IAASB CAG PAPER

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Agenda Item

F

Committee: IAASB Consultative Advisory Group

Meeting Location: New York

Meeting Date: March 8–9, 2011

Audit Quality—Issues and IAASB Task Force Proposals

Objective of Agenda Item

1. The objective of this Agenda Item is to obtain the Representatives':
   (a) Reactions to the IAASB thought piece, *Audit Quality: An IAASB Perspective*, issued in January 2011; and
   (b) Views on the proposed objectives and scope of a project to develop an international audit quality (AQ) framework, and the proposed way forward.

Papers to Be Referred to during Discussion

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

Project Status and Timeline

3. The CAG last considered this project at its September 2010 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.
5. At its March 2011 meeting, the IAASB will be asked to consider and approve:
   (a) The objectives and scope of a project to develop an international audit quality framework; and
   (b) A proposed plan and timeline for developing a related consultation draft.
6. Appendix 1 to this paper provides a project history, including links to the relevant CAG documentation.

Background

September 14-15, 2010 CAG Discussion

7. Below are extracts from the draft minutes of the September 2010 CAG meeting,[1] and an indication of how the project Task Force or IAASB has responded to the Representatives' comments.

Representatives' Comments	Task Force/IAASB Response
Ms. de Beer, Ms. Sucher and Mr. Diomeda supported the wider scope for the paper. Ms. de Beer and Ms. Sucher noted the need for further work on the interactions between the auditing standards, ethical standards and education standards and compliance with these standards, including the IFAC Compliance Program.	Support noted. The comments are consistent with the direction from the IAASB.
Mr. Diomeda noted that the project should identify key indicators of the global level of AQ, so that progress on AQ can be measured over time. Mr. Pannier noted that it was less a question of a narrow scope or wide scope and more a need to respond to the expectation of society to know what happened in the financial crisis. He supported a project focused on producing a paper in the near future that maps the drivers and weights those drivers.	Point taken into account. The project will identify the drivers of AQ. However, there is no intention to develop metrics. Many of the important drivers are difficult to measure as they are intangible.
Mr. Koktvedgaard noted that the IAASB should pursue the narrower project, but that the wider project should be undertaken by IFAC, referring the appropriate elements to the IAASB, IESBA and IAESB.	Point not accepted. The IAASB agreed that it should lead the project but that in doing so, it should work closely with other parts of IFAC.
Mr. Cassel noted that a high-quality audit may be seen as one that has followed all applicable ISAs, but that doing so may not always be sufficient. In his view, the financial crisis presented auditors with challenges not addressed in the standards. Either there is the dilemma that ISAs when applied might seem to be inconsistent or there is a situation when an ISA might leave the auditor with very little guidance. He commented that the IAASB needed to work further with the IESBA in this regard.	Point taken into account. The project will explore professional judgment in the wider context of AQ.

[1] The minutes will be approved at the March 2011 IAASB CAG meeting.

Representatives' Comments	Task Force/IAASB Response
Mr. Damant and Mr. Ratnayake noted that the need for judgment in complying with requirements was critical, and that the exercise of judgment varied around the world. Mr. Grant noted that the proper application of ISAs requires a significant amount of judgment and that these judgments were influenced by other areas of the AQ framework such as training, firm culture and the tone at the top. Mr. Grant also noted that requirements of the ISAs need to be consistently applied, regardless of the jurisdiction and circumstances of the audit.	
Ms. Lang asked whether the project was limited to AQ, or also encompassed assurance quality which is particularly relevant to SMEs and SMPs. Mr. Grant noted that the project was starting with AQ but may need to expand to cover assurance quality as well in the future. Mr. Grant noted that the topic of assurance quality may be sufficiently large to make the overall project too slow in the short term. Ms. Lang noted that Prof. Schilder's slide on AQ was also relevant to assurance engagements as well as audit engagements. Prof. Schilder supported this and noted that many of the inputs and outputs to AQ were equally applicable to assurance engagements, but that there may be fewer layers of regulation and oversight for assurance engagements.	Point accepted. The IAASB's aim is to start with a project on AQ where there is clear, immediate public interest need. Once an AQ framework is developed, there may be merit in exploring whether to extend framework considerations to other assurance engagements.
Mr. Attolini noted that this was a key project from the perspective of the IFAC SMP Committee and believes that the project should include assurance and related service engagements and be applicable to the SMEs and SMPs as well as large clients and firms.	Point accepted. The Task Force intends to engage with the SMP Committee at appropriate stages of the project.
Mr. Robberecht noted that the upcoming EC Green Paper will touch on AQ and that many of the drivers of AQ, such as auditor independence, training, oversight and governance, were already included as part of the European Statutory Audit Directive. He supported the IAASB view in paragraph 34 of the draft consultation paper on the proposed IAASB Strategy and Work Program 2012-2014 that ISAs are one component of the	Support noted.

