Agenda Item 2–D (For Reference)

Practical Example of the Implementation of Proposed ISQC 1 (Revised)[1]

Objective of this Document

The objective of this Agenda Item is to demonstrate how the requirements of proposed ISQC 1 (Revised) may be scaled according to the nature and circumstances of the firm and its engagements. It is intended to illustrate that a system of quality management is not 'one size fits all,' even in relation to the prescribed responses. This Agenda Item has been provided for reference purposes in order to obtain the Board's views about:

(a) Whether examples should be published with the explanatory memorandum of the Exposure Draft (ED) of proposed ISQC 1 (Revised) in order to demonstrate the scalability of the standard; and

(b) If so, whether an additional example should be developed and the nature of the example.

The QCTF notes the development of such a document depends on the timing and availability of resources

Introduction

1. This document demonstrates how the requirements of proposed ISQC 1 (Revised) may be scaled according to the nature and circumstances of the firm and its engagements. It illustrates how the quality objectives, quality risks and responses are related, including responses that are required by the standard. The scenarios described are simplistic and do not include all factors that may affect the nature and circumstances of the firm and its engagements.

2. There are a variety of quality risks relevant to the firm and responses that firms may design and implement that are not included in the scenarios below. Furthermore, the assessment of the quality risks described in the scenarios is dependent on the unique circumstances of the firm and its engagements. Since the examples are illustrative, they are not intended to comprehensively address all possible responses that a firm may need to address a quality risk. Furthermore, the manner in which the firm documents its quality objectives, quality risks and responses may not be in the manner set out below.

Illustration 1: Example of Relevant Ethical Requirements

Scenario 1	
Nature and circumstances of the firm and its engagements	A small firm in a single geographical location that only performs compilations of financial statements under ISRS 4410 (Revised).[2] Other services offered by the firm include tax services.

[1] Proposed International Standard on Quality Control (ISQC) 1 (Revised), *Quality Control for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance Engagements or Related Services Engagements*

[2] International Standard on Related Services Engagements (ISRS) 4410 (Revised), *Compilation Engagements*

Quality objective	The firm establishes the quality objective in paragraph 36(b) of proposed ISQC 1 (Revised).
Quality risk	The firm does not identify any quality risks relating to independence, because relevant ethical requirements do not contain requirements addressing independence when performing a compilation engagement. The firm identifies quality risks relating to other ethical requirements, but these are not further explored in the illustrations.
Response	The following response required by paragraph 37(d) of proposed ISQC 1 (Revised) is not implemented because it is not relevant to the firm: Obtaining, at least annually, a documented confirmation of compliance with the independence requirements from all personnel required by relevant ethical requirements to be independent.
Scenario 2	
Nature and circumstances of the firm and its engagements	A small firm in a single geographical location that only performs compilations of financial statements under ISRS 4410 (Revised) and reviews of financial statements under ISRE 2400 (Revised).[3] The nature of the firm's clients are local owner-managed businesses operating in industries such as farming, manufacturing and retail. The firm is located in a town with a small population.
Quality objective	The firm establishes the following sub-objective for the quality objective in paragraph 36(b) of proposed ISQC 1 (Revised): The firm, its personnel and others subject to relevant ethical requirements fulfill their responsibilities in relation to independence requirements.
Quality risk	The firm identifies the following quality risks related to the sub-objective (note that other quality risks would exist regarding the firm's independence): 1. Personnel and others subject to relevant ethical requirements, including relevant family members, do not comply with the provisions of relevant ethical requirements addressing financial interests and loans and guarantees. <u>Likelihood of occurrence:</u> The firm determines that there is a reasonable possibility that a family member or another individual with whom the individual has a close relationship has a financial interest in a client, or provides a loan or guarantee to a client or receives a loan or guarantee from a client. This is because the firm operates in a small town and the firm's clients may be owned by family members of the firm's personnel (i.e., they have a financial interest).

[3] International Standard on Review Engagements (ISRE) 2400 (Revised), *Engagements to Review Historical Financial Statements*

	Effect on the Achievement of a Quality Objective: The firm determines that if any of the quality risks were to occur, it would have a significant impact on the achievement of the quality objective, because it would result in a breach of independence requirements.. 2. Individual(s) participate as an engagement team member for an entity where a family member or another individual with whom the individual(s) has a close relationship is employed. Likelihood of occurrence: The firm determines that there is a reasonable possibility that a family member or another individual with whom the individual has a close relationship is employed by the firm's clients, because the firm operates in a small town and the firm's clients may therefore be related to, or have close relationships with, the firm's personnel. Effect on the Achievement of a Quality Objective: The firm determines that if any of the quality risks were to occur, it would have a significant impact on the achievement of the quality objective, because it would result in a breach of independence requirements. 3. Individual(s) participate as an engagement team member for an entity where (i) the individual was recently employed, or (ii) the individual provides services to the entity, such as in the capacity as a director or officer. Likelihood of occurrence: The firm determines that there is a reasonable possibility that individuals may engage in services, such as assisting the clients with functions related to the company secretary, because the clients do not have the expertise to deal with such matters. Effect on the Achievement of a Quality Objective: The firm determines that if any of the quality risks were to occur, it would have a significant impact on the achievement of the quality objective, because it would result in a breach of independence requirements. The firm further assesses the quality risks identified by further determining: (a) The likelihood of occurrence, i.e., there is a reasonable possibility, but how possible is it that the quality risk will occur. For example, the firm may determine that quality risk 3 is more likely to occur than quality risk 1 or 2. (b) The effect on the achievement of a quality objective, i.e., what is the magnitude of the effect on the quality objective. For example, the firm may determine that the effect of all of these quality risks are the same.

