



International Federation of Accountants

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Agenda Item

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Committee: IAASB Consultative Advisory Group

Meeting Location: London

Meeting Date: September 14–15, 2010

Audit Quality—Issues and IAASB Task Force Proposals

Objective of Agenda Item

1. The objective of this Agenda Item is to obtain the Representatives' views on a proposed way forward on an IAASB project on Audit Quality (AQ).

Papers to Be Referred to during Discussion

2. The discussion on this topic will follow the structure of this CAG Paper.

Project Status and Timeline

3. This project commenced in December 2009 with a preliminary discussion at the IAASB meeting. The IAASB held a subsequent discussion in June 2010. A further discussion is planned for the December 2010 IAASB meeting. The project has not previously been discussed with the IAASB CAG.

Background

4. The concept of AQ is not defined in law, regulations or auditing standards. It is, in simple terms, a concept that characterizes the quality of an audit, i.e. the provision of an appropriate audit opinion supported by evidence obtained in accordance with auditing standards and objective professional judgments. A quality audit is delivered if the audit report is independent, reliable and supported by sufficient appropriate audit evidence.

IAASB Strategy and Work Program, 2009-2011

5. After extensive stakeholder consultation in 2007, the IAASB included the topic of AQ in its strategy and work program for 2009-2011. The IAASB had noted that although the term “audit quality” has become widely used in its communications and those of its stakeholders, the term itself is not universally defined, thus potentially contributing to the “expectations gap.” In addition, the IAASB had recognized that there is more to AQ than just the ISAs. The *IAASB Strategy and Work Program 2009-2011* therefore envisions consideration by the IAASB of whether to develop a consultation paper on AQ.

IAASB Update

6. In December 2009, the IAASB held exploratory discussions on the topic, focusing on three specific matters:

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- a) Perspectives on, or approaches to, AQ that resonate with the IAASB's work;
 - b) The extent to which AQ can be assessed or measured from users' perspectives; and
 - c) The scope of a potential project on AQ.
7. The IAASB recognized that a wide range of research, thought leadership and policy analysis work has already been undertaken on the subject by various parties (see, for example, Agenda Item P.1 for an illustration and an overview of some of the different perspectives on, and approaches to, AQ internationally). The IAASB noted in particular that the UK Financial Reporting Council's (FRC) Audit Quality Framework may provide a useful point from which to further explore the topic.
 8. The IAASB also noted the importance of putting the ISAs in proper context in the broader debate about AQ, as they are only one of many inputs to the drivers (or factors) that support the achievement of AQ (examples of these drivers together with related indicators, drawn from the UK FRC's Audit Quality Framework, are given at Appendix 1; Appendix 3 helps illustrate how specific provisions in IAASB standards address AQ drivers). Further, it was acknowledged that the debate about AQ needs to be viewed in the context of wider international debates concerning financial reporting and corporate governance. It was also noted that while a focus on inputs to AQ is important, user perceptions of the quality of the outputs of the audit also need consideration. In addition, it was recognized that promoting greater communication with users about the audit, and what an audit involves and delivers, may be helpful in informing user perspectives on AQ.
 9. Partly drawing on this initial discussion, the IAASB Chairman has developed a slide summarizing key elements of AQ (see Appendix 2) which he has used in various presentations to, and meetings with, stakeholders to communicate key messages about AQ. This slide has, in turn, provoked many useful reactions from stakeholders in discussions on the topic.
 10. Subsequent to the initial discussion, the IAASB set up a Task Force comprising the following members to explore the way forward on the topic:
 - Craig Crawford, Chair, IAASB Member
 - Bernard Agulhas, Independent Regulatory Board for Auditors, South Africa
 - Jon Grant, IAASB Member
 - Kam Grewal, Canadian Public Accountability Board
 - Gert Jönsson, IAASB Member
 - Abdullah Yusuf, IAASB Member

IAASB-National Auditing Standard Setters (NSS) Discussion

11. In early June 2010, the IAASB discussed the topic with its NSS liaison group as part of the annual IAASB-NSS meeting. NSS participants expressed great interest in, and support for,

