Questions and Answers on

ISQM 1 'Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagement'

From the Desk of Technical Services

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Overview of ISQM 1

ISQM 1, replaces the IAASB's current standard, ISQC 1, which addresses firms' systems of quality control.

ISQM 1 deals with the firm's responsibility for having a system of quality management (SOQM). The SOQM is the mechanism that creates an environment that enables and supports engagement teams in performing quality engagements. ISQM 1 requires firm to customize the design, implement and operate its SOQM based on the nature and circumstances of the firm and the engagements it performs.

The ISQM 1 deals with the firm's responsibility to establish policies or procedures addressing engagements that are required to be subject to engagement quality reviews.

Q 1 - What is System of Quality Management?

ISQM 1 defines the 'System of Quality Management' (SOQM) as follows:

"A system designed, implemented and operated by a firm to provide the firm with reasonable assurance that:

(i) *The firm and its personnel fulfill their responsibilities in accordance with professional standards and applicable legal and regulatory requirements, and conduct engagements in accordance with such standards and requirements; and*

(ii) *Engagement reports issued by the firm or engagement partners are appropriate in the circumstances."*

Q 2 - Does the SOQM cover all engagements performed by the firm?

ISQM 1 requires the firm to design, implement and operate a SOQM for audits or reviews of financial statements, or other assurance or related services engagements.

In circumstances when the firm performs other types of engagements (e.g., tax or consulting services), ISQM 1 does not require that the SOQM extend to such engagements. However, these other types of engagements, or personnel performing such engagements, may be affected by matters relating to the firm's SOQM.

For example, the firm's policies or procedures may prohibit the performance of certain non-assurance services for clients for whom the firm performs audits or reviews of financial statements, or other assurance engagements.

Q 3 -   What are the key changes made in ISQM 1 which are distinct from extant ISQC 1?

Key changes include:

- The introduction of a risk assessment process;

- A new proactive and tailored approach on quality management;

- Requires firm to switch from policies and procedures that address standalone elements, as required by extant ISQC 1, to an integrated QM approach that reflects upon the system as a whole;

- Enhanced requirements to address firm governance and leadership;

The extant ISQC 1 includes six elements only:

a) Leadership responsibilities for quality within the firm;

b) Relevant ethical requirements;

c) Acceptance and continuance of client relationships and specific engagements;

d) Human resources;

e) Engagement performance; and

f) Monitoring

- Expand requirements to modernize the standard and reflect factors affecting the firm's environment, including requirements to address technology, networks, and the use of external service providers;

- New requirements addressing information and communication, including communication with external parties;

- Enhanced requirements for monitoring and remediation of the SOQM as a whole, including a specific requirement to use root cause analysis, effective and timely remediation of deficiencies.

Q 4 -   How the firm's SOQM operates?

ISQM 1 consists of following eight components that deal with the key aspects of the SOQM and operate in an integrated manner:

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 communication;

8.   The monitoring and remediation process.

The firm is required to meet all of the requirements within ISQM 1, including the requirements in the components.

In addition to above components, ISQM 1 specified requirements regarding the roles and responsibilities for the firm's leadership, overall evaluation of the SOQM system, network requirements or network services and documentation.

Q 5 -   Is the firm required to have all eight components in its SOQM?

The firm is not required to organize its SOQM according to the eight components, and may choose to use different terminology or frameworks to describe the components of the SOQM.

For example, provided that all of the requirements of the standard are still met, a firm may have different names for the components, may combine the components, or may have additional components.
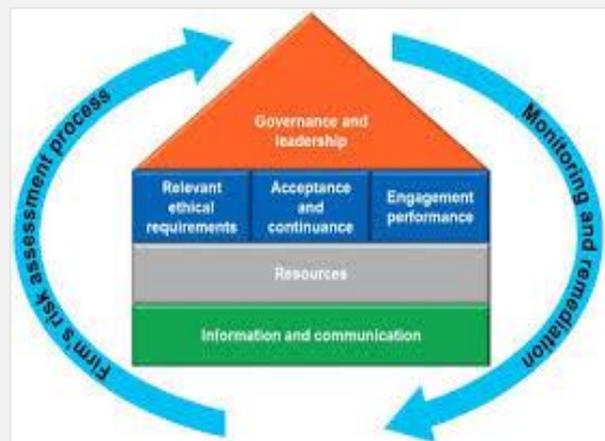
Q 6 -   Does every firm have to follow each requirement of ISQM 1?

Yes, unless the requirement is not relevant to the firm because of the nature and circumstances of the firm or its engagements.

For example, if you are a sole practitioner, the requirements related to the following matters may not be relevant:

- Organizational structure and assigning roles

- Responsibilities and authority within the firm

- Direction, supervision and review

- Addressing differences of opinion

Q 7 -   Does the firm has to exercise professional judgment in the application of ISQM 1?

Yes, ISQM 1 requires the firm to exercise professional judgment in designing, implementing and operating the SOQM.

Professional judgment will be exercised to tailor the design, implementation and operation of your SOQM, based on the nature and circumstances of your firm and the engagements performed.

Professional judgment as defined in ISQM 1 is as follows:

Professional judgment – *The application of relevant training, knowledge, and experience, within the context of professional standards, in making informed decisions about the courses of action that are appropriate in the design, implementation and operation of the firm's SOQM.*

Q 8 -   Who can be assigned responsibilities for the SOQM in the firm?

ISQM 1 explains that the individuals assigned responsibilities for the SOQM are typically partners in the firm. However, ISQM 1 also recognizes that in some cases the individual may not be a partner of the firm itself.

For example, this may be the case when the individual is a partner in a regional entity of the network, and the firm comprises one area of the region.

ISQM 1 also requires that the firm is responsible for its SOQM and the individual(s) are required to have the appropriate influence and authority within the firm. Therefore, the firm cannot outsource the leadership responsibilities to a service provider.

Further, ISQM 1 requires that the individuals assigned responsibilities for the SOQM, should also have the appropriate experience and knowledge to fulfill their assigned responsibility.

Q 9 -   Is there any scalability guidance that is specifically relevant to the assigning roles and responsibility component?