Response	The firm designs and implements the following responses: <u>Responses required by proposed ISQC 1 (Revised)</u> 1. The firm assigns operational responsibility for compliance with independence requirements to the firm's managing partner. 2. The firm identifies the Professional Code of Ethics in Country X and independence requirements contained in jurisdictional law of Country X as being the relevant ethical requirements applicable to the firm and its personnel. 3. The firm identifies that the only individuals who are expected to comply with the relevant ethical requirements are personnel within the firm. 4. On an annual basis, all personnel and others subject to the relevant ethical requirements are required to submit a written confirmation confirming their compliance with the independence requirements. <u>Other responses designed and implemented by the firm</u> 5. The firm establishes a policy that it will not accept a client that is owned by family members of the firm's personnel. (Acceptance and continuance of client relationships and specific engagements) 6. The firm trains personnel on the requirements of the relevant ethical requirements such that personnel are able to identify circumstances that create a threat to the compliance with the independence requirements, as follows: (Resources) • Upon hiring, personnel complete an online training course provided by a service provider, which covers the requirements of the relevant ethical requirements. (Service providers) • The firm uses the service provider to provide annual technical updates for all personnel, which covers a variety of topics, including changes in relevant ethical requirements. (Service providers) 7. All personnel are provided with a PDF copy of the relevant ethical requirements. (Information and communication) 8. The firm establishes policies regarding what types of services or assistance may be given to clients. The policies require personnel to refer client requests for additional services or assistance to the managing partner for approval. (Acceptance and continuance of client relationships and specific engagements) 9. The firm requests engagement team members to confirm their independence from the client in writing on each engagement (i.e., in addition to the annual declaration). (Relevant ethical requirements)

Scenario 3	
Nature and circumstances of the firm and its engagements	A larger firm across multiple geographical locations that performs audits and reviews of financial statements and other assurance or related services engagements. The nature of the firm's clients include entities that are listed or have significant public interest. The clients operate in a variety of industry segments, including the financial sector. The firm is a member of a small global network.
Quality objective	The firm establishes the following sub-objective for the quality objective in paragraph 36(b) of proposed ISQC 1 (Revised): The firm, its personnel and others subject to relevant ethical requirements fulfill their responsibilities in relation to independence requirements.
Quality risk	The firm identifies the following quality risks related to the personnel's independence (note that other quality risks would exist regarding the firm's independence): 1. Personnel and others subject to relevant ethical requirements, including relevant family members identified by the relevant ethical requirements, hold a financial interest, directly or indirectly, in relation to an entity that is not allowed by the relevant ethical requirements. <u>Likelihood of occurrence:</u> The firm determines that it is reasonably possible that the quality risks may occur because the entities for which the firm provides services are listed (i.e., shares are publicly traded). <u>Effect on the Achievement of a Quality Objective:</u> The firm determines that if any of the quality risks were to occur, it would have a significant effect on the achievement of the quality objective, because it would result in a breach of independence requirements. 2. Personnel and others subject to relevant ethical requirements, including relevant family members identified by the relevant ethical requirements, provide loans and guarantees to, or obtain loans and guarantees from an entity, that is not allowed by the relevant ethical requirements. <u>Likelihood of occurrence:</u> The firm determines that it is reasonably possible that the quality risks may occur because the firm provides services to entities operating in the financial sector (i.e., increasing the likelihood of loans or guarantees being provided). <u>Effect on the Achievement of a Quality Objective:</u> The firm determines that if any of the quality risks were to occur, it would have a significant impact on the achievement of the quality objective, because it would result in a breach of independence requirements.

	3. Individual(s) participate as an engagement team member for an entity where a family member or another individual with whom the individual has a close relationship is employed. Likelihood of occurrence: The firm determines that it is reasonably possible that the quality risks may occur because the entities for whom the firm performs engagements have many employees. Effect on the Achievement of a Quality Objective: The firm determines that if any of the quality risks were to occur, it would have a significant impact on the achievement of the quality objective, because it would result in a breach of independence requirements. 4. Individual(s) participate as an engagement team member for an entity where (i) the individual was recently employed, or (ii) the individual provides services to the entity, such as in the capacity as a director or officer. Likelihood of occurrence: The firm determines that it is reasonably possible that the quality risks may occur because the entities for whom the firm performs engagements have many employees, and the firm may employ someone from a client. Effect on the Achievement of a Quality Objective: The firm determines that if any of the quality risks were to occur, it would have a significant impact on the achievement of the quality objective, because it would result in a breach of independence requirements. The firm further assesses the quality risks identified by further determining: (a) The likelihood of occurrence i.e., there is a reasonable possibility, but how possible is it that the quality risk will occur. For example, the firm may determine that it is more possible that the quality risk 1 will occur than quality risk 4. (b) The effect on the achievement of a quality objective i.e., what is the magnitude of the effect on the quality objective. For example, the firm may determine that the effect of quality risk 1 is more significant than quality risk 2, because of the nature of the risk that involves a direct financial benefit.
Response	The firm designs and implements the following responses: Responses required by proposed ISQC 1 (Revised) 1. The firm assigns operational responsibility for compliance with independence requirements to the firm's Chief Ethics Officer. (Governance and leadership) 2. The firm identifies the Professional Code of Ethics in Country X and independence requirements contained in jurisdictional law of Country X as being the relevant ethical requirements applicable to the firm and its personnel. (Relevant ethical requirements)