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the IAASB in undertaking a project on the topic. Among the various views expressed by the NSS participants, the following significant comments were noted:

- Consideration could be given to a modeling approach to AQ that would include such matters as exploring a definition of AQ, identifying potential measures for AQ, and considering reporting aspects of AQ.
- While the elements in the AQ slide in Appendix 2 are all relevant, one should not lose sight of other important external factors such as the quality of the entity's management, the entity's corporate governance, and its reporting deadlines.
- There is a need for harmonization of approaches to regulatory inspections around the world. In this regard, the project would be of significant benefit to such bodies as the International Forum of Independent Audit Regulators (IFIAR) if it could establish some sort of common "language" of AQ that would assist in harmonizing inspection practices.

Proposed Way Forward

12. Subsequently in June 2010, the IAASB considered proposals from the project Task Force for a way forward, comprising the development of a thought piece on AQ in the short term followed by a more substantive consultation paper in the medium term.
13. Leveraging the AQ slide in Appendix 2, the thought piece would be intended to explain the context of the debate about AQ and the relevant factors that affect AQ or perceptions of AQ. The thought piece would help to address any misconceptions or misunderstandings that stakeholders may harbor regarding the role of the ISAs with respect to AQ, thereby helping to narrow any "expectations gap" that may exist in that regard. It also would serve as a platform for the IAASB to engage more broadly with stakeholders on the topic, including assisting in the delivery of key messages about AQ. The thought piece would be developed for IAASB approval by the end of 2010.
14. With regard to the consultation paper, the Task Force proposed that its objectives be as follows:
 - a) To achieve a common understanding among stakeholders of the drivers of AQ (leveraging, for example, the UK FRC's AQ framework as a starting point), and to explain how the ISAs address some of these drivers and, thus, how they contribute to AQ; and
 - b) To explore *what more* could be done to enhance AQ, from the perspective of not only the ISAs but also those elements of AQ that are not dealt with by the ISAs, such as ethics, education, regulation, etc.
15. In the Task Force's view, achieving a common understanding regarding the drivers of AQ could help establish a foundation upon which the IAASB could work more closely with key stakeholders such as IFIAR.

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16. In consulting on whether more should be done relative to each driver, questions on which the Task Force believes stakeholder views could be sought include whether there are:
 - Aspects of, or areas within, the ISAs that could be further improved; and
 - Specific actions that could be taken by other participants such as regulators, firms, educators and other standard setters to encourage effective implementation of the drivers.
17. The Task Force also felt that there could be a role for IFAC to play in this debate in ensuring that the IAASB, the International Ethics Standards Board for Accountants (IESBA) and International Accounting Education Standards Board (IAESB) work closely together on AQ and not be seen to be tackling different parts of the AQ debate in isolation. However, the Task Force acknowledged that this aspect would introduce a degree of complexity and a challenge from a coordination point of view, and could be seen as extending the IAASB's remit.
18. Appendix 3 provides an illustration of the Task Force's proposed approach to the consultation paper.
19. In relation to timing, the Task Force was of the view that the consultation paper could be targeted for publication in the latter half of 2011, which would provide time for the IAASB to liaise with relevant stakeholders, including the IAASB CAG, on key issues that should be addressed in the consultation paper.
20. While broadly supportive of a consultative approach to the project, the IAASB asked the Task Force to reflect further on the ultimate objective of the consultation paper and how it would enable the IAASB to meaningfully advance the public interest relative to AQ.

Matters for CAG Consideration

1. Taking into account the views and matters noted in paragraphs 7-9 and 11 above and the role of an auditing standard setter, what are Representatives' views regarding the key areas of AQ where focus should be placed to most effectively contribute to the global debate on AQ?
2. What, in Representatives' views, are the aspects most relevant to users in their understanding and assessment of AQ?
3. What do Representatives believe would be most useful for the IAASB to do in an AQ project, and what should be the scope (or breadth) of such a project?

Without prejudice to those views, do Representatives agree with the Task Force's proposals for the way forward as set out in paragraphs 12-19 above? If so, how could the Task Force's proposed model for a consultation paper be enhanced or refined?