Yes, ISQM 1 indicates the way the firm assigns roles, responsibilities and authority may vary. In a smaller firm, ultimate responsibility and accountability for the SOQM may be assigned to a single person. This individual may also assume responsibility for all aspects of the SOQM, including operational responsibility for the SOQM, compliance with independence requirements, and the monitoring and remediation process.

In case of a sole practitioner, the requirements addressing the organizational structure and assigning roles, responsibilities and authority within the firm, as well as direction, supervision and review, and addressing differences of opinion may not be relevant.

The Firm's Risk Assessment Process

The firm's risk assessment process is new to ISQM 1. The foundation of ISQM 1, and a key change from extant ISQC 1, is that the firm needs to follow a risk-based approach to quality management, which focuses the firm on:

- The risks that may arise, given the nature and circumstances of the firm and the engagements it performs; and

- Implementing responses to appropriately address those risks.

A risk-based approach helps the firm tailor the SOQM to the firm's circumstances, as well as the circumstances of the engagements performed by the firm. It also helps the firm effectively manage quality through concentrating on what matters most given the nature and circumstances of the firm and the engagements it performs.

Q 10 - How ISQM 1 requires a firm to apply a risk-based approach in achieving the quality objectives?

The ISQM 1 requires the firm to apply a risk-based approach in designing, implementing and operating the components of the SOQM in an interconnected and coordinated manner such that the firm proactively manages the quality of engagements performed by the firm. The risk-based approach is embedded in the requirements of this ISQM through:

(a) **Establish Quality Objectives:** ISQM 1 prescribes outcome based quality objectives and any additional quality objectives that the firm considers are necessary to achieve the objectives of the SOQM.

> **Quality Objectives**
>
> The desired outcomes in relation to the components of the SOQM to be achieved by the firm.

(b) **Identifying and assessing Quality Risks:** For identifying/assessing quality risks, a firm need to understand the conditions, events, circumstances, actions or inactions that could adversely affect the achievement of the quality objectives. The firm focuses on the nature and circumstances of the engagements it performs and types of entities for which such engagements are undertaken.

> **Quality Risk**
>
> A risk that has a reasonable possibility of:
>
> (i) Occurring; and
>
> (ii) Individually, or in combination with other risks, adversely affecting the achievement of one or more quality objectives.

(c) **Designing and Implementing Responses to address the Quality Risks**. The nature, timing and extent of the firm's responses to address the quality risks are based on and are responsive to the reasons for the assessments given to the quality risks.
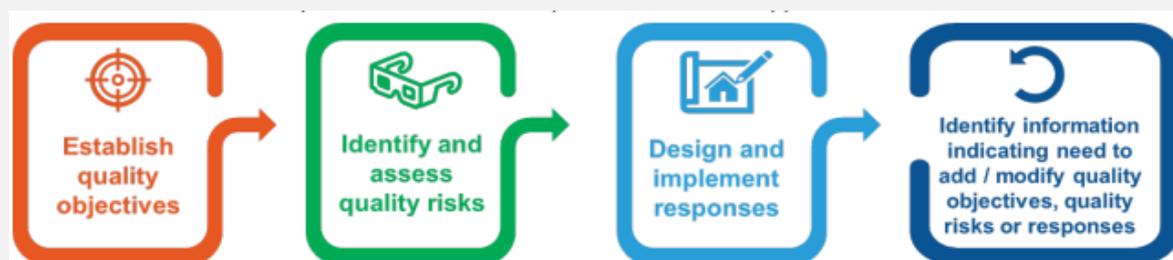
Q 11 - Is the firm expected to establish quality objectives in addition to those set out in the standard?

ISQM 1 recognizes that there may be circumstances when the quality objectives in the standard are insufficient to provide a basis for the achievement of the objective of the standard. Accordingly, paragraph 24 of ISQM 1 requires firm to establish additional quality objectives beyond those required by the standard, when those objectives are necessary to achieve objective of the standard.

ISQM 1 allows the firm to establish sub-objectives to enhance the firm's identification and assessment of quality risks, design and implementation of responses.

For example, more granular quality objectives may be established for divisions, operating units, or similar functions, by nature of engagements or by industry according to the entities for whom engagements are performed.

Q 12 - How the firm identifies and assesses quality risks?

ISQM 1 sets out the process the firm is required to follow in identifying and assessing quality risks, which is depicted as follows:

The process focuses first on understanding the various conditions, events, circumstances, actions or inactions related to the firm and its engagements that could adversely affect the achievement of the quality objectives. It is necessary to determine whether the risk meets the threshold of a quality risk.
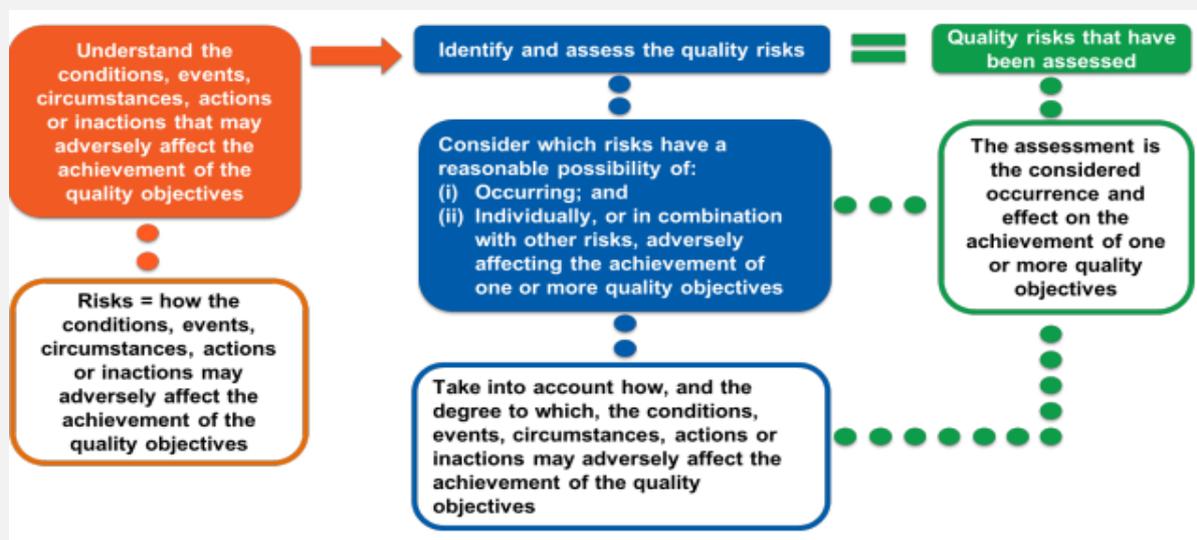
Q 13 - What factors does the firm needs to consider in assessing the quality risks?

