Illustration of Potential Frequently Asked Questions for International Standard on Quality Control 1 (Revised)

Objective of this Document

The objective of this Agenda Item is to illustrate a frequently asked questions document that could accompany and further enhance the understanding of proposed ISQC 1 (Revised). This Agenda Item has been provided for reference purposes in order to obtain the Board's views about whether the frequently asked questions should be published with the explanatory memorandum of the Exposure Draft (ED) of proposed ISQC 1 (Revised). The QCTF notes the development of such a document depends on the timing and availability of resources.

1. Is governance and leadership relevant to all firms?

Governance and leadership provides the basis for the system of quality management, because the firm needs to establish structures, reporting lines and appropriate authority and responsibility in order that the other components of the system of quality management can be developed. However, the nature and extent of the actions taken are scalable according to the nature and circumstances of the firm and the engagements the firm performs. For example, the strategic decisions and actions for a smaller firm that performs reviews of financial statements for entities that do not have a public interest may be less affected by public interest considerations because there are a few stakeholders (e.g., client management). However, a firm performing audits of financial statements of listed entities or entities that have a significant public interest has a more significant public interest role that has a more profound impact on the firm's strategic decisions and actions.

2. What is the firm's risk assessment process?

Proposed ISQC 1 (Revised) requires the firm's system of quality management to follow a risk-based approach in managing quality, so that the firm is focused on areas where risks to quality are likely to arise. This risk-based approach is captured by the component 'the firm's risk assessment process.' The firm's risk assessment process is relevant to the whole system of quality management, and involves establishing quality objectives, identifying and assessing quality risks and designing and implementing responses to address the quality risks. The other components set out areas of the system of quality management that need to be addressed such that the overall objective of the standard is achieved, and include quality objectives and responses relevant to the components.

3. How does the firm establish quality objectives?

Proposed ISQC 1 (Revised) includes quality objectives that are applicable to all firms and which need to be achieved so that the overall objective of the standard is achieved. These are referred to as 'quality objectives required by this ISQC' in proposed ISQC 1 (Revised). The quality objectives required by the standard are organized into the various components and would be the firm's starting point for establishing quality objectives.

In some circumstances the firm may determine that more granular quality objectives (or related sub-objectives) are needed to support the firm in identifying quality risks, however the standard does not require the firm to do so. For example:

(a) The firm may split the quality objectives required by the standard into more granular elements, e.g., the quality objectives for relevant ethical requirements may be divided into ethical matters related to independence and other ethical matters.

(b) 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.

There may also be circumstances when the quality objectives required by the standard do not provide a sufficient basis for the achievement of the overall objective of the standard, i.e., there are gaps in the quality objectives set out in the standard. In such circumstances, the firm is required by the standard to establish additional quality objectives.

4. How does the firm identify and assess quality risks?

There are many conditions, events, circumstances, actions or inactions that may affect the achievement of the quality objectives, resulting in quality risks. However, proposed ISQC 1 (Revised) only requires the firm to identify those quality risks that meet the threshold described in the standard, i.e.:

(a) The quality risks have a reasonable possibility of occurring; and

(b) If the quality risks were to occur, they may, individually or in combination with other quality risks, have a significant effect on the achievement of a quality objective.

Accordingly, in identifying the quality risks, the firm considers, based on a preliminary assessment, what the likelihood and effect of the quality risks may be.

Although the preliminary assessment may indicate that the quality risk has a reasonable possibility of occurrence, it may not indicate where along the scale of possibility of occurrence the quality risk is lying. Similarly, in identifying the quality risks, there may not be an indication of how significant the effect would be. Accordingly, the standard requires the firm to further assess the quality risks once they have been identified, which involves a more accurate assessment of the likelihood and effect of the quality risks. The firm's further assessment of the possibility of occurrence or effect of the quality risk is important in determining the nature, timing and extent of the response(s) that need to be designed and implemented to address the quality risk.

In some circumstances, the identification and assessment of the quality risks may be undertaken simultaneously.