Representatives' Comments	Task Force/IAASB Response
global package of AQ.	
Mr. Baumann noted that AQ had been the subject of intensive consideration over the past few years. The PCAOB had discussed AQ in a meeting but also did not define AQ. Mr. Johnson noted that AQ was too complex to define in any meaningful way and that a definition would fail to capture the full range of factors needed even if the definition was extensive. Mr. Johnson noted that it was possible to identify drivers and indicators of AQ despite the difficulty in defining AQ.	Point accepted.
Mr. Baumann noted that many of the factors considered in AQ may have unintended consequences or promote inappropriate behavior. Mr. Baumann gave the example that if AQ was measured by the number of restatements then firms have an incentive to avoid restatements even if warranted which would harm AQ.	Point taken into account.
Mr. Baumann noted that the Big 6 firms have been asked how they measure AQ but, while there were various measures and actions, there was no overall answer. He noted that firms were best placed to know how to measure AQ and they should be tasked with responsibility to determine the measures of AQ. Mr. Damant supported considering internal measures of AQ developed by the firms. Mr. Grant noted that the project was not attempting to develop measures of AQ as this was a particularly difficult task, particularly in relation to outputs of AQ, but that looking at firms' internal measures of AQ may be useful. Mr. Grant supported the need to involve the firms, noting that transparency reports by firms as required in some jurisdictions include some aspects of AQ, though more needed to be done to gain a full AQ view of each firm. Mr. Johnson supported this but noted that ultimately it was up to audit firms to improve AQ. Mr. Fleck supported Mr. Johnson's comment about the need to look at the firms, but also noted that the project needed to include the individual auditors as well as the firms involved in each audit. Mr. Johnson noted that firms have extensive internal	Point taken into account. This will be discussed with the Forum of Firms, and input received will be considered in the development of the proposed AQ framework.

Representatives' Comments	Task Force/IAASB Response
inspections as well which should give a similar picture to the external inspections.	
Mr. Johnson noted his view that the UK FRC framework of AQ did not give adequate weight to the impact of oversight and inspection of firms which had improved the rate of change within firms. Mr. Grant asked if it would be useful if the IAASB project included developing a global version of the UK FRC paper. Mr. Ratnayake noted that regulators and audit inspectors also have a key role in improving AQ and that different firms have displayed differing level of independence which affects AQ. Mr. Johnson noted that audit inspectors needed to work closely in developing consistent approaches to audit inspections.	Point accepted. Some member organizations of the International Forum of Independent Audit Regulators (IFIAR) are represented on the Task Force. Interactions with oversight bodies will be further explored within the Task Force.
Mr. Johnson noted that a key consideration was ensuring that appraisal and compensation systems reinforced the right behaviors. Mr. Attolini noted that other considerations included the education of prospective auditors and the competitiveness of the job market for graduates, which has an effect on AQ.	Point accepted. These considerations will be covered in the proposed AQ framework. Also, the Task Force notes that the UK is considering a project on how aspects of AQ are reflected in firms' competency frameworks. The Task Force Chair will keep the Task Force and IAASB informed of progress on that project.
Ms. de Beer noted that the ultimate measure of AQ is user perceptions. These user perceptions are affected by audit and other failures. Ms. de Beer noted that further work needed to be done on user perceptions as this was often overwhelmed by the focus on internal factors within the firm and the audit process affecting AQ. Ms. Sucher noted that IOSCO has looked at user perceptions in the past, most notably via consultation papers on transparency and auditor communications. Mr. Fleck noted that user perceptions of AQ were more important than trying to define AQ but that people's judgment of AQ is influenced by their understanding of accounting and independence frameworks. Mr. Kuramochi supported Ms. de Beer's comment and noted that the IAASB should produce a paper explaining the role and responsibilities of the auditor to reduce the expectation	Point taken into account. The Task Force plans to address user perceptions in the project, looking in particular at different views on AQ through the eyes of different stakeholders.

Representatives' Comments	Task Force/IAASB Response
gap.	
Ms. Sucher noted that the UK has recently focused on auditor skepticism and noted that it may be difficult to train auditors in skepticism. Ms Sucher noted that there may be non-audit services that affect perceptions of AQ and skepticism.	Point taken into account. The Task Force plans to address these considerations in the proposed AQ framework.
Mr. Hallqvist noted that the International Corporate Governance Network's (ICGN) main concern is material misstatement due to fraud, and that ICGN does not believe there are any inherent limitations to an audit. He noted his view that, while there may be time and cost limitations, any of the recent accounting frauds could have been detected if sufficient resources had been applied. He also noted that auditors should look for the precursors to fraud such as excessive performance pressure or management problems and then ask the entity's board for further funding to dedicate additional resources to fraud detection. Mr. Hallqvist noted that ICGN was doing further work on this and would continue to push for this at annual meetings. Mr. Damant noted that there were many outside the audit profession who believe that every audit is a forensic audit designed to detect fraud.	Point not accepted. The project on AQ will be undertaken in the context of the current scope of the audit. A reconsideration of the scope of the audit, for example to increase responsibilities for fraud detection, is beyond the remit of the project.
Mr. Kuramochi noted that it had been reported that audit fees had declined as the economy slowed even though audit risk increased at that time. He also noted that, in Japan, some listed companies are moving to use smaller audit firms with a corresponding decrease in audit fees. In his view, existing IAASB projects like ISA 720 would likely increase auditor's work effort and so a corresponding increase in audit fees would be expected. Mr. Kuramochi noted that some criteria may need to be developed for the appropriate amount of hours spent on an audit. Mr. Hallqvist noted that there had been recent reports of auditors being criticized for signing audit reports before sufficient audit evidence had been gained, as well as criticism for selling non-audit services that conflict with the audit. Mr. Hansen noted that audit fees	Point taken into account. The Task Force will consider how engagement economics fit into the "context" element of the proposed AQ framework.

