



ICGN

International Corporate Governance Network

May 16, 2016

Ms. Kathleen K. Healy
Technical Director
International Auditing and Assurance Standards Board
545 Fifth Avenue, 14th Floor
New York, New York 10017 USA

Re: Invitation to Comment, Enhancing Audit Quality in the Public Interest: A Focus on Professional Skepticism, Quality Control and Group Audits

Dear Ms. Healy,

On behalf of the International Corporate Governance Network (ICGN), we thank you for the opportunity to provide our comments on the International Auditing and Assurance Standards Board's (IAASB) on the *Invitation to Comment, Enhancing Audit Quality in the Public Interest: A Focus on Professional Skepticism, Quality Control and Group Audits (the ITC)*. ICGN appreciates the opportunity to comment and sees the importance of providing an international perspective to the ITC. ICGN is a global investor-led membership organization of over 670 institutional and private investors, corporations and advisors from 48 countries. Our investor members are responsible for global assets of over US\$26 trillion.

ICGN's mission is to promote effective standards of corporate governance and investor stewardship to advance efficient markets and sustainable economies world-wide. In doing so, ICGN encourages cross border dialogue at conferences and influences corporate governance public policy through its committees. We promote good practice guidance, encourage leadership development and keep our members informed on emerging issues in corporate governance through publications and the ICGN website. Information about the ICGN, its members, and its activities is available on our website: www.icgn.org.

The ICGN Accounting and Auditing Practices Committee addresses and comments on accounting and auditing issues from an international investor and shareowner perspective. The committee through collective comment and engagement strives to ensure the quality and integrity of financial reporting around the world: www.icgn.org/policy/committees/accounting-and-auditing.

The ICGN, as a global investor organization, believes that audit is essential to investor confidence in companies. We are very supportive of the IAASB's

important and continuing work to enhance audit quality in the public interest and the value of the audit and audit quality for users-- including enhancing the audit report. We appreciate the IAASB's efforts to consult the wider user community to better understand their views on these important topics. ICGN has commented on a number of the IAASB's consultations, including, *Improving Audit Quality, 24 September 2012; Consultation Paper – A Framework for Audit Quality, 9 May 2013; Auditor's Responsibilities relating to other information, 14 May 2013; and Reporting on Audited Financial Statements, Proposed new and revised International Standards on Auditing (ISAs) –Auditor Reporting*. In doing so, the ICGN has consistently emphasized that the external auditor should “challenge management’s judgment in relation to accounting estimates made and its assessment of risk,”¹ and that “investors value an independent and objective audit opinion.”² The ICGN has been focused on audit quality which is the focus of this ITC. We are pleased to provide comments on some of the specific questions posed in the ITC.

G1. Table 1 describes what we believe are the most relevant public interest issues that should be addressed in the context of our projects on professional skepticism, quality control, and group audits. In that context:

(a) Are these public interest issues relevant to our work on these topics?

(b) Are there other public interest issues relevant to these topics? If so, please describe them and how, in your view, they relate to the specific issues identified.

The seven selected issues in Table 1 all appear to be relevant to the IAASB's work in relation to professional skepticism, quality control and group audits. Each issue is important, but there should be special emphasis on the issues that “enhance the quality of audits and the value of the audit for users.”³ The ICGN believes that the primary responsibility for performing quality audits rests with auditors. The IAASB should continue to challenge audit firms about what more they can do to increase audit quality. We agree that the appropriate application of professional skepticism is “core to audit quality” and encourage the IAASB to focus on those areas that support greater

¹ 24 September 2012, ICGN letter to IAASB re: Improving the Auditor's Report. <https://www.icgn.org/sites/default/files/IAASB%20-%2024.09.2012.pdf>

² 26 November 2013, ICGN letter to IAASB re: *Reporting on Audited Financial Statements, Proposed new and revised International Standards on Auditing (ISAs) –Auditor Reporting*. https://www.icgn.org/sites/default/files/IAASB%20-%2026.11.2013_0.pdf

³ 9 May 2013, ICGN Letter to IAASB re: *Consultation Paper- A Framework for Audit Quality*. https://www.icgn.org/sites/default/files/IAASB%20-%2009.05.2013_0.pdf

consistency in its application by auditors in making professional judgments and taking appropriate actions.⁴

G2. To assist with the development of future work plans, are there other issues and actions (not specific to the topics of professional skepticism, quality control, and group audits) that you believe should be taken into account? If yes, what are they and how should they be prioritized?

Investors are increasingly more focused on the long term. Therefore, more forward-looking information from companies regarding their expectations for achieving long-term strategic objectives is more relevant to investor decision making than the current audited financial statements provide. While many companies are providing such information outside of the financial report, generally the information is not accompanied by auditor assurance to provide investors with confidence of its veracity. Moreover, with the increasing focus on ESG-related issues, especially climate change, we encourage the IAASB to consider whether current auditing standards can be responsive to these new developments and allow the audit to evolve alongside changes to financial and non-financial reporting.