The assessment of the quality risks is affected by how, and the degree to which, the conditions, events, circumstances actions or inactions affect the quality objectives, and the possible occurrence. As a result, the identification and assessment of the quality risks may be undertaken simultaneously. A firm may choose to identify and assess quality risks as two discrete steps, however this is not required or expected.

Paragraph A48 of ISQM 1 provides examples of factors that may affect the degree to which a risk may adversely affect the achievement of a quality objective(s).

Q 14 - Is the firm required to identify and document all quality risks?

ISQM 1 recognizes that it is not reasonable or practicable for firms to identify and assess every possible risk. Accordingly, ISQM 1 includes a process for identifying and assessing quality risks that is intended to filter risks and assess them, such as understanding of the conditions, events, circumstances, actions or inactions that may adversely affect the achievement of the quality objectives or the reasonable possibility of the risk occurring.

Paragraph A46 explains that not all risks meet the definition of a quality risk. Professional judgment assists the firm in determining whether a risk is a quality risk, and it is based on the firm's consideration of above factors, further discussed in Q 10 below.

The firm is required to document the identified quality risks and their assessment, as per paragraph 58 of ISQM 1.

Q 15 - Is the firm required to design and implement responses for every quality risk that has been identified?

ISQM 1 requires the firm to design and implement responses to address the assessed quality risks, i.e., only those quality risks that have been identified because they meet the threshold criteria described above.

Scalability

In applying a risk-based approach, the firm is required to take into account:

(a) The nature and circumstances of the firm; and
(b) The nature and circumstances of the engagements performed by the firm.

Accordingly, the design of the firm's SOQM, in particular the complexity and formality of the system, will vary.

The ISQM 1 application material includes examples that demonstrate how to apply aspects of the standard to less complex and more complex firms.

Paragraph 34 of ISQM 1 includes some specified responses that the firm is required to design and implement. Although the responses are specified, the nature, timing and extent of the response will vary, given the nature and circumstances of the firm.

The responses designed and implemented by the firm may operate at the firm level or engagement level, or there may be a combination of responsibilities for actions to be taken at the firm and engagement level.

Q 16 - Is the term "responses" equivalent to "internal controls"?

No, responses could be policies or procedures or a combination of both. Best practice would suggest that the terminology of ISQM 1 be used in preparing and documenting SOQM, and to generally avoid using the term "internal controls.

Q 17 - What is the difference between a policy and a procedure?

A response in relation to the SOQM can include policies or procedures (or a combination of both) designed and implemented to address one or more quality risks.

Policies are statements of what should, or should not, be done to address a quality risk. Such statements may be documented, explicitly stated in communications or implied through actions and decisions.

Procedures are actions to implement policies. It is not necessary to have a policy and a procedure to address the same quality risk; it can be one or the other or a combination.

Q 18 - Is there any scalability guidance related to the design of the risk assessment process and the establishment of quality objectives?

Yes, ISQM 1 indicates how the design of your firm's risk assessment process may be affected by the nature and circumstances of the firm, including how the firm is structured and organized.

For example, if in a firm the individual assigned operational responsibility for the SOQM also has sufficient understanding of the firm and its engagements to undertake the risk assessment process, these roles can be assigned to the same person. In addition, the documentation of the quality objectives, quality risks and responses may be less extensive for a smaller firm than for a larger or more complex firm (e.g., be contained in a single document). ISQM 1 also indicates that under certain circumstances a quality objective, or an aspect thereof, may not be relevant to your firm because of the nature and circumstances of the firm or its engagements.

For example, the quality objective addressing direction and supervision of engagement teams and review of work performed may not be relevant when the firm is a sole practitioner, with no delegation or review of work.

Examples in ISQM 1 that address scalability
- Para A35: Assigning roles and responsibilities
- Para A39 and A52: The firm's risk assessment process
- Para A99: Resources
- Para A111: Information and communication
- Para A144, A156 and A166: Monitoring and remediation process
- Para A189 and A199: Evaluating the SOQM and performance evaluations
- Para A203: Documentation

Q 19 - Is it necessary to document the consideration of every condition, event, circumstance, action, or inaction that may give rise to a quality risk?

No, firm is not required to document the consideration of every condition, event, circumstance, action, or inaction that may give rise to a quality risk. The documentation of the quality risks may include the reasons for the assessment given to the quality risks (i.e., the considered occurrence and effect on the achievement of the quality objectives).

In some circumstances, it may be appropriate for the firm to document its process and analyses for establishing the quality objectives, identifying and assessing quality risks, and designing responses to such risks, to provide a history of the basis for decisions made by the firm about its SOQM.

Governance and Leadership

Governance and leadership is of paramount importance to quality management at the firm and engagement level, because it is the way in which the firm embeds its culture, ethics and self-regulates, and serves as the framework for how the firm's decisions are made.

Q 20 - How ISQM 1 has changed the requirements with respect to governance and leadership as compared to the extant standard?

Following are new and enhanced requirements:

- ISQM 1 requires firms to demonstrate a commitment to quality through its culture. As part of the firm's culture, the requirements now also address:
  - o The firm's public interest role;
  - o The importance of professional ethics, values and attitudes;
  - o The responsibility of all personnel for quality relating to the performance of engagements or activities within the SOQM, and their expected behavior; and
  - o Quality in the context of the firm's strategic decisions and actions, including the firm's financial and operational priorities.
- New requirements addressing leadership's behavior and commitment to quality, their accountability for quality and performance evaluations of leadership annually.
- New requirements addressing the organizational structure of the firm and the firm's assignment of roles, responsibilities and authority.
- New requirements addressing resource needs, and resource planning, allocation and assignment, which also include financial resources.