5. How does the firm design and implement responses?

Proposed ISQC 1 (Revised) requires the firm to design and implement responses to address all of the identified quality risks. However, the nature, timing and extent of the response may vary based on the nature of the quality risk, its assessment and the firm's reasons for that assessment. In designing a response to a quality risk, the firm may consider many factors, including:

- Whether the response should involve a preventative activity, a detective activity or a combination of both. For example, a preventative activity would include developing the knowledge of firm personnel regarding independence requirements in order to prevent breaches of independence, and a detective activity would include activities designed to check personnel's compliance with the independence requirements.

- Whether the response should include manual or automated elements.
- The appropriate timing of the response, for example, certain activities may need to operate on a continual basis in order to be effective (e.g., monitoring and reporting breaches of the firm's independence policies or procedures).
- Whether the response alone is sufficient to address the quality risk, i.e., a combination of responses may be necessary to appropriately address the quality risk.
- Whether there are responses that address multiple quality risks and therefore may be more effective.
- The appropriate resources to support the response. For example, certain responses may need to be performed by competent personnel with the appropriate knowledge, time and experience, or the firm may need IT applications or intellectual resources to support the functioning of the response.
- The information needed to support the operation of the response.
- If the response generates information, how the information will be communicated.
- If the response is designed to identify deviations, how they will be addressed. For example, in the case of a pre-issuance review, the firm may factor the results of the pre-issuance review into performance evaluations

Some responses are apparent because they are necessary for the quality objectives required by the standard to be achieved, for example, in order to determine whether the firm has the appropriate resources to perform the engagement when accepting or continuing an engagement, the firm's information system would need to provide information about the availability of its personnel. However, there are certain responses applicable to all firms which are necessary for the achievement of the quality objectives, but may not be apparent from the quality objectives, for example, performing engagement quality control reviews. Accordingly, proposed ISQC 1 (Revised) includes responses that the firm is required to include in its system of quality management, which represent those responses applicable to all firms that are not apparent from the quality objectives.

When incorporating the responses required by the standard in the system of quality management, the firm also takes into consideration the reasons for the assessment given to the quality risks (i.e., the nature of the quality risks and the assessment of the likelihood and effect). This affects how the firm designs and implements the response required by the standard. For example, a large firm with multiple locations may use an IT application to facilitate obtaining personnel's written confirmation of compliance with the independence requirements, whereas a small firm may obtain these manually.

6. How frequently does the firm need to update its system of quality management?

Managing the quality of engagements is a continual, dynamic process that involves an ongoing awareness of the quality risks that may arise in relation to the achievement of the quality objectives, and whether the responses are appropriately designed to address the quality risks.

After initial implementation, the quality objectives, quality risks and responses may need to be updated when:

(a) There are changes in factors that affect the system of quality management (i.e., the nature and circumstances of the firm and the engagements it performs, including the types of entities for

whom such engagements are performed). These factors are also affected by external factors, such as economic and social factors or law or regulation of a jurisdiction.

(b) Deficiencies are identified.

(c) The system may operate more effectively through new techniques, for example, new technology may become available.

Accordingly, how frequently a firm updates its system varies and is scalable to the nature and circumstances of the firm and the engagements it performs. For example, a small firm that performs compilation engagements for a largely similar client base every year may experience infrequent changes in the factors affecting the system of quality management. Furthermore, leadership in a small firm that are directly involved in the firm's day to day operations are likely to be more immediately aware of factors affecting the system of quality management that create a need for change. However, in the case of a large firm with a dynamic client base offering multiple services across multiple geographical locations, there may be ongoing changes in the factors that affect the system of quality management, and the information systems that need to be developed to ensure that information affecting the system is identified, communicated and appropriately responded to may be complex.

7. Are all of the requirements applicable to small firms, or firms that are sole practitioners?

Proposed ISQC 1 (Revised) requires the firm to exercise professional judgment in designing, implementing and operating its system of quality management. This means that professional judgment is exercised in implementing the requirements set out in the standard. The standard explains the factors that may affect these judgments.

In some circumstances, the requirements of proposed ISQC 1 (Revised) may not be relevant to the firm (i.e., paragraph 22 of the standard applies). For example, in the case of a sole practitioner with no staff the following requirements may not be relevant:

(a) Paragraphs 27(a)(iii), 27(b) and 27(c) in governance and leadership, which address the structures, reporting lines, and appropriate authorities and responsibilities within the firm, performance evaluations of firm leadership and the policies or procedures for complaints and allegations.

