



**Committee:** IAASB Consultative Advisory Group

**Meeting Location:** Prague

**Meeting Date:** September 12–13, 2011

### **Audit Quality—Report Back and 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 draft paper on a proposed international audit quality (AQ) framework ("Framework").

#### **Papers to Be Referred to during Discussion**

2. The discussion on this topic will follow the structure of this CAG Paper. The draft paper, reference to which is made in this paper, is provided as **Agenda Item C.1**.

#### **Project Status and Timeline**

3. The CAG last considered this project at its March 2011 meeting.
4. The IAASB held a preliminary discussion on the topic at its December 2009 meeting. At its June and December 2010 meetings, the IAASB discussed the objectives and scope of a project on AQ, including the development of a thought piece as an introduction to substantive work on the topic. The thought piece was published in January 2011.
5. At its March 2011 meeting, the IAASB agreed that the objective of the project should reflect the holistic approach to the project and emphasize the public interest as follows:

To establish in the public interest an international framework that describes audit quality holistically, including:

  - (a) The influences of input, output and context factors;
  - (b) Stakeholders' varying perspectives on audit quality; and
  - (c) The importance of relationships between auditors and other key participants in the financial reporting supply chain (i.e., management, those charged with governance, investors and regulators), which influence audit quality.
6. At its June 2011 meeting, the IAASB discussed a preliminary draft of the paper on the proposed Framework. The plan is that a draft of the Framework will be issued in 2012 for consultation.
7. The Appendix to this paper provides a project history, including links to the relevant CAG documentation.

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### Background

#### March 8-9, 2011 CAG Discussion

8. Below are extracts from the draft minutes of the March 2011 CAG meeting,<sup>1</sup> and an indication of how the project Task Force or IAASB has responded to the Representatives' comments.

Representatives' Comments	Task Force/IAASB Response
<p>Mr. Baumann and Ms. Blomme noted that many of the stakeholders that the Task Force planned to consult with are groups which are focused on audit, and that there is a need to reach out to non-audit groups, particularly investors, preparers, audit committee members and academics who may provide valuable input. Mr. Crawford noted that stakeholder perspectives are critical to the project and that the Task Force intends to engage with many stakeholders, including representatives of those charged with governance.</p>	<p>The Task Force agrees with this and believes that the survey of stakeholders has been a useful start. There has also been a meeting with some experienced U.S. academics in August 2011, and input is planned from IFIAR, ICGN, the Forum of Firms, IOSCO, the World Bank and INTOSAI.</p> <p>The Task Force would welcome CAG Representatives' suggestions for how best to reach out to other non-audit groups either before, or during, the formal consultation phase.</p>
<p>Mr. Baumann acknowledged the difficulty in defining audit quality. He noted that a framework would be very useful if it were to include an assessment element – though not necessarily a quantitative measure – associated with audit quality at a firm and an engagement level. This would enable stakeholders, such as audit committees, to assess the quality of audits from their particular perspective. Mr. Bluhm agreed, noting that it would be helpful to have a document that could be used by smaller practitioners to talk about audit quality with those charged with governance and their staff.</p>	<p>The Task Force believes that the first phase is to develop an audit quality framework that has the requisite level of support. Once that has been achieved, stakeholders will be able to apply it for their purposes. In the UK and Australia, for example, earlier work on audit quality has resulted in guides to assist audit committees evaluate AQ.</p>
<p>Mr. Robberecht supported making contact with regulators and was of the view that oversight bodies should be encouraged to publish inspection findings. He noted that the Task Force should be careful about the inference that the framework will assist in harmonizing approaches to regulatory inspections of audit firms as it could be perceived that the IAASB is trying to set</p>	<p>Two members of the Task Force are from audit oversight bodies and the draft Framework will be discussed by IFIAR in late September 2011.</p>

<sup>1</sup> The minutes will be approved at the September 2011 IAASB CAG meeting.

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<p>guidelines for audit inspections. However, he acknowledged that if a framework were available, oversight bodies may use it for their purposes. Mr. Crawford noted that the IAASB did not intend for the outcome of this project to necessarily direct audit inspections.</p>	
<p>Mr. Koster noted the need to distinguish between “hard” and “soft” contextual factors. “Soft” contextual factors include those that impact on perceptions, such as regulatory actions and perceptions of how firms react to regulatory actions. Mr. Crawford agreed that it is important that perceptions are understood and taken into account in developing the framework.</p>	<p>The context factors include some “hard” factors such as the legislative environment, and some “soft” ones such as deference to authority. CAG Representatives’ views on whether there are additional context factors that need to be included would be very helpful.</p>
<p>Mr. Koktvegaard noted that the input, output and contextual factors may confuse audit quality with other types of quality such as governance-, regulatory- and reporting quality. He was of the view that the objectives should distinguish audit quality from other types of quality. He gave the example of improvements in internal control and accounting standards, which are about governance- or reporting quality. Mr. Crawford noted that the Task Force’s view is that these elements are contextual in nature and influence the quality of the audit from that perspective. In relation to the objectives, Prof. Schilder noted that Mr. Koktvegaard’s point was important but that further consideration is needed about incorporating it in the objective given the inter-relationships amongst the various elements.</p>	<p>The Task Force believes that AQ can most usefully be considered in the wider context of governance quality, regulatory quality and reporting quality.</p>
<p>Ms. Blomme and Mr. Peyret supported focusing on the development of a framework rather than focusing on the definition of audit quality or measures of audit quality. Ms. Blomme supported leveraging work that has already been done by other bodies in this regard. She also supported the proposed list of stakeholders to be consulted during the development of the consultation paper. Mr. Peyret noted that the perception of audit quality varied from stakeholder to stakeholder.</p>	<p>Point noted.</p>