Q 21 - How the firm demonstrates a commitment to quality through its culture?

ISQM 1 requires firm's commitment to quality throughout the firm which may be achieved through a number of following mechanisms and actions:

1. Set the tone at the top;

2. Reinforce the responsibility of all personnel for quality relating to the performance of engagements or activities within the SOQM, and their expected behavior;

3. Embedding quality in the firm's strategic decisions and actions, including the firm's financial and operational priorities;

4. Firm's policies or procedures addressing consultation that encourage consultation on difficult or contentious issues, and reinforce the importance and benefit of consultation to emphasize the importance of quality;

5. Make a firm's policy for personnel being expected to demonstrate a commitment to quality through their actions and behaviors;

6. Develop and maintain the appropriate competence to perform the role of personnel who are held accountable or recognized through timely evaluations, compensation, promotion and other incentives.

Q 22 - How a small firm can demonstrate a commitment to quality through its culture?

A smaller firm may be able to establish the desired culture of the firm through the direct interaction of firm leadership with other personnel.

Relevant Ethical Requirements

ISQM 1 requires establishing quality objectives that address the fulfillment of responsibilities by the firm and its personnel in accordance with relevant ethical requirements (e.g., *IESBA Code*) including independence requirements. It also deals with **others** external to the firm, such as a network, network firms or service providers, and the need for the firm to address relevant ethical requirements related to the firm and the firm's engagements that affect others external to the firm.

Q 23 - What is the firm's responsibility regarding the relevant ethical requirements that apply to the firm?

The firm is required to establish the following quality objectives that address the fulfillment of responsibilities in accordance with relevant ethical requirements.

The firm and its personnel should understand and fulfill their responsibilities in relation to the relevant ethical requirements to which the firm and the firm's engagements are subject.

Q 24 - What is the firm's responsibility regarding the relevant ethical requirements that apply to Others?

Given that others external to the firm may be involved in the performance of engagements or various activities in the SOQM, the firm has a responsibility to address the relevant ethical requirements that apply to others (i.e., network, network firms, individuals in the network or network firms, or service providers).

For example, the firm may need to use an engagement quality reviewer from a service provider if the firm does not have personnel within the firm that meet the eligibility requirements in ISQM 2.

It should be noted that the firm is only responsible for the relevant ethical requirements that apply to others in the context of the firm and the firm's engagements. Others may be subject to other ethical requirements that do not relate to the firm.

Paragraph A65 of ISQM 1 provides examples of relevant ethical requirements that may apply to others external to the firm.

Acceptance and Continuance of Client Relationships and Specific Engagements

Q 25 - What changes have been made in ISQM 1 with respect to acceptance and continuance of client relationships and specific engagements?

Following enhancements have been made in this component of ISQM 1:

- Adjusted to principles-based requirements to establish quality objectives addressing the acceptance and continuance of client relationships and specific engagements.

- Focus on the firm's judgments in determining whether to accept or continue the client relationships and specific engagements.

- Enhanced requirement to drive the firm to obtain information about the nature and circumstances of the engagement and the integrity and ethical values of the client (including management, and, when appropriate, those charged with governance).

- New requirement addressing the financial and operational priorities of the firm in the context of making decisions about whether to accept or continue a client relationship or specific engagement.

Paragraphs A67–A69 and A72 of ISQM 1 provide examples of information the firm may obtain in judging whether to accept or continue a client relationship or specific engagement, factors that may affect the information obtained, and the sources of the information.

Engagement Performance

Q 26 - How ISQM 1 has changed from the extant ISQC 1 with respect to engagement performance?

The following summarizes how ISQM 1 has changed from the extant standard with respect to engagement performance:

- Adjusted to principles-based requirements (including, consultation, differences of opinion and addressing the assembly, maintenance and retention of engagement documentation) to establish quality objectives addressing engagement performance.

- New requirement addressing engagement teams' responsibilities in connection with engagements, including the overall responsibility of an engagement partner for managing and achieving quality on an engagement and being sufficiently and appropriately involved throughout the engagement.

- Enhanced requirement addressing direction and supervision of engagement teams and review of the work performed.

- New requirement addressing engagement teams exercising appropriate professional judgment and professional skepticism.

- Requirements dealing with EQ reviews have been relocated in ISQM 1 and ISQM 2.

In case of a **smaller or less complex firm:**

- There may be no engagement team members other than the engagement partner (e.g., in the case of a sole practitioner). In such cases, the quality objectives addressing direction, supervision and review may not be relevant.

- The firm may not have personnel internally that have the competence and capabilities to provide consultations. In such case, the firm may determine it appropriate to make use of a service provider for the purposes of consulting on difficult or contentious matters.

- The firm may determine it appropriate to make use of a service provider for the purposes of receiving and resolving differences of opinion.

Q 27 - What actions can the firm take to prevent unauthorized access and changes to engagement documentation?

Whether engagement documentation is in paper, electronic or other media, the integrity, accessibility or retrievability of the underlying data may be compromised if the documentation could be altered, added or deleted or lost without the firm's knowledge.

Responses that the firm may design and implement to avoid unauthorized alteration or loss of engagement documentation include those that:

- Enable the determination of when and by whom engagement documentation was created, changed or reviewed;

- Protect the integrity of the information at all stages of the engagement, especially when the information is shared within the engagement team or transmitted to other parties via the internet;

- Allow access to the engagement documentation by the engagement team and other authorized parties as necessary to properly discharge their responsibilities and prevent unauthorized changes to the engagement documentation.

Resources

ISQM 1 deals with obtaining, developing, using, maintaining, allocating and assigning resources in a timely manner to enable the design, implementation and operation of the SOQM. A firm is required to consider what resources are needed, whether they are appropriate, and how they are used and maintained.

The standard highlights the importance of following resources in the conduct of an engagement:

Human Resources	Technological Resources	Intellectual Resources

Q 28 - How ISQM 1 has changed from the extant ISQC 1 with respect to Resources?

