

**Audit Quality—Issues and IAASB Task Force Proposals****A. Background***Most Recent IAASB Discussion*

1. At its June 2010 meeting, the IAASB considered the Task Force’s proposed way forward for the project. There was general support for exploring the development of a consultation paper as the substantive part of the project. The IAASB nevertheless asked the Task Force to consider developing a thought piece on audit quality (AQ) in the short term as a precursor to a broader and lengthier consultation on the topic (discussion on this thought piece is included in Section B, paragraphs 16-21, below).
2. Amongst the various comments and observations that were made during the discussion on the development of a consultation paper, the following key concerns were raised:
  - The lack of clarity regarding the ultimate objectives of the proposed consultation paper and how these would enable the IAASB to further the public interest;
  - The need for justification regarding the proposal to consult on the key drivers of AQ, as it was felt that a good amount of consensus already exists in this regard; and
  - The apparent significant overlap between the proposed thought piece and the consultation paper.
3. On the other hand, there was support amongst some IAASB members for exploring the development of a “framework” of AQ drivers. Such a framework could provide a foundation or mechanism for the IAASB to work more closely with the regulatory and oversight community. The Board’s discussions noted the experience in the UK, where such a framework was used with some success to facilitate dialogue and collaboration between the national standard setter and the audit oversight body. Importantly, it was suggested that if such an outcome could be achieved internationally, this would represent a valuable contribution from the IAASB to the public interest.
4. Other relevant observations that were made include:
  - A sense that the proposed scope of the project might be ambitious and the consultative phase of the project time-consuming.
  - The importance of obtaining user views and understanding their needs relative to their assessments of AQ.
  - The potential benefits that may arise from this project in terms of assisting the IAASB in its standard-setting efforts, particularly in identifying areas for improvement in its standards.
  - The possibility of the IAASB treading the perimeter of its remit while undertaking this project.

- Consideration of the topic and related drivers of AQ by the European Commission (EC) in its 2010 “Green Paper”<sup>1</sup> on the audit and accounting profession.

*2010 IAASB-National Auditing Standard Setters (NSS) Meeting*

5. At the 2010 IAASB-NSS meeting, NSS participants expressed significant interest in the IAASB undertaking this project. Nevertheless, they acknowledged its complexity. Participants suggested the following for consideration, amongst other matters:
  - Consideration of a modeling approach to AQ. This would include such matters as exploring a definition of AQ, identifying potential measures of AQ, and considering reporting aspects of AQ.
  - While the inputs to AQ are all relevant, one should not lose sight of 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 a common “language” of AQ that may assist in harmonizing inspection practices.

*September 2010 IAASB Consultative Advisory Group (CAG) Meeting*

6. The project was discussed for the first time with the IAASB CAG at the September 2010 CAG meeting. Amongst the views and observations that were expressed, the following were noted:
  - There was support amongst several CAG Representatives for a substantive consultation phase for the project. Such a consultation phase could explore the interactions among auditing, ethics and accounting education standards, as well as key drivers of AQ and their relative weights and related indicators. In this regard, there was some support for starting with the UK Financial Reporting Council’s (FRC) AQ Framework.<sup>2</sup>
  - It was suggested that consideration be given to involving IFAC or liaising with the International Ethics Standards Board for Accountants (IESBA) and the International Accounting Education Standards Board (IAESB), given the roles that ethics and education play in AQ.
  - While a high quality audit may be seen as one that has followed all applicable standards, this may not always be sufficient for a high quality audit.
  - It may be useful to consider firms’ internal measures of AQ, as the firms are best placed to know how to measure AQ, including through their internal quality control inspections.

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<sup>1</sup> The EC’s Green Paper, which was issued in October 2010, can be accessed at: [http://ec.europa.eu/internal\\_market/auditing/otherdocs/index\\_en.htm](http://ec.europa.eu/internal_market/auditing/otherdocs/index_en.htm).

<sup>2</sup> The UK FRC’s Audit Quality Framework is set out in the Appendix.

- The ultimate measure of AQ is user perceptions, which are affected by audit failures. Users’ understanding of the accounting and independence frameworks also has an effect on their perceptions of AQ. Further work needs to be done on those user perceptions, as these are often overlooked given the overwhelming focus on internal factors.
- There may be merit in considering the effects of audit fees on AQ.

