risks to meet the prescribed responses. Firms may see this as the quickest way to ensure that it is, or remains, compliant with the standard.

Implementation examples, outside of the standard, may be a useful way to encourage firms (especially SMPs) to think about all relevant risks to their circumstances and thereby meeting the spirit of the standard and ensuring a great level of consistency to the risks to quality.

During our outreach workshops, we asked practitioners to firstly identify risks to the objectives and then as a second step to identify related responses. It was quickly apparent that the risk and response are related. When asked to identify risks, practitioners seemed immediately drawn to a response. The reverse was also true, i.e., that when given the list of prescribed responses, the identification of risks generated new ideas for risks. This suggests that the requirement in paragraph 28, that stresses that the firm shall identify those quality risks before consideration of any responses, will be challenging. While we understand the logic of the IAASB’s approach, we think it likely that the starting point for many firms will be to look at what they are currently doing rather than more broadly. This in turn may result in the firm asking why they are doing what they are doing, i.e., using the responses to identify the risks.

The NZAuASB encourages the IAASB to revisit the level of prescriptiveness in the standard, in particular to avoid that type of unintended consequence.

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?

Response:

Yes, the NZAuASB agrees it is clear in principle that the firm is expected to design and implement responses in addition to those required by the standard. The proposals are less clear as to what would happen if the firm did not identify risks to which there are required responses.

As noted above, a response may relate to more than one risk and more than one objective. Mapping this “spiderweb” of objective, risk and response may be time consuming and challenging in practice. We encourage the use of implementation guidance to illustrate how such documentation could be prepared, and from our outreach we consider this would be well received and reinforce the need for flexibility in the approach (i.e., any guidance may have to demonstrate a multiple of ways that this could be achieved).

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

Response:

The NZAuASB is supportive of expanding the requirements to address the “tone at the top” as part of the firm’s system of quality management. However, it is not the role of the standards to prescribe audit firm governance. The NZAuASB cautions against the use of prescription which could be seen to be “telling” firms how to run their business. Trying to define requirements for good governance may also stray outside the mandate of the IAASB and a national standard setting body.

As highlighted above, the NZAuASB has heard that the requirement for periodic performance evaluations of the individual assigned ultimate responsibility and accountability may be challenging in practice. We consider this requirement may also stray into prescribing firms how to manage their human resources. Some firms, especially SMPs, may find it challenging to find the appropriate person to perform such an evaluation. To be meaningful, the evaluator would need to be independent, have the appropriate authority and be well respected to be able to challenge the firm’s leadership, and have access to criteria against which such an evaluation would be made. In principle, we think this should be left to the firm to manage as appropriate to its circumstances.

This should be less challenging for larger firms, including those within a network, where such reviews may already occur in practice. For an SMP (especially a sole practitioner), the requirement may be more challenging to apply. We think it likely that liability and other risks may deter practitioners from other firms to perform the role (for example through “peer reviews”); current experience in the New Zealand environment supports this concern.

The NZAuASB also questions whether it is appropriate to guide a firm’s performance evaluation policies by highlighting compensation, promotion and other incentives. Measuring good quality is, of course, difficult and we do not think that establishing a link between compensation and quality will necessarily enhance audit quality. One may readily identify the exceptions (e.g., a poor result from a regulatory review, or an independence breach) and penalise a partner for poor performance. However, that may not in itself incentivise or promote good quality. Instead, it may focus behaviour on avoiding being penalised and have the unintended consequences of a focus on compliance rather than quality.

In practice, we think it may also be challenging to document the culture of the firm in order to meet the documentation requirements of the standard.

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?

Response:

In principle, the NZAuASB agrees a firm would assign operational responsibility for both relevant ethical requirements and independence requirements to an individual within the firm. In fact, firms would assign operational responsibility for all components.

However, there is a need for a combined responsibility. Responsibility for compliance with both ethical and independence requirements ultimately lies with each individual. Pushing responsibility down through the whole firm and creating an ethical culture is the challenge in practice, just as it is in any corporate governance situation. Mandating operational responsibility to an individual is important, but careful management will be needed to avoid responsibility or compliance being seen in practice to lie with the relevant individual.

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

Response:

The NZAuASB is pleased that the proposals make it more explicit that the network may be subject to relevant ethical requirements. However, we consider it may be useful to clarify further whether the firm should understand how the independence requirements applicable to the network could affect the firm's system of quality management. Providing an example of when and how this would apply would be useful, such as in relation to a network firm's client acceptance systems. This could address whether a firm is expected to obtain a type of service organisation report over controls over network independence requirements.

Feedback from our targeted outreach suggested that, in practice, firms do make use of the network firm's monitoring reports to inform an understanding of whether the network firm is in compliance with its ethical requirements, including independence requirements. It may be useful for the standard to emphasise the importance of using the results of the network's monitoring activities to inform the firm's own understanding of how the independence requirements applicable to a network firm apply.

9) Has ED-ISQM 1 been appropriately modernized to address the use of technology by firms in the system of quality management?

