

DRAFT EXAMPLES: HOW THE NATURE AND CIRCUMSTANCES OF THE FIRM AND THE ENGAGEMENTS IT PERFORMS AFFECT THE IMPLEMENTATION OF PROPOSED ISQM 1¹

This publication is a draft and has been prepared by a Task Force of the International Auditing and Assurance Standards Board (IAASB) based on the exposure draft of ISQM 1 (ED-ISQM 1). It is intended to illustrate how ED-ISQM 1 can be applied in a scalable manner by firms with varying circumstances. The scenarios described in this publication are hypothetical and have been simplified to illustrate key principles of applying the standard and do not:

- Include all factors regarding the nature and circumstances of the firm and its engagements for the examples provided;
- Include all quality objectives, quality risks or responses that may be necessary or appropriate; or
- Represent how a firm should document its quality objectives, identified and assessed quality risks and responses.

This publication will be reconsidered when ED-ISQM 1 is finally approved by the IAASB.

The exposure draft of proposed International Standard on Quality Management 1 (Previously International Standard on Quality Control 1²), *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*, was approved for exposure by the IAASB in December 2018. This publication has been developed to illustrate how the nature and circumstances of the firm and the engagements it performs affect the firm's implementation of ED-ISQM 1. In particular, the examples demonstrate that the scalability of the standard is achieved through tailoring the nature, timing and extent of responses designed and implemented by the firm. The illustration is intended to assist respondents in commenting on ED-ISQM 1.

The new quality management approach in ED-ISQM 1 requires a firm to **customize** the design, implementation and operation of its system of quality management based on the **nature and circumstances of the firm and the engagements it performs**.

¹ International Standard on Quality Management (ISQM) 1 (Previously International Standard on Quality Control 1), *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*

² International Standard on Quality Control (ISQC) 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

The scenarios in this publication address the topic of independence for illustrative purposes, however, this publication does not purport to show how firms should implement the International Independence Standards in the International Ethics Standards Board for Accountants' (IESBA) *International Code of Ethics for Professional Accountants*, nor has the publication been discussed with or reviewed or endorsed by the IESBA

Scenario 1: Small Firm that Performs Only Compilation Engagements	
Nature and circumstances of the firm and its engagements	A small firm in a single geographical location that performs compilations of financial statements under ISRS 4410 (Revised). ³ The only other services offered by the firm are tax services.
Quality objective	The firm establishes the quality objective in paragraph 32(b) of ED-ISQM 1: <i>The firm, its personnel and others subject to relevant ethical requirements fulfill their responsibilities in relation to the relevant ethical requirements, including those related to independence.</i>
Quality risk	The firm does not identify any quality risks relating to independence because the relevant ethical requirements that are applicable to the firm do not include requirements addressing independence when performing a compilation engagement. The firm identifies quality risks relating to other ethical requirements, but for the purposes of this publication these are not further explored in this illustration.
Response	The following response required by paragraph 33(d) of proposed ISQM 1 is not implemented because it is not relevant to the firm: <i>Obtaining, at least annually, a documented confirmation of compliance with independence requirements from all personnel required by relevant ethical requirements to be independent.</i>

³ International Standard on Related Services (ISRS) 4410 (Revised), *Compilation Engagements*

Scenario 2: Small Firm that Performs Compilation and Review Engagements

<p>Nature and circumstances of the firm and its engagements</p>	<p>A small firm in a single geographical location that performs compilations of financial statements under ISRS 4410 (Revised) and reviews of financial statements under ISRE 2400 (Revised).⁴</p> <p>The firm's clients are local owner-managed businesses operating in industries such as farming, manufacturing and retail.</p>
<p>Quality objective</p>	<p>The firm establishes the quality objective in paragraph 32(b) of ED-ISQM 1: <i>The firm, its personnel and others subject to relevant ethical requirements fulfill their responsibilities in relation to the relevant ethical requirements, including those related to independence.</i></p> <p>The firm establishes the following sub-objective for the quality objective in paragraph 32(b) of ED-ISQM 1 with respect to review engagements (i.e. a more granular quality objective): <i>The firm, its personnel and others subject to relevant ethical requirements fulfill their responsibilities in relation to independence requirements.</i></p>
<p>Quality risk</p>	<p><u>Identify quality risks</u></p> <p>The firm identifies a number of quality risks related to the sub-objective. Among those quality risks are the following three quality risks:</p> <ol style="list-style-type: none"> 1. Personnel and others subject to relevant ethical requirements do not comply with independence 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 of an engagement team member, or another individual with whom the engagement team member 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 family members of the firm's personnel may have financial interests in the firm's clients. <u>Effect on the achievement of a quality objective:</u> The firm determines that if the quality risk 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 in a position through which the individual is able to exert significant influence over the preparation of the entity's accounting records or financial statements.