## **B. Matters for Consideration**

### PROPOSED CONSULTATION PHASE

#### *The Need for an International Framework for AQ*

7. There have been a number of attempts to define “audit quality” in the past, and none has resulted in a definition that has achieved universal recognition and acceptance. The Task Force believes that attempting to develop a definition would likely be a futile endeavor. It is unlikely that a single definition would fully capture the complexity and nuances of the concept in a meaningful way, or would comprehensively account for the whole range of factors that underpin audit quality.
8. Therefore, what the Task Force envisions as the focus of the consultation phase would be the development of an internationally agreed AQ framework (AQF). While several jurisdictions (e.g. the UK and Australia) have undertaken substantive work on the elements or “drivers” of AQ, there is not yet clear international consensus on the forces that drive AQ. Different stakeholders hold different views as to how the topic of AQ should be approached, with some emphasizing a focus on metrics, others concentrating on the factors underpinning technical quality, and yet others targeting the relevance and adequacy of the output (i.e., the audit report).
9. The general lack of consensus as to the drivers of AQ was highlighted at the June 2010 IAASB-NSS meeting where reference was made to the divergence of views on the topic during a recent meeting of the Standing Advisory Group (SAG) of the U.S. Public Company Accounting Oversight Board. In addition, the IAASB Chairman has noted that his presentations on the topic to various stakeholders around the world have invariably elicited great interest and a wide range of views amongst stakeholders. This suggests not only a market need for international consensus on the topic, but also a need for international leadership in the debate.
10. The need to establish a framework of AQ drivers has also been raised in other contexts. In particular, in its October 2008 report,<sup>3</sup> the Advisory Committee on the Auditing Profession (Advisory Committee) set up by the U.S. Department of the Treasury has called on the PCAOB to consider the feasibility of developing and disclosing AQ indicators so that more information on AQ can be developed and communicated. The Advisory Committee also noted that from feedback provided to it by various parties, the vast majority of the latter agreed in substance with the recommendation on AQ indicators. Also, the Advisory Committee noted that firms had commented that the UK FRC’s AQ Framework and Article

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<sup>3</sup> The Advisory Committee’s report can be accessed at <http://www.treas.gov/offices/domestic-finance/acap/docs/final-report.pdf>.

40 Transparency Report of the EU's Eighth Directive<sup>4</sup> could serve as starting points to build upon in this effort.

*Vision for, and Purposes of, an International AQ Framework*

11. At the June 2010 IAASB meeting, the Task Force proposed that an international AQF could be used to facilitate closer working relationships and dialogue with key stakeholders, particularly regulatory and oversight bodies. It was noted that as the Board works increasingly with oversight bodies such as IFIAR, it would be helpful to have a framework in place as a basis for constructive discussions on AQ. An international AQF would enable those responsible for oversight to better understand not only where the auditing standards fit in, but also other parts in the spectrum of AQ drivers that may deserve priority attention in furtherance of AQ.
12. Apart from providing the IAASB with a platform for further engagement with regulators and oversight bodies, the Task Force believes that an international AQF would serve the following purposes:
  - Recognizing that standard-setting is an evolving and not a static process, it could provide a mechanism to enable the IAASB to continually assess whether it has the appropriate set of standards. More specifically, it could facilitate IAASB consideration of whether there are areas within its standards, such as ISQC 1<sup>5</sup> and ISA 220,<sup>6</sup> for example, that may require increased attention.
  - It could be used by the IAASB to think through the implications of new proposals, such as on education and training, or to analyze threats to AQ from the application of the ISAs.
  - It could act as a catalyst for participants in the financial reporting process, such as regulators, preparers and other standard setters, to take appropriate action to ensure that audits are performed to a consistently high quality.
  - It could be used to better inform those charged with governance about AQ.<sup>7</sup> In particular, it could be used to encourage those individuals to think about the right questions to ask in the context of the audit.

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<sup>4</sup> The EU's Eighth Directive can be accessed at [http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l\\_157/l\\_15720060609en00870107.pdf](http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_157/l_15720060609en00870107.pdf).

<sup>5</sup> ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

<sup>6</sup> ISA 220, *Quality Control for an Audit of Financial Statements*

<sup>7</sup> Some jurisdictions have already leveraged AQ frameworks to develop educational and guidance materials for those charged with governance. See, for example:

- The February 2008 publication issued by the UK FRC, *The Audit Quality Framework*: <http://www.frc.org.uk/images/uploaded/documents/Audit%20Quality%20Framework%20for%20web1.pdf>
- The November 2009 guidance developed by the Institute of Chartered Accountants in Australia, *The Benefit of Audit – A Guide to Audit Quality*: [http://www.charteredaccountants.com.au/files/documents/0909-36\\_Audit\\_Committee\\_Guide\\_FINAL.pdf](http://www.charteredaccountants.com.au/files/documents/0909-36_Audit_Committee_Guide_FINAL.pdf); and