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Material Presented – FOR IAASB CAG REFERENCE PURPOSES ONLY

Perspectives on, and Approaches to, Audit
Quality from Various Research, Thought-
Leadership and Other Initiatives or Forums

Word file attached

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Appendix 1

The UK FRC's Audit Quality Framework

The following lists the drivers and indicators that constitute the UK FRC's AQ Framework.

| Driver | Indicators |
|---|--|
| The culture within an audit firm | <p>The culture of an audit firm is likely to provide a positive contribution to AQ where the leadership of an audit firm:</p> <ul style="list-style-type: none">• Creates an environment where achieving high quality is valued, invested in and rewarded.• Emphasizes the importance of 'doing the right thing' in the public interest and the effect of doing so on the reputation of both the firm and individual auditors.• Ensures partners and staff have sufficient time and resources to deal with difficult issues as they arise.• Ensures financial considerations do not drive actions and decisions having a negative effect on AQ.• Promotes the merits of consultation on difficult issues and supporting partners in the exercise of their personal judgment.• Ensures robust systems for client acceptance and continuation.• Fosters appraisal and reward systems for partners and staff that promote the personal characteristics essential to quality auditing.• Ensures AQ is monitored within firms and across international networks and appropriate consequential action is taken. |
| The skills and personal qualities of audit partners and staff | <p>The skills and personal qualities of audit partners and staff are likely to make a positive contribution to AQ where:</p> <ul style="list-style-type: none">• Partners and staff understand their clients' business and adhere to the principles underlying auditing and ethical standards.• Partners and staff exhibit professional skepticism in their work and are robust in dealing with issues identified during the audit. |

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| Driver | Indicators |
|---|---|
| | <ul style="list-style-type: none"> • Staff performing detailed ‘on-site’ audit work have sufficient experience and are appropriately supervised by partners and managers. • Partners and managers provide junior staff with appropriate ‘mentoring’ and ‘on the job’ training. • Sufficient training is given to audit personnel in audit, accounting and industry specialist issues. |
| The effectiveness of the audit process | <p>An audit process is likely to provide a positive contribution to AQ where:</p> <ul style="list-style-type: none"> • The audit methodology and tools applied to the audit are well structured and: <ul style="list-style-type: none"> ◦ Encourage partners and managers to be actively involved in audit planning. ◦ Provide a framework and procedures to obtain sufficient appropriate audit evidence effectively and efficiently. ◦ Require appropriate audit documentation. ◦ Provide for compliance with auditing standards without inhibiting the exercise of judgment. ◦ Ensure there is effective review of audit work. ◦ AQ control procedures are effective, understood and applied. • High quality technical support is available when the audit team requires it or encounters a situation it is not familiar with. • The objectives of ethical standards are achieved, providing confidence in the integrity, objectivity and independence of the auditor. • The collection of sufficient audit evidence is not inappropriately constrained by financial pressures. |
| The reliability and usefulness of audit reporting | <p>Audit reporting is likely to provide a positive contribution to AQ where:</p> <ul style="list-style-type: none"> • Audit reports are written in a manner that conveys clearly and |

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| Driver | Indicators |
|---|--|
| | <p>unambiguously the auditor's opinion on the financial statements and that addresses the needs of users of financial statements in the context of applicable law and regulations.</p> <ul style="list-style-type: none"> • Auditors properly conclude as to the truth and fairness of the financial statements. • Communications with the audit committee include discussions about: <ul style="list-style-type: none"> ○ The scope of the audit. ○ The threats to auditor objectivity. ○ The key risks identified and judgments made in reaching the audit opinion. ○ The qualitative aspects of the entity's accounting and reporting and potential ways of improving financial reporting. |
| Factors outside the control of auditors | <p>Factors outside the control of auditors which are likely to make a positive contribution to AQ include:</p> <ul style="list-style-type: none"> • An approach to corporate governance within the reporting entity that attaches importance to corporate and financial reporting and to the audit process. • Audit committees that are active, professional and robust in dealing with issues identified during the audit. • Shareholders that support auditors, where appropriate, thereby increasing the likelihood that directors and management will comply with their obligations in relation to the preparation of reliable financial statements. • Reporting deadlines that allow the opportunity to carry out an audit without undue reliance on work performed before the end of the reporting period. • Appropriate agreed arrangements for any limitation of liability. • An audit regulatory environment that focuses on the drivers of AQ. |

