

**Meeting:** IESBA CAG

**Meeting Location:** New York

**Meeting Date:** September 9-10, 2014

## **Agenda Item B**

### **Emerging Issues**

#### **Objectives of Agenda Item**

1. To note the report-back on the March 2014 CAG discussion.
2. To consider recent information regarding the global uptake of the Code.
3. To discuss recent developments internationally that may merit further consideration by the IESBA as emerging issues.
4. To reflect on whether there are other developments internationally that should be considered by the IESBA.

#### **Emerging Issues and Outreach Committee (EIOC)**

5. Members:
  - Reyaz Mihular, Chair, IESBA Member
  - Jim Gaa, IESBA Member
  - Chishala Kateka, IESBA Member
  - Liesbet Haustermans, IESBA Technical Advisor

#### **Activities Since Last CAG Discussion**

6. Since the March 2014 CAG meeting, the EIOC has met twice via teleconference in August 2014 to discuss possible matters to bring to the CAG's and the Board's attention, and to finalize the agenda material for the CAG meeting.

#### **Report-Back on March 2014 CAG Discussion**

7. The report-back on the March 2014 CAG discussion is set out in Agenda Item B-1.

#### **Matters for CAG Consideration**

##### **A. Status of Global Adoption of the Code**

8. Information regarding the status of global uptake of the Code as of March 2014 is set out in Agenda Item B-2. This information has been compiled by IESBA staff with the assistance of staff of the IFAC Compliance Advisory Panel (CAP).

9. This information was presented to the Board at its April 2014 meeting. Among other matters, the Board noted the following:
- The compilation of the data is a good first step in providing tangible information to stakeholders regarding the global uptake of the Code, especially among the G-20 countries. There should be regular updates on further progress to the Board. In addition, it would be helpful to understand how jurisdictions have adopted the Code, especially where the differences exist; and if the Code has not been adopted, to understand why.
  - The data represents a snap shot in time and the information will evolve over time. In particular, it does not take into account the more recent developments in the EU concerning the regulation of the independence of audit firms with respect to statutory audits of public interest entities (PIEs), which have introduced some differences with the Code.
  - The disparate nature of how the Code is adopted in individual jurisdictions presents a challenge to compiling detailed information as there is often not one body that adopts the Code nationally. In particular, not all countries that have adopted the Code have adopted it for both PIEs and entities that are not PIEs. Thus, if an analysis of adoption for PIEs and other entities were to be performed, it would produce a different snapshot. It could thus be beneficial to refine the process with more granular data. However, maintaining adoption information at a granular level would be a resource-intensive endeavor.
  - There has been a broad discussion on the adoption of the Code with the PIOB. Consideration has been given as to who should take responsibility for overseeing adoption of the Code, especially given that the Board is fully occupied with standard setting. Arguments exist for and against this responsibility to be placed on any one of the following: the regulators, IFAC member bodies or the Board. While there is a role for the Chair of the Board to promote adoption, there is no clear answer as to how much time the Chair or the Board should spend in this area.
10. Notwithstanding the latter question, the Board has committed as part of its Strategy and Work Plan, 2014-2018, to monitoring and documenting the extent of global adoption of the Code. The EIOC plans to do so as part of its remit to monitor external developments and will be providing regular updates to the Board and the CAG going forward.
11. IESBA staff is currently working with CAP staff to make the information on the global uptake of the Code available on the IESBA website. It is anticipated that this exercise will be completed in Q4 2014.

**Matters for CAG Consideration**

1. Representatives are asked for views as to what might reasonably be expected to be the IESBA's role and responsibilities regarding the global adoption of the Code, and what the implications might be for its resources.
2. What actions can CAG member organizations take to support or promote the adoption of the Code around the world?

## **B. Recent Audit Inspection Reports**

### *International Forum of Independent Audit Regulators (IFIAR) Report*

12. In April 2014, IFIAR issued its report on its 2013 survey of inspection findings.<sup>1</sup> IFIAR members reported findings from inspections of three categories of audit firm activities – audits of listed PIEs; audits of systemically important financial institutions (SIFIs), including global systemically important banks (G-SIBs); and internal systems for firm-wide quality control. In each category, the survey results generally revealed similarities in the nature and extent of inspection findings as compared to the results of the survey conducted in 2012.
13. For audits of listed PIEs, the three inspection themes with the highest number of findings were:
- Auditing fair value measurements;
  - Internal control testing; and
  - Procedures performed to assess the adequacy of financial statement presentation and disclosures.
- The first two themes above had the highest number of findings in both the 2013 and 2012 surveys.
14. For audits of SIFIs and G-SIBs, the three inspection themes with the highest number of findings, consistent with the 2012 survey, were:
- Auditing of allowance for loan losses and loan impairments,
  - Internal control testing and
  - Auditing of the valuation of investments and securities.
15. Inspections of quality control systems revealed the same three themes with the highest number of findings in both the 2013 and 2012 surveys:
- Engagement performance,
  - Human resources, and
  - *Independence and ethics requirements.*
16. The report notes that the recurrence of inspection findings suggests that audit firms should take steps to develop a robust root cause analysis to gain a clearer understanding of the factors that underlie these findings and take appropriate remedial actions.

