

The Changing Audit Environment

Key Note Speech by *Prof. Arnold Schilder, Chairman, International Auditing and Assurance Standards Board (IAASB)*

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Good afternoon ladies and gentlemen. It is my pleasure to be here, certainly because of the opportunity to hear perspectives on the important and relevant topics on today's agenda. However, it is also because this is my first visit to Baruch College—I must say how impressed I am by the cultural diversity of the college's faculty and student base, and the broad range of countries they represent. Even more impressive, if I may say, is the college's namesake, Mr. Bernard Baruch himself. At the end of his productive, 95 year life, he is quoted as saying, "*I have had a long life, a good one and a full one. But above all I have had the opportunity to serve my country. This has meant most to me.*" I am privileged to have such a fitting backdrop for my update on the activities of the IAASB.

The Changing Audit Environment

The speakers before me today already have rightly noted that there is a lot happening in today's audit environment. Indeed, the environment *is* changing. The nature of financial reporting continues to evolve: now more complex, more areas of judgment, and more qualitative disclosures. There is changing demand from users, which can be summarized as "we want to hear more"—a call directed not only to preparers of financial statements but also to auditors and others involved in the financial reporting supply chain. Then, as a result of the global financial crisis, some key questions were raised: about the quality of auditing, its effectiveness, and the role of professional skepticism and judgment; and perhaps more fundamental, about the relevance of the audit. For example, if auditors did all that they were supposed to do, yet still did not warn of the risks leading to the financial crisis, what then is the relevance of the audit? I do not see this as a criticism per se. Rather, it is an important inquiry as to whether audit could deliver more – an essential question that must be considered in the wider context of trust in the profession.

As a result, there are many important debates on auditing now happening in Europe, North America, and elsewhere. These debates acknowledge—indeed, emphasize—the importance of ongoing and structured dialogue among, and between, many stakeholders. Audit regulators, for example, are further increasing their dialogue at an international level, and I am pleased to note the leadership of Lew Ferguson, Chairman of the International Forum of Independent Audit Regulators (IFIAR), and Deputy Chair Janine van Diggelen in this regard. These developments underscore the essential importance of interactions among participants as the basis for further improving audit quality.

Interactions

Let me to pause a moment to explore a little further the idea of interactions. This concept has received attention over many decades.

In the early 1930s we learned from the Dutchman Prof. Theodore Limperg, who referred to the relevance of interactions between stakeholders and to the accountancy profession serving a fundamental public interest need. I quote: "*The place that accountants occupy in the community, and the confidence inspired by them, are the result of the interaction of the needs of the community and of the manner in which accountants meet those needs.*"

Fifty years later this theme was picked up by a Scotsman, Prof. David Flint, who said: *“Audit’s foundation in social need is a crucially important characteristic. In a changing and developing society the interpretation of the practical implementations of the audit concept must be the result of a constant interaction between the relevant groups and the auditors.”*

In between, there was a monograph in the United States by Mautz and Sharaf, who also described these concepts and further emphasized the importance of interactions.

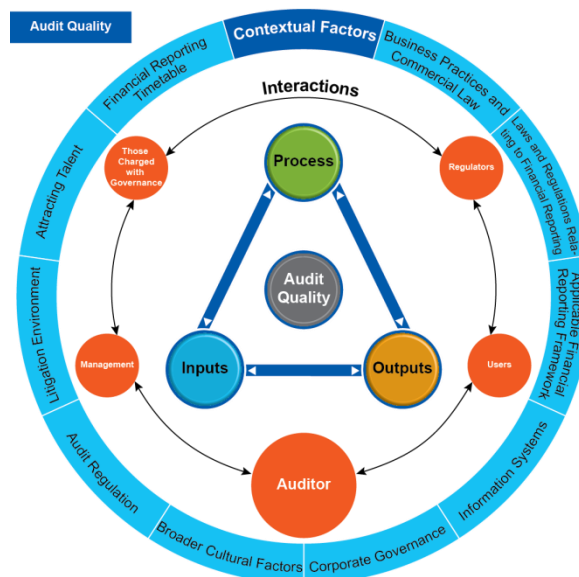
Throughout history, therefore, it is clear that there has been a strong call for professional accountants to act in the public interest and to take into account the expectations society places on them, and to understand these expectations and respond to them through meaningful interactions. Interactions, therefore, in my view, is more than a concept – rather, an essential and fundamental principal underpinning what we do.