- New requirements that address the need for technological and intellectual resources to enable the operation of the SOQM and performance of engagements.

- Expanded requirements for human resources, in particular:

  o New requirement to have competent and capable human resources to carry out responsibilities in relation to the operation of the SOQM, and assign individuals to perform activities within the SOQM;

  o New requirement addressing the need to obtain individuals from external resources (i.e., the network, another network firm or a service provider) when the firm does not have the personnel to operate the SOQM or perform engagements; and

  o New requirement addressing personnel's commitment to quality and accountability or recognition through timely evaluations, compensation, promotion and other incentives.

- New requirement addressing service providers, i.e., that resources from service providers are appropriate for use in the SOQM and performance of engagements.

Q 29 - Are all technological resources used by the firm subject to the requirements of ISQM 1?

The scope of technological resources that ISQM 1 aims to address are those technological resources that support the firm's SOQM, including the performance of engagements. Ordinarily firms will have technological resources that support the functioning or operation of the firm itself, such as email, which are not intended to be within the scope of the provisions of ISQM 1, as these are more general in nature and not specifically used in the fulfillment of the objectives of the standard.

Not all technological resources used by the firm fall within the scope of ISQM 1. Technological resources may serve multiple purposes within a firm and may affect the firm's SOQM, and some may be unrelated to the SOQM. Paragraph A99 of ISQM 1 indicates the technological resources that are relevant for the purposes of ISQM 1.

For example, the firm's IT infrastructure may include security features that control access to IT applications that are relevant to the firm's SOQM (e.g., electronic engagement files) or IT applications for independence monitoring and client acceptance and continuance.

The firm would need to apply professional judgment in determining which technological resources, or aspects thereof, are in scope of ISQM 1.

Q 30 - What is a specific quality risk related to intellectual resources?

One specific quality risk is the use of out-of-date intellectual resources, such as the use of templates or checklists that do not reflect revisions to professional standards.

The scope of Service Providers within ISQM 1

ISQM 1 allows firms to use Resources from service providers for the SOQM or performance of engagements. The firm cannot outsource its SOQM or responsibility for the SOQM; instead, the resources from service providers assist the firm in fulfilling the requirements of ISQM 1. As a result, when using resources from service providers, the firm is responsible for ensuring that the resources are appropriate for use in the SOQM or performance of engagements.

If the firm uses resources from within the firm's network, such resources are not considered resources from service providers and will be considered as part of complying with the firm's responsibilities when using network requirements or network services.

Q 31 - What is a firm expected to do when it uses an IT application from a service provider in its SOQM?

Paragraph A 107 of the ISQM 1 provides examples of the IT application from a service provider which may ordinarily involves:

- Obtaining an understanding of the service provider, including determining that the reputation, competence and capabilities of the service provider are appropriate in the context of the intended use of the IT application.

- Establishing the nature and scope of the IT application, including the firm's responsibilities for any actions that are necessary in using the IT application.

- Determining whether the IT application is appropriate for use in the SOQM in the context of the quality risks identified and assessed by the firm and the reasons for the assessments given to the quality risks, including when changes are made to the IT application.

- The IT application operates as designed and achieves the purpose for which it is intended.

- The data inputs and outputs are appropriate and confidentiality of the data is preserved. This may include determining whether the technology complies with law or regulation, such as data privacy laws.

- Updates to the IT application are made in response to changing circumstances, and are appropriately tested before being deployed.

Information and Communication

ISQM 1 goes beyond existing requirements by placing increased emphasis on information system and active two-way communication within and outside the firm on a timely basis to enable the design, implementation and operation of the SOQM. The firm culture needs to embed the need to exchange information.

ISQM 1 elevates a firm's responsibility to communicate externally with stakeholders appropriately, particularly when there is a higher public accountability (communicating to TCWG about the system when the firm performs an audit of financial statements of listed entities).

Q 32 - What information is needed to enable the design, implementation and operation of the SOQM?

In designing the SOQM, the firm would need to understand the integration of the components and the information that needs to be obtained, generated or communicated to support the firm in achieving the requirements of each of the components.

The type of information needed by the firm would vary depending on many factors, including the nature and circumstances of the firm and the engagements it performs, and the nature, timing and extent of the responses designed and implemented by the firm to address the assessed quality risks.

Q 33 - How is the firm expected to communicate information, and does it always need to be formally documented?

There are a variety of methods the firm may use to communicate information, for example, manuals of policies or procedures, newsletters, alerts, systems (e.g., the firm's engagement software), emails, intranet or other web-based applications, training, presentations, social media, webcasts or through one-on-one discussions. In determining the most appropriate method(s) and frequency of communication, the firm may take into consideration a variety of factors including:

In the case of **a smaller firm**, the communication may be undertaken in a more direct or informal manner as there are fewer personnel with whom to communicate.

However, the firm would need to document communication to the extent necessary to address the documentation requirements of ISQM 1.

- The audience to whom the communication is targeted including the cultural, ethnic and generational profile of the audience.

- The nature and urgency of the information being communicated.

In some circumstances, the firm may determine it necessary to communicate the same information through multiple methods in order to achieve the objective of the communication and in such cases the consistency of the information communicated is important to its effectiveness.

Q 34 - What requirements are given in ISQM 1 with regard to communication to external parties?

The firm may communicate with a variety of external parties. External communication related to the firm's SOQM may include a transparency report or audit quality report, direct conversations with external parties, including direct conversations with regulators and audit oversight authorities, or management and those charged with governance of clients, and information on the firm's website or provided through social media.

ISQM 1 addresses communication with external parties through the following:

- A quality objective related to communication with external parties in paragraph 33(d)(ii); and

- A specified response in paragraph 34(e) of ISQM 1.

Note: Communication within the firm's network or to service providers is dealt with in paragraph 33(d)(i) of ISQM 1.

ISQM 1 includes extensive guidance and examples related to external communication:

- Paragraph A126 describes the matters that may be communicated to external parties.
- Paragraph A130 explains matters that may affect the firm's determination of when it is appropriate to communicate externally.
- Paragraph A131 explains the attributes that the firm may be mindful of in preparing information to communicate externally.
- Paragraph A132 includes examples of the form of communication to external parties.