### **Matters Pertaining to Independence**

17. The report notes that the survey format enables IFIAR members to report data on other notable themes identified in their respective oversight programs. New IFIAR members provided such information. According to the report, the audit topics not already included in the survey and most frequently submitted include engagement quality control reviews, independence considerations (e.g., the audit firm providing prohibited non-audit services to an audit client), and provisions/reserves.

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<sup>1</sup> See [https://www.ifiar.org/IFIAR/media/Documents/IFIARMembersArea/MemberUpdates/IFIAR-Inspection-Survey-9-April-2014\\_1.pdf](https://www.ifiar.org/IFIAR/media/Documents/IFIARMembersArea/MemberUpdates/IFIAR-Inspection-Survey-9-April-2014_1.pdf).

18. With respect to reviews of systems of quality control, the report notes that 30 IFIAR members provided information relating to their inspections of the audit firms' systems of quality control. The findings were organized using the six defined elements of a system of quality control as outlined in International Standard on Quality Control (ISQC) 1.<sup>2</sup>
19. The 30 members responding to the survey inspected a total of 134 audit firms and reported 844 findings. These findings, compared to 767 findings reported in the 2012 Survey associated with inspections of 109 audit firms, are as follows:

Inspection Themes	Number of Findings	
	2013	2012
Engagement Performance	380	261
Human Resources	146	166
<i>Independence and Ethical Requirements</i>	104	130
Monitoring	93	77
Client Risk Assessment, Acceptance and Continuance	78	100
Leadership Responsibilities for Quality within the Firm (i.e., Tone at the Top)	43	33
	<b>844</b>	<b>767</b>

20. The report notes that in 2013, IFIAR members provided information regarding the number of firms inspected for each listed aspect of quality control. The following reflects the frequency of findings among firms inspected.

Inspection Themes	Number of Audit Firms in which the Topic was Inspected	Audit Firms with at Least one Finding	
		#	%
Engagement Performance	134	72	54%
<i>Independence and Ethical Requirements</i>	134	53	40%
Monitoring	134	53	40%
Human Resources	134	50	37%
Client Risk Assessment, Acceptance and	134	38	28%

<sup>2</sup> ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

Inspection Themes	Number of Audit Firms in which the Topic was Inspected	Audit Firms with at Least one Finding	
		#	%
Continuance			
Leadership Responsibilities for Quality within the Firm (i.e., Tone at the Top)	134	30	22%

21. The report states that the two IFIAR inspection findings surveys confirm the need for further targeted actions by audit firms to achieve the necessary improvements in audit quality. It explains that Individual IFIAR members take action locally to address issues identified from their specific inspection findings; individual members have the primary responsibility for improving audit quality and determining the adequacy of remedial actions taken by firms over which they have jurisdiction. The report notes that IFIAR collectively meets regularly with the leadership of the major firms individually and as a group.<sup>3</sup>
22. The report, however, does not detail the precise nature of the findings concerning independence and ethics requirements. There is therefore a need for the Board to work more closely with IFIAR to obtain a better understanding of the findings, including:
- How a finding is defined;
  - Whether the findings are related to the standards themselves or their enforceability, or related to poor compliance with, or inadequate implementation of, the standards;
  - Whether or not the findings tend to be focused on particular areas, which may highlight specific problem areas; and
  - Whether the findings are jurisdiction-specific or linked to the IESBA Code.
23. Obtaining such an understanding would enable the Board to determine whether any specific standards-related actions would be warranted or whether actions identified in its strategy and work plan would appropriately address the key issues identified.

#### *UK Financial Reporting Council (FRC) Report*

24. In May 2013, the FRC issued its Audit Quality Inspection Report for 2012/13.<sup>4</sup> The main matters this report highlights include the following:
- There has been an improvement in the overall standard of audit work subject to inspection.

<sup>3</sup> Members of IFIAR's Global Public Policy Committee (GPPC) Working Group meet to discuss audit quality matters together, as well as with representatives of the six largest audit firm networks. The GPPC Working Group meets at least three times annually with these six network firms on a collective and individual network basis. In addition, the network firms' respective global CEOs participate in a portion of IFIAR's annual plenary meetings.

