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FIRM'S RISK ASSESSMENT PROCESS AS AN COMPONENT OF THE QUALITY MANAGEMENT SYSTEM OF AN AUDITING FIRM

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ABSTRACT *International Standard on Quality Management (ISQM) 1, Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements sets out the provisions on the quality management system of an audit firm. This article discusses the issues of determining the quality management system of an audit firm, according to the author, this system includes a number of additional elements. The author classifies the risks that can negatively affect the quality management system of an audit firm. Particular attention should be paid to the quality management system for small audit firms, the author offers a number of working documents to identify risks for such firms.*

KEYWORDS: *quality management, audit, risk, assessment, ISQM*
JEL CLASSIFICATION: *M10, M42*

INTRODUCTION

In modern conditions, the requirements for information presented in the financial statements of the enterprise are noticeably tougher. In this regard, in order to qualitatively verify the information and data presented in the financial statements, audit firms must develop, implement and strictly comply with the requirements of a quality management system. It should be noted that starting from December 15, 2022, the following International Auditing Standards came into force, which present the requirements for quality management of an audit firm:

- ✓ *International Standard on Quality Management (ISQM) 1, Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements;*
- ✓ *ISQM 2, Engagement Quality Reviews; and*
- ✓ *International Standard on Auditing (ISA) 220 (Revised), Quality Management for an Audit of Financial Statements.*

ISQM 1 requires the audit firm to make the transition from policies and procedures relating to individual elements, as required by the current International Standard on Quality Control 1, to integrated quality management.

At the same time, ISQM 1 (ISQM 1) establishes that the quality management system (QMS) of an auditing firm is a mechanism that creates an environment that guides and supports auditors in the qualitative performance of tasks. This helps the firm to achieve consistent audit quality of financial statements, as it focuses on how the firm manages the quality of completed assignments. According to the author, this definition considers only one side of the quality management system, while in this system it is a complex mechanism that includes methods, tools, as well as human resources aimed at the qualitative performance of audit tasks.

Audit firms may perform different types of engagements in accordance with the IAASB Engagement Standards:

- ✓ *Audits or reviews of financial statements performed in accordance with ISAs and International Standards on Review engagement (standards starting from 2400-2410);*
- ✓ *Assurance engagements performed other than audits or reviews of historical financial information. In accordance with the International Engagement Standards (standards starting from*

3000-3420) that provide assurance (for example, an extended financial reporting guarantee or an organization's controls guarantee, etc.); or

✓ *Related Services Engagements performed in accordance with the International Standards for Related Services (Standards 4400-4410) (i.e. agreed procedures and compilation assignments*

SURVEY

ISQM 1 (ISQM 1) establishes that the purpose of the quality management system is to provide the audit firm with reasonable assurance that:

• *the firm and its staff perform their duties in accordance with professional standards and applicable legal and regulatory requirements, as well as fulfill obligations in accordance with such standards and requirements; and*

• *the audit report issued by the firm or the partners on the assignment correspond to the circumstances of the audit assignment.*

According to the author, it is possible to supplement this definition with the phrase that the purpose of the quality management system is its effective creation in such a way that, in order to obtain reasonable confidence.

The ISQM 1 First-time implementation guide (GUIDE) examines the following components of an audit firm's quality management system