(b) Paragraphs 37(a)(ii) and 37(d) in relevant ethical requirements, which address the identification of personnel and others that are required to comply with the relevant ethical requirements and the annual confirmation of compliance with independence requirements.

(c) Paragraph 40(b) of resources, which addresses the assignment of personnel to engagements.

(d) Paragraph 43(a) of engagement performance, which addresses the direction, and supervision of engagement teams and review of their work.

(e) Paragraph 43(b) of engagement performance, which addresses the communication of information to the engagement team.

(f) Paragraph 43(d) of engagement performance, which addresses differences of opinion.

(g) Paragraph 45(a) of information and communication, which addresses communication internally within the firm and with the firm's network.

(h) Paragraphs 55 and 56 of monitoring and remediation, which address communication internally regarding matters related to monitoring and remediation.

Paragraphs A10, A16, A19, A23, A25, A30, A35, A48, A82, A87, A97, A117 and A181 of proposed ISQC 1 (Revised) provide specific examples of how the related requirements may be scalable to the circumstances of a smaller firm.

8. How does the information and communication component relate to the other components?

The information and communication component is critical to supporting the other components of the system of quality management. There may be quality risks related to information and communication that affect quality objectives across the components, for example, quality risks related to a lack of communication may affect the ability of firm leadership to make appropriate strategic decisions. There may also be responses in the information and communication component that address quality risks for other components, for example, the responses addressing the identification, capturing, processing and maintenance of relevant and reliable information may address multiple quality risks across the other components because of the variety of information used by the other components. Examples of information that is used by the other components include:

(a) Governance and leadership:

- Information to support decision-making.
- Information to plan resources appropriately, including anticipating resource needs.
- Information to undertake the periodic performance evaluations.

(b) The firm's risk assessment process:

- Information about the conditions, events, circumstances, actions or inactions that may affect the achievement of the quality objectives.
- Information about changes in the nature and circumstances of the firm or its engagements so that the quality objectives, quality risks and responses can be considered and updated.

(c) The monitoring and remediation process:

- Information to establish criteria for the inspection of engagements.
- Information in order to evaluate whether those performing monitoring activities have the experience, knowledge and capacity to perform the monitoring activity and are sufficiently objective from the activity subject to monitoring.
- Information from other sources in order to identify deficiencies in the firm's system of quality management.
- Information in order to investigate the root causes.
- Information to evaluate the effectiveness of the remedial actions.
- Information to support firm leadership's evaluation of the system of quality management.

9. Is the firm required to monitor the firm's risk assessment process?

The purpose of the firm's monitoring and remediation process is to support the evaluation of the design, implementation and operation of the components of the system of quality management. This includes the firm's risk assessment process. However, the activities the firm undertakes to monitor the responses in the other components may differ from the activities the firm undertakes to monitor the firm's risk assessment process. For example, the monitoring activities of the firm's risk assessment process may include an evaluation of matters such as:

(a) Who is assigned responsibility for the firm's risk assessment process.

(b) The process to identify and assess quality risks (i.e., how this is assigned throughout the firm, how the quality risks are collated and recorded and methodology for the assessment).

(c) How information is communicated such that changes in the system are identified.

(d) How often the system is reviewed to determine its continued relevance.

(e) The extent of involvement of firm leadership in the identification and assessment of quality risks.

10. Is the firm required to investigate the root cause of all deficiencies?

The firm is required to investigate the root cause of all deficiencies. However, the firm is required to scale the nature, timing and extent of the root cause procedures based on the nature of the deficiencies and their possible severity.

In some circumstances, the root cause may be obvious and the firm may need to do very little to identify the root cause. For example, in the circumstance of a small firm, there is likely an intimate knowledge of the firm and the root cause may be more easily identified. However, in other circumstances the firm's procedures for investigating the root cause may be more complex, for example, they may include:

(a) Identifying those responsible for performing the root cause analysis, and establishing their competency to do so, including providing training on how to effectively investigate the root cause.

(b) Conducting interviews of engagement teams and others, in order to gain insight into what may have caused the deficiency.

(c) Evaluating the evidence and other information available and identifying the root cause(s) based on such evidence.

(d) Performing a trend analysis.