

# Proposed ISQM 1 – Overview of Governance and Leadership Comment

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This article, in the series of articles on the International Auditing and Assurance Standards Board (IAASB) provides an overview of the *Governance and Leadership* comment of the system of quality management (SOQM).

## Reason for revision

A gap in the requirements relating to the leadership responsibilities contained in extant ISQC 1 was noted. The standard does not specifically address firm governance or include sufficient detail around what is expected from firm leadership in relation to firm governance. As such, revisions to the requirements have been proposed to address leadership responsibilities, with the view of enhancing the role that leadership play in sustaining and continually improving audit quality.

## Overview of changes

*Governance and Leadership* is at the forefront of an effective SOQM in that leadership set the tone at the top by establishing the culture of the firm in terms of behavioural aspects and providing the framework within which decisions are made. This is therefore included as the first component in ED-ISQM 1 and is based on the component *Leadership Responsibilities for Quality within the Firm* contained in extant ISQC 1.

The *Governance and Leadership* component contained in ED-ISQM 1 has been substantially enhanced to improve the robustness of firms' governance and leadership. It addresses the expected behaviour of firm leadership in setting the tone at the top, the appropriate qualifications of leadership and holding leadership accountable through performance evaluations. ED-ISQM 1 also addresses the effect of the firm's strategic actions, including financial and operational decisions, on engagement quality and the firm's public interest role, as well as firm leadership's ability to influence decisions about the firm's resources.

With the importance placed on strong firm governance structures and leadership, the requirements have been significantly enhanced. Extant ISQC 1 includes two paragraphs under *Leadership Responsibilities for Quality within the Firm*, which require the firm to:

- establish policies and procedures designed to promote an internal culture recognising that quality is essential to performing engagements. These policies and procedures shall require that the chief executive officer (or equivalent), or, if appropriate, the firm's managing board of partners (or equivalent) to assume ultimate responsibility for the firm's system of quality control<sup>1</sup>; and
- that any person assigned operational responsibility for the firm's system of quality management have sufficient and appropriate experience and ability and the necessary authority to assume this responsibility<sup>2</sup>.

In accordance with the requirements of the risk assessment process that forms part of a firm's SOQM, ED-ISQM 1 includes six quality objectives that firms are required to establish<sup>3</sup>. The firm is then required

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<sup>1</sup> Extant ISQC 1.18

<sup>2</sup> Extant ISQC 1.19

<sup>3</sup> ED-ISQM 1.23

to identify quality risks that need to be further assessed based on a preliminary consideration of the possibility of the quality risks occurring and the effect on the achievement of the quality objectives<sup>4</sup>.

As part of the requirement to design and implement responses to address the assessed quality risks, ED-ISQM 1 prescribes three detailed responses that firms are required to implement<sup>5</sup>.

The prescribed quality objectives and required responses to the assessed quality risks are explained in more detail in the sections to follow.

### Quality objectives (paragraph 23 of ED-ISQM 1)

In the house of a SOQM diagram, *Governance and Leadership* is depicted as the roof to recognise that this component should provide overarching support to the design, implementation and operation of the other components of the SOQM, including the firm's culture, decision-making process, actions, organisational structure and leadership.

The quality objectives that firms are required to establish here are:

- The firm's culture promotes a commitment to quality, including recognising and reinforcing the importance of professional ethics, values and attitudes throughout the firm and emphasising the responsibility of all personnel for quality relating to the performance of engagements or activities within the system of quality management<sup>6</sup>.

The application material expands on the concept of a firm's culture and recognises that this is an important factor in influencing behaviour. As indicated above, all components are highly integrated and this is one such instance where integration can be seen. Firm culture cannot be divorced from relevant ethical requirements that are addressed in the component *Relevant Ethical Requirements* as these ordinarily establish the principles of professional behaviour. Furthermore, a culture that promotes a commitment to quality is likely to involve clear, consistent, frequent and effective communication, as addressed in the component *Information and Communication*<sup>7</sup>.