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<p>Ms. Blomme noted that this project would be of specific interest to the EC, especially given that the EC Green Paper touches on aspects of audit quality.</p>	<p>Point noted.</p>
<p>Mr. Roussey supported the project, noting that it includes a broader view of the aspects of audit quality than had been expressed previously, such as governance and internal controls. He was of the view that this would encourage further thinking amongst stakeholders. He noted that, while good governance and internal controls should assist in delivering a quality audit, it should be possible to deliver a quality audit for an entity with poor governance and ineffective internal controls. He also noted that there are a number of difficult questions to be addressed, such as what audit quality means to audit committees, and therefore the project will be challenging. Nevertheless, he was of the view that it will add to the body of knowledge on the topic.</p>	<p>The Task Force believes that it is useful to distinguish between the quality of an individual audit and audit quality in a more systemic sense. The Task Force believes that the Framework will be more useful for firms and regulators in developing their environments than for the evaluation of the quality of individual audits.</p>
<p>Mr. Fleck agreed with Mr. Roussey, noting that the events of the global financial crisis have demonstrated the need to take a holistic view. He also noted that a valuable output of the project would be to provide a platform that would encourage interactions amongst stakeholders that could lead to actions being taken that ultimately improve audit quality; for example, actions taken by investors to influence improvements in corporate governance. Mr. Ratanake noted that factors that affect professional judgment, such as tone at the top, remuneration, promotion prospects, are also important to audit quality. Ms. de Beer supported Mr. Fleck's comment about the importance of encouraging the involvement of other stakeholders, and suggested that this might be a useful consideration for the objectives.</p>	<p>The Task Force agrees with this and hopes that a framework dealing with audit quality in a systemic sense will be of assistance.</p>
<p>Mr. Bluhm noted that another input factor is the complexity of accounting standards, particularly when the accounting standards are applied to smaller entities. Mr. Koktvegaard disagreed that the complexity of accounting standards affected audit quality, noting that,</p>	<p>The Task Force is developing a holistic framework that includes the complexity of accounting standards. This seems to be an especially important aspect from a small practitioner standpoint.</p>

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<p>in his view, the complexity of accounting standards affects reporting quality and not audit quality. He noted the importance of not confusing audit quality with the quality of financial reporting. Mr. Crawford responded that the complexity of the financial reporting framework does have an impact on the environment in which the auditor operates and that, in turn, audit quality is indirectly affected.</p>	
<p>Mr. Peyret noted that users of audited information need education about the limitations on the powers of auditors as some users believe that auditors have the same powers as regulators.</p>	<p>There may be more that could be said on this. However, there is a limit to what can be achieved in a single project. The Task Force does not see the project as dealing with all expectation gap issues.</p>
<p>Mr. Peyret noted that the project should encourage stakeholders to take actions to support audit quality, such as organizations performing early analysis of accounts and ensuring that key personnel outside of the finance function are readily identifiable and available to the auditor. He also noted that, where there are service organizations covering accounting data, the service organization need to give assurance about the data that will be used in the financial reporting process.</p>	<p>Point noted.</p>
<p>Mr. Peyret commented that there are perceptions that entities need to educate auditors about their industry rather than being challenged by the auditors. He noted that auditors should be more aware of industry risks and industrial processes, enabling the provision of valuable insight into the organization.</p>	<p>The draft paper touches on these issues.</p>
<p>Mr. Peyret also noted that the auditor's report is too often "boiler plate" and perceptions of audit quality could be improved if the report was more informative.</p>	<p>The draft paper touches on these issues but does not duplicate the current IAASB consultation on this topic.</p>
<p>Mr. Uchino noted that the project should also consider stakeholder expectation of the cost/benefit tradeoff in improving audit quality. For example, the stronger the governance relative to oversight of management, the easier the audit will be and, therefore, the less costly the</p>	<p>There is a reference to audit fees at the start of the section dealing with stakeholder perspectives. There may be more that could be said on this.</p>

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audit should be. Mr. Roussey noted that there should also be consideration of the benefit to the entity in obtaining a lower cost audit if the internal control or corporate governance environment was strengthened.	