G3. Are you aware of any published, planned or ongoing academic research that may be relevant to the three topics discussed in this consultation? If so, please provide us with relevant details.

There are many articles that address the issues raised in the ITC. Below are some examples:

Mark W. Nelson, Chad A. Proell, and Amy E. Randel (2016) *Team-Oriented Leadership and Auditors' Willingness to Raise Audit Issues*. The Accounting Review In-Press, highlights the importance of team-oriented leaders in auditors' willingness to raise audit issues.

Sarowar Hossain, Gary S. Monroe, Mark Wilson, and Christine Jubb (2016) *The Effect of Networked Clients' Economic Importance on Audit Quality*. AUDITING: A Journal of Practice & Theory In-Press, examines interlocking networks of audit clients to understand the effects of audit partner from other companies in the network on audit quality.

Elizabeth Carson, Roger Simnett, Greg Trompeter and Ann Vanstraelen (2014) *The Impact of Group Audit Arrangements on Audit Quality and*

⁴ ITC, p. 7.

Pricing,⁵ explores the role of monitoring in group audits by audit firms and regulators.

Sanaz Aghazadeh, Yoon Ju Kang, and Marietta Peytcheva (2014) *How do Behavioral Indicators of Audit Committee Effectiveness Influence Audit Effort?*⁶ Researchers found that audit effort is highest when the audit committee is least effective because auditors' assessment of a weak tone at the top will lead auditors to increase their assessment of control risk. More effective audit committees increase auditor accountability for their judgment and decision making process regarding significant accounting issues.

Professors Steven M. Glover and Douglas F. Prawit (2013) *Enhancing Auditor Professional Skepticism*,⁷ considers the importance of developing a shared understanding of what professional skepticism is, how it should be applied, the threats to professional skepticism and the safeguards that may be cost effective.

David Plumlee, Brett A. Fixom, Andrew J. Rosman (2012) *Training Auditors to Think Sceptically*.⁸ Researchers found that auditors trained to apply professional skepticism through a diagnostic reasoning process are much more likely to choose the correct explanation in a skepticism-inducing audit simulation.⁹

PS1. Is your interpretation of the concept of professional skepticism consistent with how it is defined and referred to in the ISAs? If not, how could the concept be better described?

ICGN views professional skepticism as critical to investor confidence and requires a challenging, questioning approach to the audit be undertaken by all on the audit team. The ISA definition of professional skepticism is that it is “an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.”¹⁰ ICGN believes these important concepts would be more

⁵ See; http://www.isarhq.org/2014_downloads/papers/ISAR2014_Carson_Simnett_Trompeter_Vanstraelen.pdf

⁶ Available at http://isarhq.org/2014_downloads/papers/ISAR2014_Aghazadeh_Kang_Peytcheva.pdf.

⁷ Available at <http://www.thecaq.org/docs/research/skepticismreport.pdf>.

⁸ Available at http://web.ku.edu/~audsymp/myssi/_pdf/Plumlee%20et%20al.%202012%20Training%20Audit%20ors%20to%20Think%20Skeptically%20-%20April%202012%20KU%20Symposium.pdf.

⁹ The researchers determined that the notion of a “questioning mind” that is embodied in auditing standards governing professional scepticism “translates into a diagnostic-reasoning framework because scepticism involves identifying, investigating, and resolving evidence that is unexpected.” See pp. 4-5.

¹⁰ ISA 200, par. 13(I).

operational if the audit literature more clearly connected them with actions the auditor should take to demonstrate and document how they apply skepticism. A clearer definition of professional skepticism might outline its relationship to professional judgments that prompt the auditor to act.¹¹

PS2. What do you believe are the drivers for, and impediments to, the appropriate application of professional skepticism? What role should we take to enhance those drivers and address those impediments? How should we prioritize the areas discussed in paragraph 37?

The ICGN believes that audit quality is primarily dependent on the objectivity, independence and professional skepticism of the auditor. We think it is important to have robust professional standards, rules, and internal policies and procedures at the audit firms that deal with the threat of familiarity between the auditor, the entity and management.

The ICGN believes that enhanced auditor reporting may indirectly drive professional skepticism by the auditor on significant audit risks by providing more transparency into the audit process, including actions taken by the auditor to address key audit matters. Additionally, we believe that the disclosure of the engagement partner's name in the audit report improves transparency.

We think staffing requirements, along with training, are additional attributes that may impact the level of auditor skepticism exhibited during the audit. We believe increased training and the culture of the audit firm can be major factors in instilling auditor skepticism.