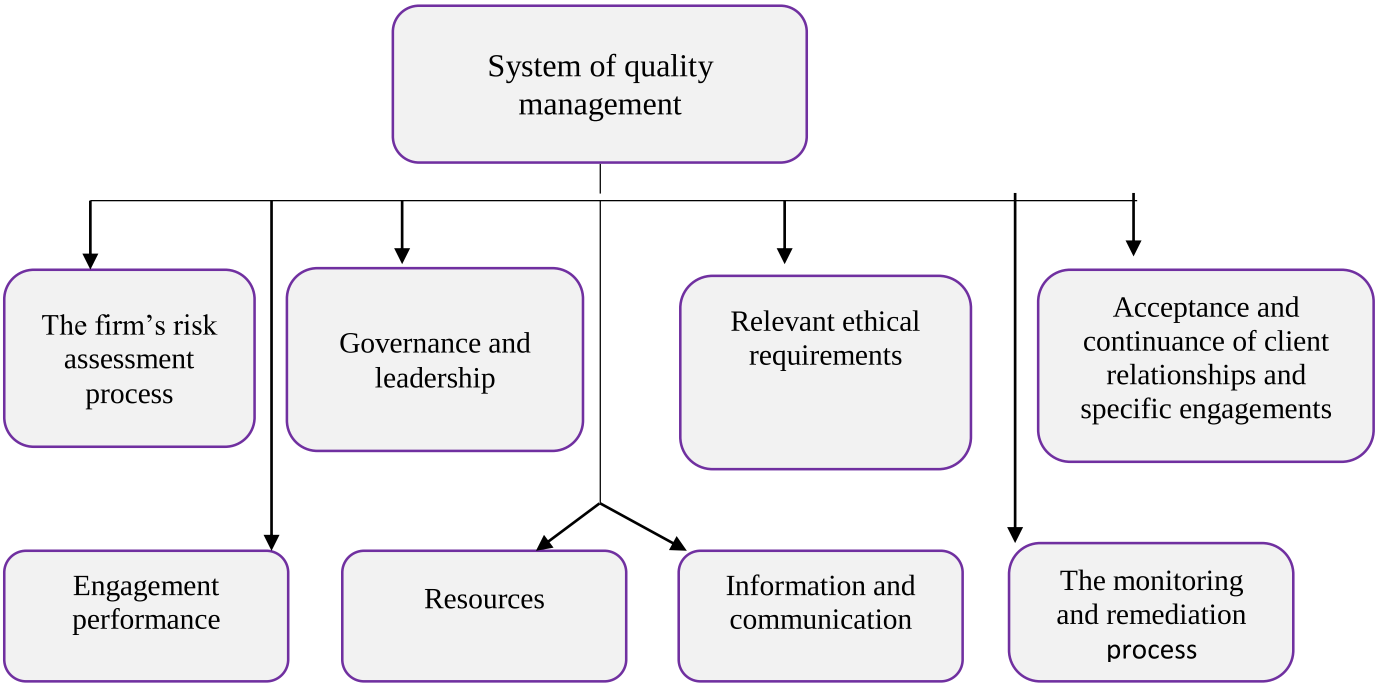

Figure 1. Elements of the audit firm's quality management system.
Source: Developed by the author based on the materials of ISQM 1

As a result, ISQM 1 requires the audit firm to share responsibility for the quality management system, as well as to hold individuals accountable for poor performance. The audit firm should periodically evaluate the performance of those individuals who have ultimate responsibility for quality management.

In this case, the audit firm must appoint responsible persons who will:

✓ the top (highest) responsibility for the quality management system,

✓ operational responsibility for the quality management system.

The core principle of ISQM 1 and the key difference from the existing ISQC 1 is that an audit firm should follow a risk-based approach to quality that focuses the firm on:

- *identification of risks that may arise depending on the nature and circumstances and obligations of the firm; as well as*

- *Taking action to address these risks appropriately.*

How an audit firm develops a firm's risk assessment process may depend on the size of the firm, including how it is structured and organized.

Examples of scope to show how a firm's risk assessment process can differ are as follows:

• *In a less complex firm, the person who has operational responsibility for the quality management system has sufficient knowledge of the firm and its obligations to assess risks. In addition, documentation of quality objectives, quality risks, and responses may be less extensive than for a more complex firm (for example, it may be a single document).*

• *In a more complex audit firm, there may be a risk assessment process involving multiple individuals and multiple activities. The process can be centralized (for example, quality objectives, quality risks, and responses are set centrally for all business units, functions, and service lines) or decentralized. The network of audit firms can also provide the firm with quality objectives, quality risks, and responses to be included in the firm's quality management system.*

The audit firm should establish quality management objectives at all levels:

- *Governance and leadership;*
- *Relevant ethical requirements;*
- *Acceptance and continuance of client relationships and specific engagements;*
- *Engagement performance*
- *Resources;*
- *Information and communication.*

There may be many risks that can adversely affect the achievement of quality objectives. However, not all risks are considered quality risks in accordance with the provisions of ISQM 1, since it is impractical or practically impossible for a firm to identify and assess each possible risk, as well as to develop and implement measures to respond to each risk. SM 1 aims to focus the firm's attention on the risks that have the greatest impact on achieving quality goals, so that the firm properly considers these risks. The definition of quality risk in ISQM 1 includes a threshold value for what risks are considered quality risk.