- It could enable firms to identify impediments to their ability to consistently apply, on a global basis, accounting and auditing standards or internally-developed guidance.
  - It could help quickly raise the level of awareness and understanding of the important building blocks of AQ around the world, particularly in jurisdictions that have not completed substantive research or other work, or held substantive debate, on the topic, whether due to capacity constraints or otherwise.
  - It could level the playing field given inconsistent approaches and practices around the world relative to assessing and promoting AQ, and communicating information about AQ.
  - As highlighted by the U.S. Treasury’s Advisory Committee, such a framework would help facilitate the development and communication of information about AQ by firms and others, which would be in the public interest.
  - It could also, to some extent, assist oversight bodies in harmonizing their approaches to regulatory inspections around the world, a need that has been flagged in discussions with NSS and the IAASB CAG.
13. Last but not least, the Task Force envisions the possibility of linking the AQ initiative in time with wider IFAC projects, such as the development of educational or awareness products targeted at those charged with governance. However, regardless of how the output of this phase might be utilized by IFAC to achieve its broader public interest objectives, the Task Force recognizes that there will be a need to liaise with the appropriate boards and committees of IFAC, such as the IESBA and the IAESB, throughout this project.

#### *Timing*

14. Subject to the IAASB’s views on the proposed way forward, the Task Force anticipates that a draft of the consultation paper would be available for the Board’s consideration and approval by Q4 2011. The proposed AQF could then be finalized in the latter part of 2012. Combined with results from Phase II of the Clarity ISA Implementation Monitoring project, also anticipated in 2012, the availability of this framework would provide a solid platform for the Board’s next strategy review cycle starting in 2013.
15. In terms of early consultation with stakeholders, the Task Force would plan on bringing preliminary matters for consideration regarding the proposed framework at the March 2011 IAASB CAG and April 2011 IAASB-NSS meetings. Input from these forums, particularly from the user groups on the CAG (e.g., analysts and preparers), would be of benefit in helping frame the approach to the consultation paper.

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- The May 2010 guidance developed by the Hong Kong Institute of Certified Public Accountants, *Audit Committees and Audit Quality*:  
[http://www.hkicpa.org.hk/file/media/section6\\_standards/quality\\_assurance/audit-quality/booklet/acp.pdf](http://www.hkicpa.org.hk/file/media/section6_standards/quality_assurance/audit-quality/booklet/acp.pdf).

### **Matters for IAASB Consideration**

Q1. Does the IAASB support the development of an international AQF as a key objective of the consultation phase of this project?

If so, would the UK FRC's AQF<sup>8</sup> represent an appropriate starting point?

If not, what other approach might be more appropriate?

Q2. Subject to IAASB agreement on the proposed way forward:

(a) In addition to discussions with the IAASB CAG and NSS, should further input be obtained from stakeholders (e.g., IFIAR) prior to issuance of the consultation paper and, if so, when and how might this be done?

(b) What other considerations should be taken into account in developing the proposed framework?

### SHORT-TERM THOUGHT PIECE

16. During the June 2010 IAASB discussion, the view was expressed that the thought piece the Task Force was asked to consider developing could identify elements that are often acknowledged as contributing to AQ, as a way to emphasize that auditing standards are a component of the bigger “picture.” It was suggested that this would help place the ISAs in proper context in the broader debate about AQ, and better define where the IAASB's focus lies.
17. The Task Force generally accepted this idea, viewing the thought piece as a signal for more substantive work to come from the IAASB relative to Phase II of the project. In highlighting elements that are often considered important to AQ, the Task Force recognized that ISQC 1<sup>9</sup> and the IAASB Chairman's external presentations on the topic would provide helpful material for consideration.
18. The Task Force also took the view that the thought piece could usefully communicate a number of other important messages about AQ from the Board's perspective, including:
  - The fact that AQ cannot be dissociated from the broader debate about the quality of financial reporting;
  - The fact that the IAASB is not the only player responsible for audit quality;
  - The fact that stakeholders may hold different perceptions of AQ, which compounds the challenges of identifying and agreeing common approaches to enhancing AQ (i.e., no broadly recognized definition);
  - The existence of many different influences on audit quality, some of which are within the control of auditors and some not;
  - The IAASB's substantial efforts in developing high-quality ISAs and supporting their effective implementation; and

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<sup>8</sup> See the Appendix.