Response:

The NZAuASB supports the introduction of requirements addressing the use of technological resources, in both the performance of engagements and the operation of the system of quality management, in a principled way.

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?

Response:

Transparency reporting is not required and is uncommon in New Zealand. The NZAuASB is supportive of the proposed approach, and agrees the proposals may encourage transparency as appropriate, without being too prescriptive.

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?

Response:

The NZAuASB is supportive of broadening the requirements for an engagement quality reviews (EQR) more broadly than listed entities. This is consistent with amendments already made by the NZAuASB when adopting extant ISQC 1 in New Zealand. Specifically, the NZAuASB is supportive of reference to an EQR required by law or regulation. New Zealand stakeholders were generally supportive of introducing a reference to the public interest in determining the scope of the EQR requirements.

However, the NZAuASB recommends that the IAASB and IESBA align terminology. The concepts of a “public interest entity” and “entities of significant public interest” are very similar, and may introduce unnecessary confusion in practice. The application material for firms to consider in the Code of Ethics and the application material in ED ISQM 1 also cover similar entities. We recommend that either the same terminology is used or, if it is intended that the meaning is different, the IAASB should clarify further in ISQM 1 how the application of these terms is expected to differ in practice, to ensure they are appropriately and consistently applied in the context of ISQM 1.

We also note that IESBA has included a new project to consider the definition of listed entity and public interest entity in its Strategy and Work Plan 2019-2023. We encourage the IAASB and IESBA to continue to collaborate on these terms with a view to aligning terminology where appropriate or clarifying differences in terminology as needed.

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?

Response:

Yes, the NZAuASB considers that expanding the monitoring requirements to cover all aspects of the system of quality management as a whole may promote a culture of continuing improvement, and therefore promote proactive and effective remediation activities. We have heard this is already happening in mid-sized to larger practices but formalising this as a new requirement is likely to encourage innovative techniques.

(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?

Response:

Yes, the NZAuASB agrees there should be a requirement for the inspection of at least one completed engagement. However, there is a need for additional implementation material to assist SMPs to comply with this requirement.

Paragraph A167 states that external inspections are not a substitute for the firm's internal monitoring activities but may inform those activities. In practice it will be a challenging to find appropriately experienced people to perform this review. While this is an existing requirement, it is one that many SMPs currently fail to meet. Practical solutions may be to allow for SMPs to perform inter-firm reviews (although as noted earlier there are liability and other factors which could deter firms from doing this), or alternatively to allow for a completed review by an external regulator or (in the public sector) by the office of the Auditor-General (or equivalent) to meet this requirement. Practical implementation to assist SMPs is likely to be well received.

We recommend that the statement in paragraph 45 that inspections may include in-process reviews should be moved to the application material, as this is not strictly a requirement. The idea of an in-process or "hot review" is something that is happening in practice in New Zealand, and our targeted outreach indicated that it works well and can enable timely corrective action to be taken. However, if this is not required, and may not replace the inspection of a completed engagement, we recommend this should only be referenced in application material.

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

Response:

No, the NZAuASB considers the distinction between a finding and a deficiency could be clarified further. Illustrative examples of what would be a finding versus what would be considered to be a deficiency would be helpful. This is particularly important given that firms will be required to respond in different ways. To promote consistency in practice, the standard should include a clear expectation as to when a root cause analysis is expected.

It is unclear when a finding would not be a deficiency, especially in paragraph 51(b): i.e., when a finding related to an inappropriate report would not be considered a deficiency. It could also be made clearer that paragraph 51 applies to findings and not deficiencies.

Paragraph A180 states that the firm's policies or procedures for the nature, timing and extent of the procedures to investigate root causes "... may include whether the deficiency ... indicates a trend or systemic issue". Practitioners noted during our outreach that the root cause analysis would need to be performed in order to determine whether the matter is systemic.

Practitioners were also concerned that a root cause analysis may be required in order to determine whether the issue is a deficiency. The NZAuASB sees merit in this point, and considers the language could be clearer here to clarify that a root cause analysis is not required to be performed for all findings; rather, firms' policies or procedures should address when a root cause analysis is appropriate. In practice, firms may be performing root cause analysis on findings categorised as "high", i.e. those findings for which there is a high risk of a material misstatement occurring. They may also choose to analyse "medium" findings.

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

Response:

Yes, the NZAuASB agrees with the new requirement and considers this is making explicit what is (or should be) happening implicitly. Practitioners raised concern with us that there is already external guidance on performing a root cause analysis, prepared by others, that would appear to go beyond the requirements of the proposals. For this reason, we agree that it would be useful for the standard to explicitly address the root cause analysis. However, additional application material is needed to assist firms, especially SMPs and sole practitioners, to apply and evidence this analysis.

- (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?**

Response:

The NZAuASB considers there are challenges to fulfilling the requirement. Requiring the individual(s) to evaluate the system of quality management for which they are ultimately responsible may not achieve much to enhance quality, unless this evaluation can be supported by information gathered from other individuals. This may be more practicable for larger firms but may not be as effective for SMPs where the individual(s) evaluating the system of quality management are also involved in the engagements that are performed.