With this backdrop, allow me to highlight some of the IAASB’s key responses to current developments.

Enhancing the Value of Audit

Audit Quality

At its meeting next week, the IAASB intends to finalize a new publication entitled *A Framework for Audit Quality: Key Elements that Create an Environment for Audit Quality*. Our simple but essential goals for this Framework are to: raise awareness of the key elements of audit quality; encourage key stakeholders to reflect on ways to improve audit quality; and facilitate greater dialogue between key stakeholders on the topic. The Framework is qualitative in nature, describing not only the different elements that create the environment for audit quality at the engagement, firm, and national levels, but also, importantly, their interrelationships. It elaborates on input, process, and output factors, as well as interactions in the financial reporting supply chain and contextual factors. The essence of the Framework is depicted below:



In considering audit quality, focus is often placed on input and process factors, such as standards, methodology, education and training, etc. These are certainly essential, but we should not stop there. Consider the importance of output factors: what users of financial statements see and read on which they base their perceptions and conclusions of audit quality. The current developments in auditor reporting, therefore, are very important. Also consider, for example, context factors such as culture, corporate

governance, and the regulator regime and litigation environment. They have the potential to impact financial reporting and directly or indirectly audit quality, and auditors need to respond properly to them. Finally, consider all those involved in the financial reporting process—from the auditor, who is ultimately responsible for audit quality, to management, regulators and inspectors, audit committees, and users. Their roles, and the interactions they have, influence the environment in which audits are conducted, and their actions can meaningfully and positively contribute to audit quality.

We are certainly interested in the U.S. Public Company Accounting Oversight Board (PCAOB)'s efforts on the topic of Audit Quality Indicators, and we will continue to monitor developments. We are simply approaching the issue of audit quality from different, but complementary, perspectives. Our next steps will be to continue the dialogue on audit quality and stimulate organizations to use the Framework in exploring how best they might contribute to helping improve audit quality.

New Proposals for Auditor Reporting

Now, let me turn to the topic of the auditor's report. Informed by international academic research, global outreach to stakeholders, and two consultation papers, the IAASB unanimously approved and released in July this year a comprehensive exposure draft of proposed new and revised International Standards on Auditing (ISAs) addressing reporting on audited financial statements.

I am pleased to note the degree of similarity between our auditor reporting proposals and those of the PCAOB, which were released shortly after the IAASB's. The ongoing dialogue between the boards' leadership and senior staff on this topic had, in my view, helped achieve this positive outcome. We have focused similar efforts in relation to developments in Europe, holding constructive meetings with senior representatives of the European Commission, European Parliament, and Council of the European Union. These actions supplement our broader outreach efforts on auditor reporting globally.

There are many important changes proposed to the auditor's report—for example, clarification of the responsibilities of the auditor, and giving greater prominence to the auditor's opinion within the report. But let me focus in on one of the more fundamental changes we propose: new ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*. This proposal involves a new section in the auditor's report to communicate those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period.

Communicating key audit matters is not a tick in the box. It requires professional judgment, and a careful consideration of what is unique about the specific entity and the specific audit undertaken—and therefore the matters of relevance to users of the auditor report and the entity's financial statements. The required thought process is inherently no different than that the auditor would go through when preparing for discussion with the entity's audit committee—a focus on what is important and relevant.

The proposed standard directs the auditor to select key audit matters from those matters communicated with the audit committee. Some have expressed concern that this may prompt the auditor to not communicate certain matters to the audit committee if there is pressure from management against bringing further transparency to an issue, and therefore the standard should indicate a broader source from which the auditor would consider the matters to communicate in the auditor's report. However, I believe we must continue to appeal to the 'backbone' of the auditor to not concede to any such pressure and to communicate what is necessary in the circumstances. In any event, irrespective of the starting point, when there is a key audit matter to be communicated the auditor will certainly inform the audit committee.