	3. The firm identifies the personnel within the firm who are expected to comply with the relevant ethical requirements and others, which includes the firm's network, other network firms and personnel in the network or other network firms. (Relevant ethical requirements) 4. Twice a year, the network requires all personnel to submit a confirmation in the firm's Independence IT application confirming their compliance with the independence requirements. The confirmation asks various questions, aligned with the independence policies or procedures, which are consistent across the network. Each question contains an automated link to an online learning program that provides an explanation of the independence policies or procedures, including practical examples. (Relevant ethical requirements and Networks) <u>Other responses designed and implemented by the firm</u> 5. The network requires the firm to establish independence policies or procedures, differentiating between personnel who perform audit or review engagements or support engagement teams (e.g., technical department) and other personnel not involved with these engagements (e.g., tax and consulting services). The policies or procedures required by the network address: (Resources (intellectual) and networks) • Circumstances when financial interests may be held by an individual, or their relevant family member, in a client. • Circumstances when an individual, or their relevant family member, may provide loans and guarantees to, or obtain loans and guarantees from a client of the firm. • Circumstances when an individual may participate in the engagement team when the individual has a family member or other close relationship with an individual who is employed by the entity. • The period that an individual may not be an engagement team member following their employment with an entity and that prohibits providing services (e.g., director or officer) to a client of the firm. 6. The firm trains personnel on the requirements of the relevant ethical requirements such that personnel are able to identify circumstances that create a threat to the compliance with the independence requirements, as follows: (Resources) • Upon hiring, personnel complete an online training course developed by the firm's network, which covers the requirements of the independence policies or procedures, which are consistent across the network. (Information and communication and networks) • Every 2 years, or when changes in the relevant ethical requirements occur, the firm provides an online training course, developed by the network, that is compulsory for all personnel to complete and that

addresses changes in the relevant ethical requirements or refreshes key concepts. (Information and communication and networks)

7. Engagement team members are required to confirm their independence from the client through answering a question located in the engagement IT application. (Information and communication, engagement performance and resources)

8. The network provides the firm with an electronic, interactive copy of the independence policies or procedures, which is available through an online library tool (IT application) and is available to all personnel. The firm is able to supplement the policies or procedures for jurisdictional specific matters. The firm also adds the Professional Code of Ethics in Country X and independence requirements contained in jurisdictional law of Country X to the library tool. (Resources (intellectual and technological) and information and communication)

9. The firm implements an IT application, provided by the network, which requires all personnel and others subject to the relevant ethical requirements to record all financial interests, loans and guarantees that the individual, or their relevant family members hold. The firm is required to capture all clients for whom engagements are performed in the IT application, including the nature of the engagement, in order that the IT application can identify possible financial interests. The IT application sends automated alerts of financial interests, loans and guarantees that are in conflict with the independence policies or procedures to the firm's chief ethics officer. (Resources (technological and human) and information and communication)

10. The Chief Ethics Officer appoints a team of individuals (Independence Team) who are responsible for: (Resources)

    - Providing consultation on questions related to independence. (Engagement performance)
    - Providing training to personnel. (Resources)
    - Preparing communications regarding matters related to independence (e.g., changes in relevant ethical requirements or new policies or procedures). (Information and communication)
    - Communicating independence matters with the network. (Information and communication)
    - Supporting the Chief Ethics Officer in investigating circumstances when the IT application has indicated financial interests in conflict with the firm's policies and procedures. (Relevant ethical requirements)
    - Performing annual testing of personnel by selecting a sample of individuals and requesting the individual to provide supporting documentation regarding the individual, and their relevant family member's, financial interests, loans and guarantees. This information is compared to the IT application to determine that all financial interests,

	loans and guarantees have been captured. The firm takes disciplinary action against personnel who have failed to capture the information timeously and correctly. (Relevant ethical requirements and resources) • Monitoring that all personnel have submitted their confirmations in the IT application. (Relevant ethical requirements) 11. Every 2 years, or when changes in jurisdictional law, regulation or professional standards occur, a member of the Independence Team submits a summary to the network of any jurisdictional law, regulation or professional standards regarding independence that need to be adhered to by the network, other network firms or personnel in other network firms. The network updates this information in the Independence IT application, and the information is available to all firms in the network and their personnel. (Information and communication and networks)