Q 35 - Does ISQM 1 require communication to be formally documented?

No, not all communication needs to be formally documented. Communication may be more informal and achieved through direct discussions with personnel and engagement teams. This approach may be sufficient, given the nature of your firm and the nature of information being communicated, remembering that documentation of all communication (formal and informal) is required to the extent necessary to address the documentation requirements of ISQM 1.

The more important the communication, the more formal the communication is likely to be.

Monitoring and Remediation Process

The purpose of monitoring and remediation process is to:

- monitor the firm SOQM so that the firm has relevant, reliable and timely information about the design, implementation and operation of the SOQM; and

- To take appropriate actions to respond to deficiencies such that deficiencies are remediated on a timely basis and to avoid recurrence.

Changes from extant ISQC 1

The monitoring and remediation process has been extensively enhanced from extant ISQC 1, including:

- A new focus on monitoring the SOQM as a whole (a shift from engagement-level monitoring);

- A new framework for evaluating findings and identifying and evaluating identified deficiencies;

- Robust remediation.

The requirements addressing communication of matters related to monitoring and remediation are similar to extant ISQC 1.

Q 36 - What is to be monitored?

The SOQM is monitored, as a whole, which may include monitoring:

- How responsibilities are assigned to leadership, if applicable, and whether the requirements of ISQM 1 have been met;

- The design and operation of firms risk assessment process, i.e., establishing quality objectives, identifying and assessing quality risks, designing and implementing responses, and identifying information related to changes in the nature and circumstances of your firm and engagements it performs that may impact the quality objectives, quality risks, or responses;

- The implementation and operation of the responses, including whether they properly operate according to how they have been designed and whether the responses effectively address the related quality risks;

- Whether the monitoring and remediation process is achieving its intended purpose;

- Leadership's evaluation of the SOQM and whether it has met the requirements of ISQM 1.

Q 37 - How can we differentiate whether an activity is a "response" or "monitoring activity"?

When designing the SOQM, the firm determines the nature of an activity (i.e., a response or a monitoring activity) based on what the activity is intended to achieve.
For example:

- If you establish a policy that requires engagements to apply or be subject to a certain procedure to prevent a quality risk from occurring, then it is likely a response (e.g., the firm's methodology requires engagements meeting certain criteria to be subject to a pre-issuance review to assist in determining the appropriateness of the engagement report before it is issued or disclosure of a lack of independence in a compilation engagement).

- If you design an activity to accumulate information about the execution of policies or procedures to determine their effectiveness, it is most likely a monitoring activity (e.g., inspections of engagements that include determining whether the engagements meeting the criteria for a pre-issuance review were appropriately subject to the pre-issuance review, and that the issued reports were appropriate in the circumstances).

Q 38 - How the firm monitors the SOQM?

The firm designs and performs monitoring activities that are tailored for the firm. The nature, timing and extent of the monitoring activities are tailored by taking into account a number of factors set out in ISQM 1, which are as follows:

- The size and complexity of the firm.

- The nature, timing and extent of the monitoring activities.

- Who performed the monitoring activities (e.g., a service provider, the network, a separate group within the firm designated to perform monitoring activities or personnel who are responsible for the response).

- The results of previous monitoring activities.

- Information available from other sources about the effectiveness of the firm's monitoring and remediation process (e.g., external inspections, a network or service provider), including information that indicates that the firm's monitoring activities failed to identify a deficiency.

Q 39 - Who performs the monitoring activities?

ISQM 1 does not specify who is required to perform the monitoring activities. However, it does specify that the firm needs to have policies or procedures dealing with the competence and capabilities (including sufficient time) of the individuals performing the activities, and the objectivity of the individuals.

ISQM 1 further specifies that for inspections of engagements, the individual cannot be an engagement team member or the engagement quality reviewer of the engagement. Further, an individual should have the appropriate competence, capabilities and objectivity to perform monitoring activities.

Q 40 - What are the various aspects of monitoring and remediation process given in ISQM1?

The monitoring and remediation process can be broken down into four aspects:

The design of the monitoring and remediation process will vary based on many factors, including how other aspects of the SOQM are designed, and the nature and circumstances of the firm.

The monitoring and remediation process is intended to be a non-linear process that operates in a dynamic and iterative manner.

Q 41 - Are there monitoring activities other than inspection of engagements that a firm is able to use to monitor the SOQM?

Extant ISQC 1 is largely focused on the inspection of completed engagements, which only address monitoring responses that are implemented at the engagement level.

ISQM 1 focuses more on proactively monitoring all aspects of the SOQM and tailoring the monitoring activities to provide a sufficient basis for the firm to evaluate the system. Therefore, the inspection of engagements is only one type of monitoring activity that a firm may perform.

Examples of other monitoring activities include:

- Inspections of in-process engagements.

- Interviewing firm personnel, or undertaking formal surveys, to understand how personnel perceive the culture of the firm and also to evaluate the effectiveness of the firm's communication in relation to certain matters.

- Evaluating the process for establishing the quality objectives, identifying and assessing quality risks and designing responses, including who within the firm has been assigned this responsibility.

- Using peer reviews, or other types of reviews, designed with the purpose of monitoring areas of the firm's system of quality management.

- Inspecting records of firm to establish that prohibited services were not provided to audit client.

- Inspecting time records for number of hours spent by engagement partners and other senior personnel and their sufficiency.

- Evidence of involvement of experts on certain types of engagements for certain industries, to determine the appropriate use of experts.

Q 42 - Why is the inspection of completed engagements a monitoring activity?

Inspections of completed engagements are designed to evaluate whether policies or procedures (i.e., responses) or other aspects of the SOQM are designed, implemented and operating in the manner intended. It is important to recognize that the inspection of completed engagements is different from an engagement quality review.

An engagement quality review is designed to evaluate the judgments of the engagement team *before the engagement report* is issued. An inspection of the file after completion, and on a cycle basis, is part of monitoring activities.

Q 43 - How information about the design, implementation and operation of the SOQM and deficiencies may be used?