#### April 2011 IAASB-National Auditing Standard Setters (NSS) Discussion

- At the April 2011 IAASB-NSS meeting, NSS participants discussed aspects of the consultation paper, including the general approach to addressing the elements of the Framework. Participants expressed strong support for a collaborative approach to the development of the consultation paper. In this regard, a large majority of the NSS agreed to assist the IAASB in conducting an informal survey on perspectives of audit quality from key stakeholder groups, including institutional investors, audit committee members, owner managers of smaller enterprises, senior members of management of larger companies, and public sector users. Some CAG Representatives also participated in this survey.
- The survey responses were received in the latter part of June 2011 and were used by the project Task Force in advancing its analysis of perspectives of audit quality. The results of the survey were summarized and incorporated into the draft paper.

#### June 2011 IAASB Discussion

- At its June 2011 meeting, the IAASB considered a preliminary draft of the paper. Amongst other matters, the IAASB discussed:
  - The comprehensiveness of the proposed framework;
  - The organization and structure of the paper in setting out the various elements of the framework;
  - The tone and level of detail in the description of those elements; and
  - The plan for consultation with stakeholders.

#### August 2011 Academic Focus Group Discussion

- In August 2011, the Task Force held a focus group meeting with a small number of very experienced academics to obtain their views on the draft paper. The meeting generated a number of useful ideas regarding the structure and approach to the paper for the Task Force's further consideration.

#### Comments from the Small and Medium Practices (SMP) Committee

- In commenting on the March 2011 IAASB meeting papers, the SMP Committee noted its support for the proposed objective of the project. In addition, the SMP Committee suggested considering the impact of the complexity of financial reporting frameworks on audit quality,

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and whether the input, output and contextual factors for SMPs are different from those for larger entities.

14. In commenting on the June 2011 IAASB meeting papers, the SMP Committee expressed support for the organization and structure of the draft paper. Nevertheless, the SMP Committee commented on the need for greater coverage of the SMP perspective and provided suggestions for areas in which SMP considerations could be included. Since then section 7 of the paper has been added.

#### Matters for CAG Consideration

15. The draft paper included in **Agenda Item C.1** has been updated based on the June 2011 IAASB discussion but has not yet been considered by the IAASB.
16. Given the relatively early stage of development of the proposed Framework, the paper does not include questions for respondents at this time. The Task Force anticipates being able to present proposed questions for consultation for the IAASB's consideration at its December 2011 meeting.

#### Matters for CAG Consideration

1. CAG Representatives are asked for their views on the following matters in relation to draft paper:
  - (a) Do Representatives believe the proposed Framework embodies the most important elements of audit quality, and is balanced and credible?
  - (b) Are there key issues or dimensions that need to be added or emphasized more in order to meet (a)?
  - (c) Does the paper strike an appropriate balance between concepts and 'real world' audit quality?
  - (d) How should the IAASB best reach out to non-audit groups other than those mentioned in the first item in the report-back above, either before, or during, the formal consultation phase?
2. What are CAG Representatives' views regarding the value of identifying the main threats to audit quality with respect to the separate elements of the Framework, and possible actions to address such threats, as summarized in **Agenda Item C.2**?

#### Material Presented – IAASB CAG PAPER

Agenda Item C.1      Draft Paper—*Audit Quality: An International Framework*

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Agenda Item C.2      Summary of Main Threats to Audit Quality and Possible Actions to Address Them

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Appendix

### Project History

**Project: Audit Quality**

**Summary**

	CAG Meeting	IAASB Meeting
Project commencement	September 2010	December 2009 June 2010 December 2010
Issues Paper and IAASB Working Group Proposals	March 2011	March 2011
Development of Proposed Consultation Paper	September 2011	June 2011 September 2011 December 2011
Consultation – planned for March 2012		

**CAG Discussions: Detailed References**

<b>Project Commencement</b>	<p><u>September 2010</u></p> <p>See IAASB CAG meeting material:  <a href="http://www.ifac.org/IAASB/Meeting-FileDL.php?FID=5665">http://www.ifac.org/IAASB/Meeting-FileDL.php?FID=5665</a></p> <p>See CAG meeting minutes (in Agenda Item P of the following):  <a href="http://www.ifac.org/IAASB/Meeting-FileDL.php?FID=6186">http://www.ifac.org/IAASB/Meeting-FileDL.php?FID=6186</a></p> <p>See report back on September 2010 CAG meeting (in paragraph 7 of the following):  <a href="http://www.ifac.org/IAASB/Meeting-FileDL.php?FID=6085">http://www.ifac.org/IAASB/Meeting-FileDL.php?FID=6085</a></p>
<b>Issues Paper and IAASB Working Group Proposals</b>	<p><u>March 2011</u></p> <p>See IAASB CAG meeting material:  <a href="http://www.ifac.org/IAASB/Meeting-BGPapers.php?MID=0248&amp;ViewCat=1491">http://www.ifac.org/IAASB/Meeting-BGPapers.php?MID=0248&amp;ViewCat=1491</a></p>

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	<p>See CAG meeting minutes (in Agenda Item F of the following):</p> <p>See draft March 2011 CAG meeting minutes at Agenda Item A.</p> <p>See report back on March 2011 CAG meeting in paragraph 8 of this CAG paper.</p>
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