Among those areas for further exploration by the Joint Working Group that comprises the IAASB, IAESB, and IESBA, the ICGN recommends that the following be prioritized:

- The role of engagement partners, engagement quality reviewers, audit committees, audit oversight bodies and others in influencing the appropriate application of professional skepticism, and
- How auditor training can be enhanced to further develop the application of professional skepticism.

PS3. What actions should others take to address the factors that inhibit the application of professional skepticism and the actions needed to mitigate them?

¹¹ For example, the diagram on p. 13 of the Overview illustrates how professional scepticism is applied in making professional judgments and driving action.

There is a need for education, ethics training, leadership training and regulatory monitoring and enforcement. Organizations and regulators focused on those items are in a position to address the factors that inhibit the application of professional skepticism.

Business is increasingly complex and global in nature, which in turn affects the skills and staffing requirements needed to conduct a high quality audit. Increased training of auditors, from junior members to partners and mid-career professionals, will give auditors up-to-date technical skills, assist in developing professional skepticism, and help identify potential material audit “misses.” The application of an appropriate degree of professional skepticism is a crucial skill for auditors. Unless auditors are prepared to challenge management’s assertions, they will not act as a deterrent to fraud nor be able to confirm, with confidence, that a company’s financial statements give a true and fair view.

The ICGN also would suggest that professional schools of accountancy at universities provide better and more targeted coursework for auditors that prepare them through simulations on the appropriate application of professional skepticism under various audit scenarios.

All participants in the financial reporting supply chain need to exercise skepticism. Companies, including internal audit, those that govern, and audit firms must exercise skepticism and promote an environment that encourages questioning and challenge. The tone at the top and culture of companies, along with whistle blower protections, support an environment in which auditors and others are encouraged to challenge management about whether their assertions are reasonable and to challenge themselves as to whether sufficient appropriate audit evidence was obtained.

Greater transparency into the root causes of findings of lack of professional skepticism by independent audit regulators and audit firms in conducting their reviews of individual audits could drive better auditor performance. An approach to this is being implemented by the U.K. Financial Reporting Council (FRC) in requiring, on a comply or explain basis, audit committees to disclose significant findings from audit quality reviews in the annual report and how they and the auditors were responding to the issues raised.¹² The FRC’s decision to periodically publish the names of the companies the audits of which were subject to an Audit Quality Review provides a basis for investors

¹² *FRC Statement: Transparency of AQR Findings* (20 Nov. 2014), available at <https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2014/November/Transparency-of-AQR-Findings.aspx>.

to make companies and their auditors accountable for making appropriate disclosures.¹³

QC1. We support a broader revision of ISQC 1 to include the use of a quality management approach (QMA) as described in paragraphs 51–66. (a) Would use of a QMA help to improve audit quality? If so why, and if not, why? What challenges might there be in restructuring ISQC 1 to facilitate this approach?

Emphasizing the responsibility of firm leaders in audit quality should have a positive impact. Each firm is a business and, to be successful, leaders should mainly be focused on the long-term success of their businesses. For public company auditors this means being responsive to the needs of its clients, which are investors.

(b) If ISQC 1 is restructured to require the firm’s use of a QMA, in light of the objective of a QMA and the possible elements described in paragraph 65, are there other elements that should be included? If so, what are they?

The elements outlined in paragraph 65 if followed would appear to lead to quality audits.

QC2. We are also thinking about revising our quality control standards to respond to specific issues about audit quality (see paragraphs 67–83).

(a) Would the actions described in paragraphs 68–83 improve audit quality at the firm and engagement level? If not, why?

The actions described in paragraphs 68-83 should improve audit quality by further ensuring that firms respond appropriately to inspection findings. The focus is at the firm level. Paragraphs 67-83 suggests that addressing network issues would be very challenging (71). Given the importance of networks in coordinating global audits, there should be strong effort to address quality controls at the network level as well.

GA1. We plan to revise ISA 600 (and other standards as appropriate) to respond to issues with group audits.

(c) Should we further explore making reference to another auditor in an auditor’s report? If yes, how does this impact the auditor’s work effort?

¹³ FRC, *Feedback Statement and Impact Assessment, Enhancing Confidence in Audit: Proposed Revisions to the Ethical Standard, Auditing Standards, UK Corporate Governance Code and Guidance on Audit Committees* (April 2016), p. 23.

Each auditor or other entity doing substantial work on the audit should be referenced in the auditor's report. The ICGN believes that requiring disclosures in the auditor's report about the role of other auditors in the group audit will provide more transparency about the audit and how it was performed so that users can evaluate the participation of other auditors.

ICGN appreciates the opportunity to respond and appreciates the IAASB's continued focus on audit quality. We hope that these comments are useful in your deliberations and the ICGN Policy Director, George Dallas (george.dallas@icgn.org)

We would be happy to elaborate on any of the points raised in this letter. Thank you for your consideration.

Yours truly,

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