Information about the design, implementation and operation of the firm's SOQM, including deficiencies and remedial actions, may be used by:

•   Firm leadership in the annual evaluation of the SOQM.

•   The firm, or individuals assigned activities within the SOQM, to proactively and continually improve engagement quality and the SOQM. This includes engagement quality reviewers who may use the information as a basis for performing the engagement quality review.

•   Engagement partners to manage and achieve engagement quality.

Q 44 - How frequently should monitoring activities be undertaken?

The frequency of the monitoring activities will vary from firm to firm and are affected by multiple factors.

For example, the firm may determine that more frequent monitoring activities are needed in relation to certain types of engagements (e.g., entities operating in industries that are subject to frequent change or engagements where a high number of deficiencies have been identified through previous monitoring activities).

In the case of a smaller firm, given the close oversight of the firm's leadership, the monitoring activities may involve more periodic consideration of the SOQM.

Q 45 - What guidance is given in ISQM 1 with respect to evaluating findings and identified deficiencies?

•   ISQM 1 includes a framework for evaluating findings and identifying deficiencies and evaluating the severity and pervasiveness of the deficiencies;

•   Not all findings are deficiencies. In determining whether deficiencies exist, the firm considers whether a finding, or combination of findings when considered together, meet the definition of a deficiency;

•   The firm is required to investigate the root cause(s) of deficiencies;

•   Based on investigation, evaluate the effect on SOQM (individually and in aggregate both).

Q 46 - Why the firm is required to evaluate the severity and pervasiveness of identified deficiencies?

The firm is required to evaluate the severity and pervasiveness of identified deficiencies because it:

•   Drives the nature, timing and extent of remedial actions to respond to the identified deficiencies, by focusing on deficiencies that pose the biggest risk to the SOQM; and

•   Affects leadership's evaluation of the SOQM.

Furthermore, the severity and pervasiveness of identified deficiencies may affect whether, or the extent to which, audit engagement teams depend on the firm's policies or procedures in complying with the requirements of ISA 220 (Revised).

Q 47 - How the severity and pervasiveness of deficiencies is evaluated?

In order to evaluate the severity and pervasiveness of deficiencies, the firm is required to:

- Investigate the root cause(s) of the identified deficiencies; and

- A deficiency with multiple root causes, which may exist across multiple components or aspects of the SOQM.

- Multiple deficiencies affected by the same root cause.

- Based on investigation, evaluate the effect on SOQM (individually and in aggregate both).

Paragraph A192 of ISQM 1 explains when an identified deficiency may be considered pervasive.

Also paragraphs A192 and A193 of ISQM include examples to contrast:

• A deficiency that is severe but not pervasive; and

• A deficiency that is severe and pervasive.

Q 48 - What is the communication requirement given in ISQM 1 related to the monitoring and remediation?

The information communicated about the monitoring and remediation to the individual(s) assigned ultimate responsibility and accountability for the SOQM may be communicated on an ongoing basis or periodically. The individual(s) may use the information in multiple ways, for example:

- As a basis for further communications to personnel about the importance of quality.

- To hold individuals accountable for their roles assigned to them.

- To identify key concerns about the SOQM in a timely manner.

The information also provides a basis for the evaluation of the SOQM, and conclusion thereon, as required by paragraphs 53–54.

Q 49 - How the firm will respond to the identified deficiencies?

The firm needs to take appropriate action to respond to identified deficiencies. This is achieved through:

- Remediating identified deficiencies in a timely manner to prevent them from reoccurring; and

- Evaluating the effectiveness of the remedial actions, and if they are not effective, taking further action.

- Leadership is required to determine that remedial actions are effective.

In some circumstances, the remedial action may include establishing additional quality objectives, or quality risks or responses may be added or modified, because it is determined that they are not appropriate.

There may be circumstances when the firm determine that the root cause of an identified deficiency relates to a resource provided by a service provider. In such case, the firm may consider whether to continue using the resource provided by the service provider or communicate the matter to the service provider (paragraph A 172).

Q 50 - What actions firm should take when procedures were omitted or issued report is inappropriate?

In circumstances when procedures were omitted or the report issued is inappropriate, the action taken by the firm may include:

- Consulting with appropriate individuals regarding the appropriate action.

- Discussing the matter with management of the entity or those charged with governance.

- Performing the omitted procedures.

In **the case of a smaller firm**, an individual may assume responsibility for all aspects of the SOQM, i.e., ultimate responsibility and accountability for the SOQM, operational responsibility for the SOQM and operational responsibility for monitoring and remediation.

In such cases, the communication requirement in paragraph 46 of ISQM 1 would not be relevant.

The actions taken by the firm do not relieve the firm of the responsibility to take further actions relating to the finding in the context of the SOQM, including evaluating the findings to identify deficiencies and when a deficiency exists, investigating the root cause(s) of the identified deficiency.

Q 51 - Is the firm required to communicate information from the monitoring and remediation process externally?

The firm may communicate information from the monitoring and remediation process externally to the firm's network; service providers; those charged with governance when performing an audit of financial statements of listed entities; or other external stakeholders.

Q 52 - I am a sole practitioner, without staff, and I assume responsibility for all aspects of the SOQM. Are the on-going communication requirements related to monitoring and remediation relevant?

No, if a sole practitioner has the ultimate responsibility and accountability for the SOQM, including the operational responsibility for the SOQM and the monitoring and remediation, then there is no need for the ongoing communication related to monitoring and remediation, as it would be redundant.

Network Requirements or Network Services

A network firm is a firm or entity that belongs to the firm's network. Paragraph A19 of ISQM 1 explains that networks and the network firms may be structured in a variety of ways. Any network requirements or network services that are obtained from the network, another network firm or another structure or organization in the network are considered "network requirements or network services." As a result, they are subject to the requirements in paragraphs 48–52 of ISQM 1.

Changes from extant ISQC

The requirements addressing network requirements or network services are mostly new to ISQM 1.

Extant ISQC 1 only includes a requirement dealing with the network's communication when the firm relies on the network's common monitoring policies and procedures.

Q 53 - What is the firm responsibility with regard to Network requirements or Network services?