<sup>4</sup> See <https://www.frc.org.uk/Our-Work/Publications/Audit-Quality-Review/Audit-Quality-Inspections-Annual-Report-2012-13.aspx>

- There has been an increase in the proportion of audits of entities outside of the FTSE 350 that are requiring significant improvements.
  - There is a need for firms to increase their focus on professional skepticism and the effectiveness of their independence and ethical policies and procedures.
25. The report additionally noted the following key areas requiring improvement:
- Focus on audit quality – there is a need to ensure there are appropriate controls and procedures in place to ensure that efficiencies in audits, largely a result of fee pressure, are not being made at the expense of audit quality. The report questioned whether ‘offshoring’ adversely affected audit quality.
  - The need to maintain professional skepticism – initiatives to reinforce professional skepticism are working but more needs to be done to ensure that professional skepticism is fully embedded within audit procedures.
  - Audits of financial services entities – firms should strengthen their testing in respect of loan loss provisioning and general IT controls.
  - Group Audits – where work for group audits is performed predominantly by component auditors, there is generally a lack of control, supervision and review by the group auditor.
  - *Auditor independence and ethical issues – firms continue to adopt a boilerplate approach to independence reporting and failures in the correct application of ethical procedures. The report recommends that firms should review the adequacy of their independence and ethical procedures and ensure that the training that they provide to all levels of staff is sufficient.*
  - Audit quality monitoring – monitoring of internal audit quality may not be as robust as it could be and may be performed to a lower set of standards and expectations than would be expected from an external provider.

#### Matters Pertaining to Independence

26. The report noted the following key points relating to auditor independence and ethical issues:
- The nature and extent of independence and ethical issues continue to be of concern.
  - Audit committees are entitled to expect a good standard of independence reporting from their auditors and should seek additional information where it is not initially provided. Audit committees should also be prepared to challenge firms to demonstrate their independence, both in form and in substance, and to understand the specific safeguards the auditors have in place to protect their independence and the particular consideration given to the threats identified.

#### Matters Pertaining to Ethics

27. The FRC also noted that a number of specific issues relating to compliance with the requirements of the Ethical Standards were identified across all firms. These included:
- References to targets for the cross-selling of non-audit services to audited entities in partner appraisal documentation;

- Failure to consult the Ethics Partner on the appropriateness of contingent fee arrangements for certain tax services;
- Key partners involved in the audit from other network firms not being identified as such or monitored for potential rotation; and
- Instances where shareholdings in audited entities were not disposed of on a timely basis.

*Canadian Public Accountability Board (CPAB) Report*

28. In March 2014, CPAB issued its 2013 Annual Report “Thinking Differently about Audit Quality.” The report notes the following:
- The trend in audit quality is positive.
  - Canadian firms are taking challenge to improve audit quality seriously.
  - Improvements are mainly due to action plans that the firms have adopted.
  - CPAB has not been granted access to audit work done in foreign jurisdictions. Firms may be acquiring foreign entities where the risks may not be fully understood and the auditor has little or no experience of that region. Use of competent audit work or foreign firms with loose network affiliations is high.
  - Audit committee should regularly have discussions with the auditors about quality.
29. Generally, the report notes CPAB’s view that audit quality is improving, but highlights its concern over overseas audits. The report did not highlight any significant matters pertaining to independence and ethics standards.

**Matters for CAG Consideration**

3. Representatives are asked to:
- (a) Share any reactions to, or insights they may have into, the key inspection findings highlighted above, particularly those pertaining to independence and ethics;
  - (b) Reflect on whether there are any particular themes from the inspection findings highlighted above that may be of global relevance for the IESBA; and
  - (c) Advise what actions, if any, the Board should consider taking regarding the inspection reports.

**C. Big Data / Data Analytics**

30. “Big data” is an all-encompassing term used to describe the massive growth in the availability of data. Data analytics is the science of examining this data with the intention of drawing conclusions from the information. For example, data comparisons, summaries, and aggregations could detect potential anomalies, patterns, or trends that may indicate possible fraud or other misconduct.
31. In addition, more accurate analyses of data can detect correlations that could result in greater operational efficiencies, cost reductions, reduced risk, and hence better strategic decision making.

Data analytics is already used in many industries to allow companies and organizations to make better business decisions.