ED-ISQM 1 recognises that the nature and extent of actions of the individual assigned ultimate responsibility and accountability for the SOQM in establishing the firm's culture depend on the size, structure, geographical dispersion and complexity of the firm<sup>8</sup>.

- The firm has leadership who is responsible and accountable for quality<sup>9</sup>.

In expanding on this quality objective, it is important to note the prescribed response for the firm to assign ultimate responsibility and accountability for the SOQM to the:

- firm's chief executive officer; or
- firm's managing partner (or equivalent); or, if appropriate
- firm's managing board of partners (or equivalent)<sup>10</sup>.

The person assigned's ultimate responsibility for the SOQM depends on the leadership structure that exists. For example, the case of a smaller firm, ordinarily this person is the chief executive

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<sup>4</sup> ED-ISQM 1.28 and A54

<sup>5</sup> ED-ISQM 1.24

<sup>6</sup> ED-ISQM 1.23 (a)

<sup>7</sup> ED-ISQM 1. A26–A27

<sup>8</sup> ED-ISQM 1. A28

<sup>9</sup> ED-ISQM 1.23 (b)

<sup>10</sup> ED-ISQM 1.24(a)

officer (or equivalent), or the firm's managing partner (or equivalent). In contrast, leadership structures at larger firms may involve sharing the responsibility and accountability for the SOQM among the firm's managing board of partners (or equivalent)<sup>11</sup>.

- The firm's strategic decisions and actions, including financial and operational priorities, demonstrate a commitment to quality and to the firm's role in serving the public interest, by consistently performing quality engagements<sup>12</sup>.

In developing the firm's strategic decision-making process, the importance of considering how the firm's financial and operational decisions affect the performance of quality engagements has been emphasised<sup>13</sup>.

- The firm has an organisational structure with appropriate assignment of roles, responsibilities and authority that supports the firm's commitment to quality and the design, implementation and operation of the firm's system of quality management<sup>14</sup>.

The organisational structure of the firms and how roles, responsibilities and authority are assigned will vary depending on the nature and circumstances of the firm. In line with the objective to modernise the standard, it is recognised that firms may make use of service delivery centres to assist in the performance of specific tasks, for example those that are either repetitive or specialised in nature<sup>15</sup>.

- The firm plans for its resource needs, including financial resources, and obtains, allocates or assigns resources in a manner that supports the firm's commitment to quality and enables the design, implementation and operation of the firm's system of quality management<sup>16</sup>.

Although there is a separate component entitled *Resources* included in the SOQM, resources has specifically been included under *Governance and Leadership* to address the challenge of the leadership not being able to achieve the objective as a result of lack of resources.

Resources referred to under the *Governance and Leadership* component relate to financial resources. The resources referred to in the *Resources* component of the SOQM encapsulates human, technological and intellectual resources. The integration between these two components is evident in the fact that human, technological or intellectual resources cannot be obtained without the necessary financial resources<sup>17</sup>.

- The firm fulfils its responsibilities in accordance with law, regulation and professional standards that relate to the governance and leadership of the firm, if applicable<sup>18</sup>.

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<sup>11</sup> ED-ISQM 1.A36

<sup>12</sup> ED-ISQM 1.23 (c)

<sup>13</sup> ED-ISQM 1.A29

<sup>14</sup> ED-ISQM 1.23 (d)

<sup>15</sup> ED-ISQM 1.A31-A32

<sup>16</sup> ED-ISQM 1.23 (e)

<sup>17</sup> ED-ISQM 1.A33-A34

<sup>18</sup> ED-ISQM 1.23 (f)

## Required Responses to Identified and Assessed Quality Risks (paragraph 24 of ED-ISQM 1)

The purpose of a SOQM is to support the consistent performance of quality engagements, by providing the firm with reasonable assurance that the objectives of the system are achieved<sup>19</sup>. The quality objectives are achieved through the process of identifying and assessing risks to achieving the quality objectives and designing and implementing responses to the identified quality risks.