I am very pleased that many countries and firms already are preparing now in anticipation of the new standards. For example: the UK has introduced similar new standards; last week while I was visiting the professional and regulatory bodies in Vietnam there was much discussion on how best they may prepare; and several firms already are 'field testing' the proposals. As the IAASB moves forward, we will study and respond to comments on our exposure draft and maintain an active dialogue with stakeholders. We have heard the call for continued effort towards a global solution, and we will therefore stay in close contact with the PCAOB and others as developments progress.

The IAASB is fully committed to finalizing its new auditor reporting standards in 2014. I anticipate they will result in significant change to the way auditors communicate information about their audits. They will also be critical to improving the perceived value and relevance of the auditor's report and the profession as a whole. It is therefore essential that the intentions of the auditor reporting proposals be achieved, and their full benefit realized. Our work on this important topic will therefore not end in 2014—we anticipate taking actions in 2015 and beyond to facilitate adoption and implementation of these standards, including a review after a period of implementation.

Further Enhancement of the Clarified ISAs

Today there are 92 jurisdictions already using the Clarified ISAs, or committed to using them in the near future, and we anticipate more in 2014. In light of this increasing global use of the Clarified ISAs, we seek to capitalize on opportunities to learn about the implementation experience, whether the standards are operating with the intended effects, and where further enhancements may be necessary. In this regard, we have continued our active dialogue with international and national regulatory and audit oversight bodies—strengthening our relationships with groups such as IFIAR, the International Organization of Securities Commissions, the World Bank and the Basel Committee on Banking Supervision. These groups, together with input from both larger firms and smaller practices, national standards setters and others, have been instrumental in providing feedback to the IAASB's post-implementation review of the Clarified ISAs.

In this regard, the overall feedback has been positive: the Clarified ISAs are more understandable and better fit for purpose, and the revisions to their content a positive contribution to audit quality. Nevertheless, there were also some areas where future review may be appropriate: professional skepticism, quality control, and group audits. In addition, the IAASB has been encouraged to consider new developments in the environment of the audit, such as "big data" and data analytics, and emerging IT risks, and how these may affect standards addressing risk assessment and evidence gathering. Responding to this feedback on the other findings from the Clarity ISA post-implementation review will feature prominently in our future Strategy and Work Program.

Looking Ahead

This brings me to my last topic, the IAASB's forward strategy.

At its meeting next week, the IAASB intends to finalize for public consultation our strategy for 2015-2019 and the related work plan for 2015-2016. The proposal will include action in a number of areas, including responding to the findings from our ISA implementation monitoring review, supporting the implementation of the new auditor reporting standards, and addressing auditing issues related to financial institutions, including fair value estimates and loan impairment.

Audits of financial statements, however, are not the only service provided by professional accountants for which there is a demand for international standards. I am therefore pleased that in September the board

completed the revision of its umbrella assurance standard, ISAE 3000. This standard serves as an important platform for a wide range of assurance engagements by both large and smaller practices, and supports continued innovation in services. We also established our *Innovation, Needs, and Future Opportunities* Working Group to monitor emerging developments in assurance and related services. Our forward strategy, therefore, will also include efforts to monitor the adoption and implementation of IAASB's other assurance and related services standards, and consideration of new assurance standards, e.g. in relation to Integrated Reporting.

In Conclusion

Our efforts need to continue to be focused and ambitious. All of us, in our individual capacities and collectively, need to seize the global momentum for stronger corporate and auditor reporting. There will be challenges, but they are not insurmountable.

There will continue to be critical comments with regard to the relevance and effectiveness of audit and assurance, in light of the financial crisis and findings from audit inspections across the world. However, underlying these comments are the positive expectations that many have of the contributions that professional accountants can make to this global, dynamic marketplace, and, in turn, to financial stability and trust. That is the public interest that all of us want to serve.

For me, the essence of our role has not been better expressed than through the compelling words of Mahatma Gandhi: "*Be the change that you wish to see in the world.*"

Thank you for your attention.