- The firm leadership is responsible for its own SOQM and accordingly it is important that the firm understands the network requirements or network services and the impact they have on the firm's SOQM.

- The firm needs to understand their responsibilities for any actions that are necessary to implement the network requirements or use network services.

- The firm needs to monitor activities undertaken by the network across network firms, including those to determine that network requirements have been appropriately implemented across network firms.

- If a firm identifies a deficiency in the network requirements or network services, the firm is required to communicate to the network and also design and implement remedial action.

Q 54 - Can the network perform monitoring activities across the network firms?

The network may perform monitoring activities across the network firms. The nature, timing and extent of these monitoring activities varies across networks, and may also vary from year to year within a network.

ISQM 1 requires the firm to comply with paragraphs 35–47 of ISQM 1 dealing with monitoring and remediation.

Evaluating the SOQM

The requirement to evaluate SOQM is new to ISQM 1.

ISQM 1 includes requirements for the individual(s) assigned ultimate responsibility and accountability for the SOQM to evaluate and conclude whether the objectives of the SOQM are being achieved.

Q 55 - How the firm will evaluate the effectiveness of its SOQM?

The evaluation of the SOQM is, in effect, a self-assessment process, however, in order to reinforce the responsibility and accountability, the individual(s) assigned ultimate responsibility and accountability for the SOQM. The outcome of the evaluation of the SOQM is indicative of how leadership has fulfilled their responsibilities, and therefore is an essential consideration in undertaking the performance evaluations of leadership.

Although the individual(s) assigned ultimate responsibility and accountability for the SOQM undertakes the evaluation, the firm remains responsible to ensure that the evaluation is undertaken, by holding the individual accountable for doing the evaluation.

The evaluation is at a point in time and the conclusion is focused on whether the SOQM provides reasonable assurance that the objectives of the SOQM are being achieved and that:

- The firm and its personnel are fulfilling their responsibilities in accordance with professional standards and applicable legal and regulatory requirements, and engagements are being conducted in accordance with such standards and requirements; and

- Reports being issued by the firm and engagement partners are appropriate in the circumstances.

The evaluation is internal to the firm; the firm is not required to obtain independent assurance about the effectiveness of its SOQM. Further the evaluation is required to be undertaken at least annually. The firm needs to take further action if the conclusion is unsatisfactory.

Q 56 - How the evaluation is undertaken, including what information is considered?

Information about the firm's monitoring and remediation that is communicated to the individual(s) assigned ultimate responsibility and accountability for the SOQM may generally provide the information that is needed to perform the evaluation.

Based on the evaluation of the SOQM, the individual(s) assigned ultimate responsibility and accountability for the SOQM is required to conclude on whether the objectives of the SOQM are being achieved.

In accordance with paragraph A190 of ISQM 1, the individual(s) may consider the following in concluding on the SOQM:

- The severity and pervasiveness of identified deficiencies, and the effect on the achievement of the objectives of the SOQM;

- Whether remedial actions have been designed and implemented by the firm, and whether the remedial actions taken up to the time of the evaluation are effective;

- Whether the effect of identified deficiencies on the SOQM have been appropriately corrected (E.g., taking appropriate action when procedures were omitted in performing an engagement or the report issued was inappropriate).

Documentation

ISQM 1 provides an overarching principles-based requirement for documentation and specific requirements to document certain matters related to the SOQM. The requirement addressing the retention of documentation for the SOQM is consistent with extant ISQC 1.

Q 57 - Why the documentation of SOQM is important?

Documentation is important because:

- It helps personnel understand the SOQM and what is expected of them, so that they are able to perform engagements, and fulfill their roles and responsibilities with respect to the firm's SOQM.

- It enables the responses to be implemented and operated in the manner that the firm intended and the basis for why decisions related to the SOQM were made.

- It helps the firm monitor the SOQM, and provides information so that leadership is able to evaluate and conclude on the SOQM.

- It establishes accountability for the firm by evidencing that the firm has designed, implemented and operated a SOQM in accordance with ISQM 1 and applicable legal and regulatory requirements.

- It helps external oversight authorities in fulfilling their duties in inspecting the firm's SOQM, which is an important element to the financial reporting ecosystem.

The firm's SOQM may change and evolve over time. Retaining documentation of the SOQM and how it is designed may be important to explaining how the SOQM was designed at a point in time.

Q 58 - Which matters need to be documented by the firm?

ISQM 1 does not prescribe every matter that needs to be documented by the firm, because the nature and extent of documentation will vary as a result of a number of factors, including the size and complexity of the firm and the types of engagements performed by the firm.

A less complex firm may not need to have granular documentation, such as a matrix, that indicates the quality objective, the related quality risk(s), and the related responses to address those quality risks.

ISQM 1 requires the firm to prepare documentation to achieve three principles:

- Support a consistent understanding of the SOQM by personnel, including an understanding of their roles and responsibilities with respect to the SOQM and the performance of engagements;

- Support the consistent implementation and operation of the responses; and

- Provide evidence of the design, implementation and operation of the responses, to support the evaluation of the SOQM by the individual(s) assigned ultimate responsibility and accountability for the SOQM.

Over and above applying these principles, ISQM 1 requires the firm to prepare documentation addressing specific matters like the firm's risk assessment process.

Q 59 - What is the IAASB effective date for ISQM 1?

As per IAASB ISQM 1, firms are required to have their system of quality management designed and implemented by December 15, 2022.

Q 60 - What is the effective date for ISQM standards in Pakistan?

The Institute has adopted IAASB's Quality Management Standards (November 2022) on the recommendation of the Auditing Standards and Ethics Committee from the following dates:

Firms performing the audits of public interest companies -	Effective from December 15, 2023
Firms performing the audits of other than public interest companies	Effective from December 15, 2024

Firms are required to have the system of quality management (SOQM) designed and implemented in accordance with ISQM1 by the above-noted effective dates. The evaluation of the SOQM is required to be performed within one year following the above effective dates.

Implementation support

The IAASB's implementation Guide and other support material on ISQM 1 are available on the IAASB and ICAP website at the link:

https://www.iaasb.org/focus-areas/quality-management
http://www.icap.net.pk/quality-management-standards