<sup>9</sup> ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

- The need for active stakeholder engagement in the debate on AQ.
19. In putting the thought piece together, the Task Force has aimed for a concise and accessible, yet impactful, document that conveys these important messages about AQ. Consistent with the document being intended as a thought piece, several of the messages are aimed at stimulating further thought and debate on the topic. In addition, the Task Force has positioned the document as an introduction to the more substantive consultation phase being planned for next year. **Agenda Item 9-B** sets out a draft of the document, prefaced by a message from the Chairman.
  20. The Task Force believes that it would be important to aim for the document to be issued in early 2011 to maximize the thought piece’s effectiveness. This also takes account of the anticipated timing of issuance of the proposed consultation paper.
  21. The thought piece is intended to be a Board communication and not a pronouncement. Accordingly, process-wise, the Task Force envisages circulating an updated draft of the thought piece (incorporating any Board input) electronically to the Board soon after the meeting for “fatal-flaw” clearance, prior to issuance in early January 2011.

#### **Matters for IAASB Consideration**

Q3. Does the IAASB support issuing the thought piece as proposed?

If so, does the IAASB have any fundamental objection to the messages in the thought piece?

If the IAASB has no fundamental objection, what are the IAASB’s views on those key messages? In particular, are the messages:

- (a) Clearly articulated?
- (b) Succinct?
- (c) Impactful?
- (d) Uncomplicated?

What other important messages should be included?

## Appendix

### The UK FRC’s Audit Quality Framework

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

Driver	Indicators
<p>The culture within an audit firm</p>	<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"> <li>• Creates an environment where achieving high quality is valued, invested in and rewarded.</li> <li>• 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.</li> <li>• Ensures partners and staff have sufficient time and resources to deal with difficult issues as they arise.</li> <li>• Ensures financial considerations do not drive actions and decisions having a negative effect on AQ.</li> <li>• Promotes the merits of consultation on difficult issues and supporting partners in the exercise of their personal judgment.</li> <li>• Ensures robust systems for client acceptance and continuation.</li> <li>• Fosters appraisal and reward systems for partners and staff that promote the personal characteristics essential to quality auditing.</li> <li>• Ensures AQ is monitored within firms and across international networks and appropriate consequential action is taken.</li> </ul>
<p>The skills and personal qualities of audit partners and staff</p>	<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"> <li>• Partners and staff understand their clients’ business and adhere to the principles underlying auditing and ethical standards.</li> <li>• Partners and staff exhibit professional skepticism in their work and are robust in dealing with issues identified during the audit.</li> <li>• Staff performing detailed “on-site” audit work have sufficient experience and are appropriately supervised by partners and managers.</li> <li>• Partners and managers provide junior staff with appropriate “mentoring” and “on-the-job” training.</li> </ul>

Driver	Indicators
	<ul style="list-style-type: none"> <li>• Sufficient training is given to audit personnel in audit, accounting and industry specialist issues.</li> </ul>
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"> <li>• The audit methodology and tools applied to the audit are well structured and:                             <ul style="list-style-type: none"> <li>○ Encourage partners and managers to be actively involved in audit planning.</li> <li>○ Provide a framework and procedures to obtain sufficient appropriate audit evidence effectively and efficiently.</li> <li>○ Require appropriate audit documentation.</li> <li>○ Provide for compliance with auditing standards without inhibiting the exercise of judgment.</li> <li>○ Ensure there is effective review of audit work.</li> <li>○ AQ control procedures are effective, understood and applied.</li> </ul> </li> <li>• High quality technical support is available when the audit team requires it or encounters a situation it is not familiar with.</li> <li>• The objectives of ethical standards are achieved, providing confidence in the integrity, objectivity and independence of the auditor.</li> <li>• The collection of sufficient audit evidence is not inappropriately constrained by financial pressures.</li> </ul>
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"> <li>• Audit reports are written in a manner that conveys clearly and 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.</li> <li>• Auditors properly conclude as to the truth and fairness of the financial statements.</li> <li>• Communications with the audit committee include discussions about:                             <ul style="list-style-type: none"> <li>○ The scope of the audit.</li> <li>○ The threats to auditor objectivity.</li> </ul> </li> </ul>

Driver	Indicators
	<ul style="list-style-type: none"> <li>○ The key risks identified and judgments made in reaching the audit opinion.</li> <li>○ The qualitative aspects of the entity’s accounting and reporting and potential ways of improving financial reporting.</li> </ul>
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"> <li>• An approach to corporate governance within the reporting entity that attaches importance to corporate and financial reporting and to the audit process.</li> <li>• Audit committees that are active, professional and robust in dealing with issues identified during the audit.</li> <li>• 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.</li> <li>• Reporting deadlines that allow the opportunity to carry out an audit without undue reliance on work performed before the end of the reporting period.</li> <li>• Appropriate agreed arrangements for any limitation of liability.</li> <li>• An audit regulatory environment that focuses on the drivers of AQ.</li> </ul>