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Financial Reporting Council

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The International Auditing and Assurance Standards Board

Re: A Framework for Audit Quality

Dear Mr Gunn

I refer to the Consultation Paper issued by the International Audit and Assurance Standards Board (IAASB) in January 2013 entitled 'A Framework for Audit Quality'.

I am pleased to attach a submission by the Financial Reporting Council (FRC). I would like to thank you for giving us an opportunity to comment on your proposals.

The FRC is currently conducting a number of audit quality projects as part of its role in providing strategic advice. The FRC Audit Quality Committee has been specifically tasked with assisting the FRC in providing advice on audit quality to the Australian Government.

Please feel free to contact me or the FRC Secretary (frcsecretary@treasury.gov.au) should you have any queries regarding the FRC submission.

Yours sincerely

A handwritten signature in cursive script that reads "Lynn Wood".

Lynn Wood
FRC Chairman

SUBMISSION OF THE AUSTRALIAN FINANCIAL REPORTING COUNCIL ON THE IAASB CONSULTATION PAPER 'A FRAMEWORK FOR AUDIT QUALITY'

Summary

The recommendations in this submission may be summarised as follows:

- A key point is that the Australian Financial Reporting Council (FRC) supports the development of a Framework for Audit Quality, and strongly supports the IAASB's ongoing interest in improving audit quality.
- The involvement of all participants in the financial reporting supply chain is needed in order to improve audit quality.
- There is merit in further considering the objective of the audit process, for which we have proposed a working definition, as well as the difference between audit failure and corporate failure.
- How audit quality is evaluated by regulators is an important consideration, including the relative weight placed on documentation and auditor judgement/scepticism, which can influence behaviours.
- International liaison to improve the processes for monitoring audit quality should be encouraged, which could be facilitated by a definition of audit quality.

Overview

The Australian Financial Reporting Council (FRC) is pleased to provide input into the IAASB consultation processes on the proposed Framework for Audit Quality (the Framework).

The FRC is the key external advisor to the Australian Government on the financial reporting system. In summary, its functions are to provide broad oversight of the processes for setting accounting and auditing standards for the public and private sectors, to provide strategic advice on the quality of audits conducted by Australian auditors, and to advise the Minister, and in some areas the professional accounting bodies, on these and related matters to the extent that they affect the financial reporting system in Australia.

The FRC monitors the development of international accounting and auditing standards, works to further the development of a single set of accounting and auditing standards for world-wide use and promotes the adoption of these standards. The FRC's Audit Quality Committee assists the FRC to provide advice to the Australian Government on audit quality.

The FRC has a wide range of stakeholders including a broad spectrum of preparers and users of financial reports, the Australian Government, State and Territory Governments, and other government bodies such as standard setters and regulators. Key stakeholder bodies are represented on the FRC as members. In addition, the Australian and New Zealand Governments have established cross-appointment arrangements to promote closer economic relationships between the two countries. The FRC accordingly has a New Zealand representative as one of its members.

The FRC strongly supports the IAASB's ongoing interest in improving audit quality at the international level through initiatives such as proposed improvements to the auditor's report and the development of the Framework.

The objective of the Framework is to improve audit quality. The FRC considers that the Framework would benefit from a succinct working definition of audit quality. The FRC proposes a possible working definition of audit quality as “the likelihood of the audit achieving the fundamental objective of the audit which is to obtain reasonable assurance that material misstatements in the overall financial report are detected, and addressed or communicated to relevant stakeholders.”

The FRC has responded to the questions posed about the Framework with this working definition in mind. There could also be merit in distinguishing between the terms ‘audit quality’ and the ‘quality of individual audits’ if necessary.

1. Does the Framework cover all of the areas of audit quality that you would expect? If not, what else should be included?

The Framework comprehensively covers key influences on audit quality. It is of particular importance that the Framework breaks down the areas by level (engagement/firm/national) and inputs (values/knowledge/processes) in order to effectively cover the spectrum of influences on audit quality.

The Foreword from the IAASB Chairman proposes that a quality audit is likely to be achieved when the auditor’s opinion on the financial statements can be relied upon (pp. 10). Audit is designed to provide reasonable assurance, rather than absolute assurance, about the financial reports.¹ As such, it may be more appropriate to cast audit as enhancing the degree of confidence of intended users in the financial statements, as noted in paragraph 1 of the Framework. This is consistent with the approach taken in paragraph 8 of the Framework.

We note the reference to the deterrence effect of audit in relation to fraud (paragraph 44). While one of the responsibilities of an auditor is to try to identify any material misstatement in the financial statements due either to error or fraud, the risk of the auditor not detecting a material misstatement resulting from fraud is higher, due to the likely concealment involved, compared to the risk of not detecting misstatements resulting from error. If this point is retained in the Framework, it would be useful to also note that the primary responsibility for the prevention and detection of fraud lies with the company management and those responsible for governance.