⁴ International Standard on Review Engagements (ISRE) 2400 (Revised), *Engagements to Review Historical Financial Statements*

Scenario 2: Small Firm that Performs Compilation and Review Engagements

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 in such a position. This is because the firm operates in a small town and the firm's clients may therefore employ individuals who are related to, or have close relationships with, the firm's personnel.

Effect on the achievement of a quality objective:

The firm determines that if the quality risk 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 in a position through which the individual was able to exert significant influence over the preparation of the entity's accounting records or financial statements, or (ii) the individual provides services to the entity, such as in the capacity of director or officer.

Likelihood of occurrence:

The firm determines that there is a reasonable possibility that the firm may employ individuals who were recently employed in such positions at the firm's clients because the firm operates in a small town and the availability of individuals with appropriate financial knowledge and experience is limited.

Effect on the achievement of a quality objective:

The firm determines that if the quality risk 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.

Assess identified quality risks

In relation to the examples of the identified quality risks, the firm may assess the identified quality risks by determining:

1. The likelihood of occurrence. In identifying the quality risk, the firm has already established that there is a reasonable possibility of the risk occurring, but the assessment of the likelihood of occurrence is a more precise assessment of how probable it is that the quality risk will occur. For example, the firm may determine that quality risk 2 is more likely to occur than quality risk 1 or 3.
2. The effect on the achievement of a quality objective. In identifying the quality risk, the firm has already established that if the risk were to occur it may, individually or in combination with other quality risks, have a significant effect on the achievement of a quality objective. The assessment of the effect on the achievement of a quality objective is a more precise assessment of the magnitude of the effect on the quality objective. For example, the firm may determine that the effects of all of these quality risks are approximately the same.

Scenario 2: Small Firm that Performs Compilation and Review Engagements

Response

Examples of responses that the firm may design and implement to address the examples of the identified quality risks may include the following:

Responses required by ED-ISQM 1

1. The firm assigns operational responsibility for compliance with independence requirements to the firm's managing partner. (Paragraph 24(a)(iii)(b)) (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. (Paragraph 33(a)) (Relevant Ethical Requirements)
3. The firm identifies that the only individuals who are expected to comply with the relevant ethical requirements are personnel within the firm. (Paragraph 33(a)) (Relevant Ethical Requirements)
4. On an annual basis, all personnel are required to submit a written confirmation confirming their compliance with the independence requirements. (Paragraph 33(d)) (Relevant Ethical Requirements)

Other responses designed and implemented by the firm

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 compliance with the independence requirements, as follows: (Resources)
 - Upon hiring, personnel complete an online training course provided by a service provider, which covers the relevant ethical requirements. (Service Providers)
 - The firm uses the service provider to provide annual technical updates for all personnel, which cover 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. Engagement team members are required by the firm 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: Larger Firm With Multiple Locations that is Part of a Network and Performs Multiple Engagements

<p>Nature and circumstances of the firm and its engagements</p>	<p>A larger firm across multiple geographical locations that performs audits and reviews of financial statements and other assurance or related services engagements.</p> <p>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.</p> <p>The firm is a member of a small global network.</p>
<p>Quality objective</p>	<p>The firm establishes the quality objective in paragraph 32(b) of ED-ISQM 1: <i>The firm, its personnel and others subject to relevant ethical requirements fulfill their responsibilities in relation to the relevant ethical requirements, including those related to independence.</i></p> <p>The firm establishes the following sub-objective for the quality objective in paragraph 32(b) of ED-ISQM 1 with respect to audits, reviews and other assurance engagements (i.e., a more granular quality objective): <i>The firm, its personnel and others subject to relevant ethical requirements fulfill their responsibilities in relation to independence requirements.</i></p>
<p>Quality risk</p>	<p><u>Identify quality risks</u></p> <p>The firm identifies a number of quality risks related to the sub-objective. Among those quality risks are the following four quality risks:</p> <ol style="list-style-type: none"> 1. Personnel and others subject to relevant ethical requirements, including other network firms and personnel in the other network firms, 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 risk may occur, because the entities for which the firm provides services are listed (i.e., shares are publicly traded and widely held). <u>Effect on the achievement of a quality objective:</u> The firm determines that if the quality risk 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 obtain loans and guarantees from an entity that are not allowed by the relevant ethical requirements. <u>Likelihood of occurrence:</u> The firm determines that it is reasonably possible that the quality risk may occur, because the firm provides services to entities operating in the financial sector (i.e., increasing the likelihood that the entities from which loans or guarantees are obtained are clients).