32. Accounting firms are starting to gather data from a variety of sources and employ that data in analytics. This could change the way audits are performed and also allow firms to provide clients perspectives on their competitive standing, the industry in which they operate and larger markets as a whole.
33. For example, KPMG UK is due to invest £20m in a partnership with Imperial College London to create a center of advanced business analytics. The KPMG Centre for Advanced Business Analytics will develop new approaches, analytical methods and tools for using big data to help UK businesses solve issues such as fraud or understanding consumer behavior.
34. Large firms able to integrate robust, efficient, and value-based data analytics into their audit model could gain a competitive advantage, particularly as the need for scale and sophistication increases with the increasing complexity and global reach of clients' businesses. Data analytics can have an impact in many stages and on many aspects of the audit process. In the planning and risk assessment stage, for example, analytics tools could help guide audit teams regarding the level of auditing that is necessary and the types of procedures that would be most relevant for specific clients. Data analytics tools can include order-to-cash, procurement-to-pay, inventories, fixed assets, and journal entries.
35. Analytics tools can also help identify higher-risk transactions by highlighting deviations from the expected business processes and relationships. This approach reduces the resources needed to gather and provide the information, support, reconciliations, and other documentation to the audit team. Procedures that often require client personnel to prepare supporting documentation could instead be performed using data analysis extracted directly from the client's systems.
36. There is therefore a need to understand whether, how, and the extent to which firms are planning to leverage, or are already using, data analytics to increase the effectiveness and efficiency of their audit processes, and what potential ethical issues might arise from such a development.
37. Further, management and audit committees are often looking to their audit firms to add value above and beyond the statutory audit. Increasingly, audit firms are being asked to provide thought leadership, industry expertise, and more. Data analytics is one of the ways in which auditing firms could meet the heightened expectations of clients.
38. The provision of big data services, or services leveraging data analytics, could raise potential independence issues, such as self-review threats and the assumption of management responsibilities, as well as concerns relating to confidentiality under both the Code and the law. In addition, professional accountants in business (PAIBs) may face ethical issues should they be expected to utilize this data for inappropriate purposes.
39. Data analytics is also changing internal audit by introducing the concept of continuous auditing. This is the collection of audit evidence and indicators by an internal auditor on IT systems, processes, transactions, and controls on a repeatable and continuous basis, not just at set periods.
40. Currently, many internal audit functions lack the resources (financial and human) to design and implement a continuous auditing model. As a result, many organizations are only just beginning to employ data analytics as they move to a more developed continuous audit process.



41. Internal audit functions with more advanced data analytic tools often focus on transactional-based analytics which can use data to identify exceptions that could indicate potential gaps in internal controls. These analytics could focus on trends and patterns in key performance benchmarks such as number of outstanding sales days or number of purchase orders per week. Data analytics can assist an internal audit function by automating the collection and mapping of organizational data and applying various tools to analyze and interpret the data in a more meaningful way.

**Matters for CAG Consideration**

4. Representatives are asked:
- (a) To share any experiences with big data/data analytics applications within their organizations;
  - (b) For views on potential ethics issues that may arise from the growing trend in the use of such applications by PAIBs or auditors, or the provision of big data/data analytics services by professional accountants in public practice; and
  - (c) For views on what actions, beyond monitoring, the EIOC or the Board should take in the short to medium term in response to this development.

**D. Other Matters for Consideration**

- 1) *European Union (EU) Audit Reform*
42. Since the March 2014 CAG meeting, the following key events relating to the EU Audit Reform have taken place:
- The compromise agreement (endorsed by the Member States at the COREPER<sup>5</sup> meeting of December 18, 2013) was adopted by the Committee on Legal Affairs of the European Parliament on January 21, 2014.
  - The two compromise texts were adopted by the European Parliament on April 3, 2014, and endorsed by the Member States in the Council on April 14, 2014.
  - The co-legislators formally signed the texts on April 16, 2014 which brought the legislative process to a close.
  - The amending Directive and the new Regulation on Statutory Audit were published in the Official Journal of the EU on May 27, 2014. The two texts entered into force on June 16, 2014.
43. On June 27, 2014, FEE released a briefing paper related to the implementation of the new EU audit legislation, highlighting the need for clarification and consistency regarding the provision of non-audit services to PIE statutory audit clients. The Briefing Paper is provided for reference as Agenda Item B-2.

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<sup>5</sup> COREPER is the designation of the two working groups/committees of officials whose task is the preparation of meetings of the Council. COREPER is an acronym made up of the initial letters of the French title for the Committee of Permanent Representatives (Comité des Représentants Permanents).

**Matter for CAG Consideration**

5. Representatives are asked to note the update regarding the EU Audit Reform.

2) *Other Developments*

44. Representatives are asked whether there are any other significant developments internationally that may warrant consideration by the Board. In this regard, the IESBA CAG Chair intends to perform a tour-de-table to facilitate Representatives' input.

**Material Presented – CAG Reference Papers**

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|-----------------|---|
| Agenda Item B-1 | Report-Back – March 2014 CAG Discussion   |
| Agenda Item B-2 | Status of Global Adoption of IESBA Code   |
| Agenda Item B-3 | FEE Briefing Paper, <i>Provision of Non-Audit Services to Public Interest Statutory Audit Clients: A Need for Clarification and Consistency</i> |