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Appendix 2

| Important Elements of AUDIT QUALITY | |
|--|--|
| Context Factors | <ul style="list-style-type: none">• Governance Arrangements• Regulation and Oversight• Players and Perceptions |
| Outputs & Responses | <ul style="list-style-type: none">• Auditor's Report• Other Auditor Communications and Disclosures• User Responses, e.g. Audit Committees; Regulators• Client Service and Audit Fees |
| Inputs & Indicators | <ul style="list-style-type: none">• Audit Process and Quality Control• Audit Evidence and Auditor Judgment• Auditing Standards• People: Education, Ethics, Mindsets• External Expectations (also a context factor) |

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Appendix 3

Illustration of a Possible Approach to a Consultation Paper

| AQ Driver | Specific Provisions in IAASB Standards that Address the Driver | Possible Questions for Consultation |
|---|---|---|
| The culture within an audit firm | For example: ISQC 1 ¹ , e.g. <ul style="list-style-type: none">• Tone at the top• Policies regarding evaluation, compensation, promotion, etc• Consultation• Monitoring | <ul style="list-style-type: none">• Are the drivers complete and appropriate? If not, what is missing or what further refinement would be appropriate?• What further improvement could be made to the ISAs relative to each driver, and why?• What actions can other participants take to encourage or facilitate effective implementation of the drivers, e.g.<ul style="list-style-type: none">○ IFIAR○ Firms○ Professional institutes○ National standard setters○ The International Ethics Standards Board for Accountants (IESBA)○ The International |
| The skills and personal qualities of audit partners and staff | For example: ISQC 1, e.g. <ul style="list-style-type: none">• Ethics• Recruitment• Competence• Career development ISA 200 ² , e.g. <ul style="list-style-type: none">• Professional judgment• Professional skepticism ISA 220 ³ , e.g. <ul style="list-style-type: none">• Engagement team with appropriate experience | |

¹ ISQC 1, *Quality Controls for Firms that Perform Audits and Reviews of Financial Statements and Other Assurance and Related Service Engagements*

² ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*

³ ISA 220, *Quality Control for an Audit of Financial Statements*

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| AQ Driver | Specific Provisions in IAASB Standards that Address the Driver | Possible Questions for Consultation |
|---|--|--|
| | <ul style="list-style-type: none"> Direction and supervision ISA 315⁴, e.g. Understanding clients' businesses | <p>Accounting Education Standards Board (IAESB)</p> <ul style="list-style-type: none"> Trainers and educators? |
| The effectiveness of the audit process | <p>For example:</p> <p>ISA 220 – independence, review of work done, consultation, etc</p> <p>ISA 230⁵ – documentation</p> <p>ISA 300⁶ – Planning</p> <p>ISA 315 – involvement of senior engagement team members in planning, risk assessment</p> | |
| The reliability and usefulness of audit reporting | <p>For example:</p> <p>ISA 260⁷ – communication with TCWG</p> <p>ISA 700⁸ – forming the opinion</p> | |
| Factors outside the control of auditors | N/A | <ul style="list-style-type: none"> What specific actions can other participants take relative to this driver to enhance AQ, and how could the IAASB effectively work with |

⁴ ISA 315, *Identifyin and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

⁵ ISA 230, *Audit Documentation*

⁶ ISA 300, *Planning an Audit of Financial Statements*

⁷ ISA 260, *Communication with Those Charged with Governance*

⁸ ISA 700, *Forming an Opinion and Reporting on Financial Statements*

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| AQ Driver | Specific Provisions in IAASB Standards that Address the Driver | Possible Questions for Consultation |
|-----------|--|--|
| | | those participants, e.g. <ul style="list-style-type: none">○ Those charged with governance○ Preparers○ Investors○ Regulators○ Accounting standard setters? |