Further to the above point, the FRC supports the acknowledgement that improving audit quality depends upon all participants in the financial reporting supply chain, despite audit quality remaining the primary responsibility of the external auditor. The external audit relies on input from a number of other participants, including the compilation of information by management and the endorsement of the accounts by those charged with governance. Australia’s corporation’s law supports these interactions by requiring that company officers provide auditors with key information, formalising relationships between the board and the external auditor and requiring directors to declare that the financial reports comply with accounting standards and are a true and fair view of the company’s position and performance. Australia’s corporation’s law also acknowledges the responsibility of each participant in the financial reporting supply chain to act in the interest of company stakeholders (paragraph 34).

¹ ASA 200 *Overall Objectives of the Independence Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards*

2. Does the Framework reflect the appropriate balance in the responsibility for audit quality between the auditor (engagement team and firm), the entity (management and those charged with governance), and other stakeholders? If not, which areas of the Framework should be revised and how?

The Framework appropriately balances the responsibility for the oversight and completion of the audit. While in practice it is likely that the Framework will be more relevant for participants who have a clear connection to audit processes (such as auditors and audit regulators), there is merit in contextualising their role in relation to other participants in the financial reporting supply chain.

The Framework could seek to revise or enhance paragraphs that consider the interactions between users of financial statements and auditors, management, governance and audit regulators. The Framework could also identify possible means by which shareholders or their representatives could better hold those charged with governance to account. This may require further emphasis on the role of management in preparing the financial reports and those charged with governance in endorsing the financial reports.

Following high profile corporate collapses in Australia, claims have been made that audit failures, namely in relation to the application of the going concern principle, have contributed to corporate failures. There may therefore be merit in distinguishing between audit failure and corporate failure and considering any relationship between them. Users should be able to rely on audited financial reports to make investment decisions. These investment decisions, however, can be based on unaudited information accompanying the financial statements. From this perspective, it does not necessarily follow that all users of financial statements would necessarily like more resources allocated to audit to improve audit quality, especially where additional costs would be incurred (paragraph 13).

The Framework could also enhance the coverage of the role of regulators (both audit regulators and financial and prudential regulators) to reflect the importance of a robust regulatory environment on the likelihood of a material error being found.

In late 2012 the Australian Securities and Investments Commission (ASIC) released its Audit Inspection Program Report for 2011-12 (the ASIC Report), which revealed perceived deficiencies in Australian audit firms. Consistent with other international audit regulators, the ASIC Report identified a need for the sufficiency and appropriateness of audit evidence obtained by the auditor to be improved. The ASIC Report process generally adopted an 'if it is not documented, it is not done' approach, also providing audit firms with the opportunity to describe the details of work that was completed but not documented in order to more accurately reflect auditor behaviour on issues requiring auditor judgement and scepticism.

More generally, the Framework could further consider the appropriate balance between auditors focusing on audit documentation and use of professional judgement. In particular, it is important that firms ensure that audit staff apply judgement in all aspects of the audit including selecting audit procedures rather than a 'tick-a-box' approach.

The FRC understands that audit regulators are currently working with the large audit firms internationally through the International Forum of Independent Audit Regulators to promote audit quality and encourage the firms to improve their measures of audit quality. The FRC supports this liaison, including possible discussion of processes for measuring audit quality.

3. How do you intend to use the Framework? Are there changes that need to be made to the form or content of the Framework to maximize its value to you?

The Framework could be useful in assessing the effectiveness of the audit process. For example, in order to assess whether audits conducted by Australian auditors are likely to obtain reasonable assurance that misstatements are detected, a regular assessment of auditor values, ethics and attitudes, required knowledge and audit processes will assist in identifying weaknesses that may be addressed in order to improve audit quality. The Framework's consideration of different audit practices also provides a useful basis for discussions on possible audit reforms.

4. What are your views on the suggested Areas to Explore? Which, if any, should be given priority and by whom? Are there additional Areas to Explore?

Reflecting features of the audit industry (for example, principal-agent issues and information asymmetries), it is likely that audit quality will benefit from regular monitoring. The Areas to Explore that are identified should assist ongoing discussions about how best to monitor and, if necessary, improve audit quality.

The FRC supports the further consideration of best practice governance standards for audit firms and of improving the role of the audit regulator through information exchange mechanisms. Improvements to the flow of information between regulators and audit firms may mediate what may be an otherwise adversarial relationship and establish a mutually supportive means of improving audit quality.

The FRC also supports the consideration of 'root causes' of audit failure and best practice by regulators, audit firms and the wider audit profession, especially where proposals are developed that have the potential to impact a number of international jurisdictions.

Additionally, other Areas to Explore may warrant further work. With reference to the sharing of information between audit firms, industry competition and concerns about litigation remain possible impediments that could be considered in more detail. The proposed harmonization of the role of audit committees could also encounter obstacles relating to the difficulty in harmonizing diverse audit committee practices.² The FRC believes that it could be more effective to establish best practice standards in relation to audit committees and to assess their effectiveness in a range of jurisdictions rather than pursuing the harmonization of standards regarding audit committees between jurisdictions.

² Recent studies have revealed the extent to which practices differ in the European region alone. Federation of European Accountants (FEE) The Functioning of Audit Committees: Discussion Paper, June 2012
http://www.fee.be/images/publications/company_law/Discussion_Paper_on_Audit_Committees_120615156201218855.pdf