Scenario 3: Larger Firm With Multiple Locations that is Part of a Network and Performs Multiple Engagements

Effect on the achievement of a quality objective:

The firm determines that if the quality risk 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(s) has a close relationship is employed in a position for which the individual is able to exert significant influence over the preparation of the entity's accounting records or financial statements

Likelihood of occurrence:

The firm determines that it is reasonably possible that the quality risk may occur because the entities for which the firm performs engagements have many employees.

Effect on the achievement of a quality objective:

The firm determines that if the quality risk 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 in a position for which the individual was able to exert significant influence over the preparation of the entity's accounting records or financial statements, or (ii) the individual provides services to the entity, such as in the capacity of director or officer.

Likelihood of occurrence:

The firm determines that it is reasonably possible that the quality risk may occur, because the entities for which 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 the quality risk 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.

Assess identified quality risks

In relation to the examples of the quality risks, the firm may assess the identified quality risks by determining:

1. The likelihood of occurrence. In identifying the quality risk, the firm has already established that there is a reasonable possibility of the risk occurring, but the assessment of the likelihood of occurrence is a more precise assessment of how probable it is that the quality risk will occur. For example, the firm may determine that it is more probable that the quality risk 1 will occur than quality risk 4.
2. The effect on the achievement of a quality objective. In identifying the quality risk, the firm has already established that if the risk were to occur it may,

Scenario 3: Larger Firm With Multiple Locations that is Part of a Network and Performs Multiple Engagements

individually or in combination with other quality risks, have a significant effect on the achievement of a quality objective. The assessment of the effect on the achievement of a quality objective is a more precise assessment of 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

Examples of responses that the firm may design and implement to address the examples of the identified quality risks may include the following:

Responses required by ED-ISQM 1

1. The firm assigns operational responsibility for compliance with independence requirements to the firm's Chief Ethics Officer. (Paragraph 24(a)(iii)(b)) (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. (Paragraph 33(a)) (Relevant Ethical Requirements)
3. The firm identifies the personnel within the firm and others who are expected to comply with the relevant ethical requirements, which includes other network firms and personnel in the other network firms. (Paragraph 33(a)) (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. (Paragraph 33(d)) (Relevant Ethical Requirements; and Network Requirements or Network Services)

Other responses designed and implemented by the firm

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 Network Requirements or Network Services)
 - 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 obtain loans and guarantees from a client of the firm.

Scenario 3: Larger Firm With Multiple Locations that is Part of a Network and Performs Multiple Engagements

- 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 during which an individual may not be an engagement team member following their employment with an entity.
 - A prohibition on providing certain 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 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 Network Requirements or Network Services)
 - 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 Network Requirements or Network Services)
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

Scenario 3: Larger Firm With Multiple Locations that is Part of a Network and Performs Multiple Engagements

- 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 by selecting a sample of individuals and requesting the individual to provide supporting documentation regarding the individual's and their relevant family members' 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 timely 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 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 Network Requirements or Network Services)

This document was prepared by a Task Force of the International Auditing and Assurance Standards Board (IAASB).

The objective of the IAASB is to serve the public interest by setting high-quality auditing, assurance, and other related standards and by facilitating the convergence of international and national auditing and assurance standards, thereby enhancing the quality and consistency of practice throughout the world and strengthening public confidence in the global auditing and assurance profession.

The [IAASB](#) develops auditing and assurance standards and guidance for use by all professional accountants under a shared standard-setting process involving the [Public Interest Oversight Board](#), which oversees the activities of the IAASB, and the IAASB Consultative Advisory Group, which provides public interest input into the development of the standards and guidance. The structures and processes that support the operations of the IAASB are facilitated by the International Federation of Accountants (IFAC). For copyright, trademark, and permissions information, please go to [permissions](#) or contact permissions@ifac.org.



**International Auditing
and Assurance
Standards Board**

529 Fifth Avenue, New York, NY 10017
T + 1 (212) 286-9344 F +1 (212) 286-9570
www.iaasb.org