A risk qualifies as a quality risk when it meets both criteria in the definition:

1) Reasonable possibility of risk,

2) The risk has the possibility, individually or in combination with other risks, to negatively affect the achievement of one or more quality objectives

Examples of quality risks that may arise may be the following:

- Strategic and operational decisions, actions, business processes and business model of the firm: the overall financial goals of the firm are excessively dependent on the volume of services provided by the firm,
- Characteristics and leadership style: The firm is a small firm with several task partners with general authority. In the context of management and leadership, this can lead to a number of quality-related risks, such as:

- *the responsibilities of management for quality are not clearly defined and distributed.*

- *actions and behavior of management that do not contribute to quality improvement.*

When evaluating risks, the following should be taken into account:

- *The complexity and operational characteristics of the audit firm,*
- *Strategic and operational decisions and actions, business processes and business model of the audit firm,*
- *Characteristics and management style of the management of the audit firm,*
- *Company resources,*
- *Laws, regulations, professional standards and the environment in which the audit firm operates,*
- *Belonging to the network and its requirements,*
- *Types of services provided by the audit firm and types of audit reports,*
- *Types of enterprises for which the audit firm provides services.*

In identifying and evaluating risks, the audit firm must develop and implement procedures and policies to respond to risks.

When developing risk responses, an audit firm should take into account:

- ✓ *Effectiveness of the established measures (preventive, non-compliance measures or a combination thereof),*
- ✓ *Will the measures developed be effective,*
- ✓ *What resources should be used in response to quality control measures,*
- ✓ *Establish who will implement the response measures and whether they need to be implemented at the task level.*
- ✓ *Establish a period of identification, assessment and response to risks,*
- ✓ *Classification of risks by urgency of response.*

The audit firm establishes policies or procedures when receiving, investigating and resolving complaints and allegations of non-performance in accordance with professional standards and applicable legal and regulatory requirements or non-compliance with the policies or procedures of the audit firm.

In developing and implementing this response, the firm may consider issues such as:

- o *the appointment of a responsible employee who should receive, investigate and resolve complaints,*
- o *the possibility of outsourcing the complaints process to a service provider and whether several suppliers should be involved in the process.*
- o *provisions of legislative and regulatory acts or relevant ethical requirements regarding liability for the firm or its staff in relation to complaints, for example, the obligation of the firm or its staff to report this to the relevant public authority.*
- o *the approach to be used by the firm or its staff in response to non-compliance or suspicion of non-compliance with laws or regulations.*
- o *the process of communication regarding complaints (how an employee of an audit firm should report complaints.*
- o *confidentiality of complaints and notifications.*
- o *situations where the management of an audit firm may involve a lawyer.*

Analyzing the provisions of the International Standard on Quality Management (ISQM) 1, Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements, as well as audit practice, the author proposes to consider and evaluate the following risks that may affect on quality management of the audit firm itself:

- ✓ *operational (associated with incorrect interference of owners or other related parties in the activities of an audit firm, etc.),*
- ✓ *financial (associated with the fact that the audit firm can accept the task when there are unfavorable conditions for the acceptance of the client, only due to the fact that the firm is experiencing financial difficulties, etc.),*
- ✓ *insufficiency of resources (lack of qualified personnel, problems with the audit software, problems with the methodology for completing tasks, etc.)*

The above risks may lead to the establishment of a poor quality management system for an audit firm. In all these cases, the audit firm should develop response measures to protect the quality management system in accordance with the requirements of ISAs.

CONCLUSION

ISQM 1 sets out the rules for the application of an audit firm's quality management system. At the same time, according to the author, the definition of this system should be expanded: as a complex mechanism that includes methods, tools, as well as human resources, aimed at the quality performance of audit assignments. First of all, management responsibility should be strengthened, including control, decision-making regarding the acquisition, deployment and management of human, financial, technological, material and non-material resources.

Analyzing the procedure for creating a quality management system in small audit firms, it should be noted that the final responsibility for the quality system can be assigned to one person. This person may also take responsibility for all aspects of SQM, including operational responsibility for SOQM, compliance with independence requirements, and the monitoring and correction process. For example, if you are the sole practitioner, the requirements for organizational structure and roles, responsibilities and authority within the firm, leadership, oversight and review, and dispute resolution may not be relevant.

Thus, for small audit firms, the author proposes to draw up a memorandum for risk assessment, which will reflect the risks of quality management: operational, financial and resource, in the context of their identification, response to risks and explanations.

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