In line with designing and implementing responses to identified and assessed quality risks in *Governance and Leadership*, a firm is required to:

- Assign ultimate responsibility and accountability for the SOQM to the firm's chief executive officer or the firm's managing partner (or equivalent) or, if appropriate, the firm's managing board of partners (or equivalent). The individual(s) to whom such responsibility and accountability is assigned shall:
  - Have the appropriate experience and knowledge to fulfil the assigned responsibility.
  - Demonstrate a commitment to quality through their actions and behaviours, including recognising and reinforcing the importance of professional ethics, values and attitudes, and establishing the expected behaviour of personnel relating to the performance of engagements and activities within the system of quality management.
  - Establish structures, reporting lines, and appropriate authorities and responsibilities, including assigning operational responsibility for the following matters:
    - The SOQM as a whole; and
    - Specific aspects of the SOQM, as appropriate to the nature and circumstances of the firm, which shall include operational responsibility for compliance with independence requirements and the monitoring and remediation process<sup>20</sup>.

The personnel assigned operational responsibility for the SOQM as a whole as well as specific aspects understand their assigned responsibilities and accountability for such responsibilities. The personnel assigned operational responsibility must have:

- the appropriate experience and knowledge and sufficient time to fulfil the assigned responsibility; and
- a direct line of communication to the individuals assigned ultimate responsibility and accountability for the SOQM<sup>21</sup>.

The person assigned ultimate responsibility and accountability for the SOQM remains responsible for and accountable for the firm achieving the objectives of ED-ISQM 1. This person may then either retain or assign **operational responsibility** for the SOQM as a whole, as well as specific aspects of the SOQM, as considered appropriate<sup>22</sup>.

- Establishing policies or procedures for periodic performance evaluations of the individual(s) assigned ultimate responsibility and accountability for the firm's system of quality

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<sup>19</sup> ED-ISQM 1.7

<sup>20</sup> ED-ISQM 1.24 (a)

<sup>21</sup> ED-ISMQ 1.25

<sup>22</sup> ED-ISQM 1.A37

management, and the individual(s) assigned operational responsibility, in order to hold individuals accountable for the responsibilities assigned to them<sup>23</sup>.

The periodic performance evaluations are a required response to promote the accountability of individuals for the assigned responsibilities. Any positive performance evaluations may be rewarded through compensation, promotion and other incentives that focus on the individual's commitment to quality, and reinforce accountability. In considering the performance of the individuals, the firm may take into account the results of firm's monitoring activities as well as actions taken by the individual in response to identified deficiencies<sup>24</sup>.

- Establishing policies or procedures for dealing with complaints and allegations about the commitment to quality of the firm or its personnel, including clearly defining channels within the firm that enable reporting by personnel or external parties to appropriate individual(s) without fear of reprisal and enabling the investigation and resolution of the complaints and allegations<sup>25</sup>.

Establishing policies and procedures for dealing with complaints and allegations supports the firm's commitment to quality. Such complaints or allegations may originate from within or outside the firm and may be made by firm personnel or external parties. These may relate to either a failure to perform work in accordance with the professional standards and applicable legal and regulatory requirements, or a non-compliance with the firm's policies or procedures. Complaints or allegations may indicate a deficiency in the firm's SOQM and therefore represents other relevant information to be considered by the firm as part of its monitoring and remediation process, as required in terms of the component relating to *Monitoring and Remediation* <sup>26</sup>.

### In summary

ED-ISQM 1 has been substantially enhanced to improve the robustness of firms' governance and leadership. In particular, it addresses the expected behaviour of firm leadership in setting the tone at the top, the appropriate qualifications of leadership, and holding leadership accountable through performance evaluations. ED-ISQM 1 now also addresses the effect of the firm's strategic actions, including financial and operational decisions, on engagement quality and the firm's public interest role, as well as firm leadership's ability to influence decisions about the firm's resources.

Source:

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

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<sup>23</sup> ED-ISQM 1.23 (b)

<sup>24</sup> ED-ISQM 1.A40-A41

<sup>25</sup> ED-ISQM 1.23 (c)

<sup>26</sup> ED-ISQM 1.A44