- 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?**

Response:

Yes, the NZAuASB is supportive of the proposals to ensure firms understand the network requirements or network services and the effect they have on the firm's system of quality management, so as to emphasise that the firm is responsible for its own system of quality management. We consider this may assist to reduce any apparent undue reliance on network requirements or network services.

However, the NZAuASB does consider this may pose implementation challenges, as firms work to identify what further information is required from the network and what actions to implement when determining the impact of the firm's system of quality management.

14) Do you support the proposals addressing service providers?

Response:

The NZAuASB is supportive of the proposal for the firm to determine the appropriateness of the use of resources provided by service providers. However, we consider this may be onerous for SMPs which outsource their audit methodology and, ultimately, their system of quality management to an external service provider.

Many SMPs in New Zealand rely on one software programme for their audit methodology to perform their audit engagements. We are aware that the programme also covers, in essence, the requirements of ISQC 1. Further clarification around what each firm is expected to do in relation to using such software may assist SMPs' transition to the new standard.

In addition, it may be useful to clarify the examples of the types of IT software providers that could be used, i.e., those that develop specific audit methodology as opposed to more general applications like Excel.

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?

Response:

In New Zealand, the XRB has adopted ISQC 1 but amended the scope as appropriate for its mandate, limited to assurance engagements. The XRB standard was renamed Professional and Ethical Standard 3 (Amended) *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance Engagements* i.e., the XRB has not adopted the title "International Standard on Quality Control".

The change in title from ISQC to ISQM is unlikely to have an impact for the XRB as it will continue to issue this standard as part of the Professional and Ethical Standards. The NZAuASB intends to adopt the new title amended for its mandate *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance Engagements*.

Appendix
NZAuASB suggestions for shortening the standard to enhance readability and understandability

Remove non “shall” statements from the requirements

- i. Para 22. Remove the second sentence “The requirements are designed to enable the firm to achieve the objective stated in this ISQM. The proper application of the requirements in this ISQM is expected to provide a sufficient basis for the achievement of the objective of this standard.” Neither of these sentences are requirements. It is superfluous to state that the requirements enable the firm to achieve the objective.
- ii. Para 45 – Engagement inspections may include the inspection of in-process or completed engagements, this is better positioned in application material as it is not required.

Caution against overly granular requirements

- a) Para 41(c). Consider whether (i)-(iv) could be factors to consider in application material rather than a prescriptive list of parties.

Less is more approach for application material

- a. A26 – not application material to assist in how to establish an appropriate culture, rather is explaining why it is important. Could condense and combine A26-A28.
- b. A31 –It is not clear how this helps explain the objective. Firms can arrange themselves in various ways, and the standard does not have to give them permission to do so?
- c. A32 – how does this link to QM – it is stating the obvious that firms will have different leadership structures based on their size, etc. How does this help?
- d. A33 – sounds like a debate around which component you classify things in which does not really matter. Rather need application material on what/how this looks like.
- e. A34 – repeats 20(a). Not very helpful
- f. A35 – sounds like telling the firms how to plan?
- g. A36 – why repeating A32? – as above A32 is not very helpful and this just repeats it.
- h. A38 – sentence “in addition to assigning responsibility for compliance with independence requirements and the monitoring and remediation process” is repeating the requirement – condense?
- i. A39 – how does this help – surely the firms can add more anywhere?
- j. A41 – why is the standard setting out the consequences of performance evaluation for the leadership of the firm.
- k. A44 – first sentence superfluous – establishing policies or procedures for dealing with complaints supports the firm’s commitment to quality. This would not be a requirement if it did not do so. Does not help in any way, rather is a justification. Delete.
- l. A44 – what about failure to meet expectations?
- m. A45 – unclear why this cross reference is here?
- n. A72 – given there is already references to the IESBA code in para A67 why need to repeat the conceptual framework here? (Same as A74) Cannot summarise the Code in a few para – have to comply with all of it, so why try to include a few excerpts?
- o. A154 is justification (or benefits from) not application- suggest delete
- p. A155 – how does this help. Is the purpose to highlight the need for professional judgement or highlight matters to consider.
- q. A157 – sounds like a debate about which component – does it really matter which component it is in? How does effort in fitting responses into components promote audit quality? Is it not better to focus on making sure the responses happen?
- r. A171 – why repeat A65 and the IESBA Code? Suggest condensing to example to illustrate the threat or consider whether this is included in the IESBA Code rather?
- s. A178 – why repeat the requirement. Why repeat A174?
- t. A179 – why lay out the justification for the requirement? That does not really help in application, i.e. how to perform not why perform?

- u. A180 – why is a requirement in application material ...the policies and procedures are required to take into account...? Condense to what the firm may consider.
- v. A188 – how does that help – stating the obvious can remove.
- w. A189 – very dense paragraph