Representatives' Comments	Task Force/IAASB Response
had been extensively discussed in the US recently and that NASBA will be issuing a paper on loss-making and low cost audits. Mr. Baumann noted that the PCAOB was looking at fee decreases on audit engagements. Mr. Koktvedgaard noted that AQ and audit fees may not be related as audit fees should decrease if the company has improved internal controls, for example, or if the audit fee had been too high in previous years.	

December 2010 IAASB Discussion

8. At its December 2010 meeting, the IAASB agreed on the issuance of a thought piece on AQ (see **Agenda Item F.1**). The IAASB also considered a proposal for the development of an international AQ framework. Comments from several IAASB members supported the view that such a framework would fulfill a number of valuable purposes, including that it would:
   (a) Establish a foundation for debate on AQ.
   (b) Help the IAASB in setting appropriate standards.
   (c) Facilitate dialogue with audit committees.
   (d) Help stakeholders make decisions about AQ and assist them in findings answers to questions such as how to assess AQ.
   (e) Provide useful input to the IAASB's ISA Implementation Monitoring project.
   (f) Stimulate further research on AQ.
9. However, a number of IAASB members also thought that there was a need for greater specificity around the objectives and scope of the initiative, particularly in relation to how such a framework might be used.
10. A strong theme throughout the IAASB discussion was the need for a collaborative approach to the project. Dialogue and coordination with both stakeholders and other parts of IFAC, including the International Ethics Standards Board for Accountants (IESBA) and the International Accounting Education Standards Board (IAESB) were flagged as important.
11. In addition, while there was agreement that there would be merit in building on the work of the UK Financial Reporting Council (FRC) on its AQ framework, there was a strong view that the approach to the IAASB project should be holistic rather than inwardly focused on the inputs to AQ.

Comments from the SMP Committee

12. In commenting on the project papers for the December 2010 IAASB meeting, the SMP Committee expressed general support for the proposal to develop an international AQ

framework. However, the SMP Committee indicated that a particular focus should be given to the audit of small- and medium-sized entities (SMEs), questioning whether the AQ drivers for SME audits are necessarily the same as for larger audits. The SMP Committee also raised concerns about the cost of applying ISAs for SME audits and the complexity of financial reporting standards.

Matters for CAG Consideration

13. The following are matters that the IAASB will be asked to consider at its March 2011 meeting.

OBJECTIVES AND SCOPE OF THE PROPOSED AQ FRAMEWORK

14. There is currently no clear international consensus on the forces that drive AQ. In particular, different stakeholders continue to hold different views on AQ. Some find it more relevant to focus on the factors underpinning technical quality. Others believe it is more appropriate to focus on the relevance and adequacy of the outputs of the audit.

15. In the Task Force's view, there is a strong case for developing on a collaborative basis an international AQ framework that describes the influences of input, output and context factors on AQ. Such a framework could serve a number of specific purposes in the public interest, namely:

    (a) *In relation to stakeholders generally*

    The framework could be used to facilitate closer working relationships and dialogue between the IAASB and key stakeholders as well as amongst the key stakeholders themselves, including investors, those charged with governance, regulatory and oversight bodies, and firms. In particular:

    - Given the importance of building strong working relationships between the IAASB and various stakeholders (e.g., oversight bodies such as IFIAR), it would be helpful to have a framework in place as a basis for constructive discussions on AQ. Also, from the perspective of oversight bodies, a framework may be of assistance in harmonizing approaches to regulatory inspections around the world.
    - A framework could be of high impact in helping to raise the level of awareness and understanding amongst stakeholders of the important elements of AQ,[2]

[2] There is already active interest in a number of forums on the topic of AQ. For example:

- The European Commission's October 2010 Green Paper on the auditing profession, *Audit Policy: Lessons from the Crisis,* refers to AQ and asks what actions can be taken to improve it. The Green Paper can be accessed at: http://ec.europa.eu/internal_market/consultations/2010/green_paper_audit_en.htm.
- In March 2010, the Australian Treasury issued a discussion paper on the topic entitled *Audit Quality: A Strategic Review*. The discussion paper seeks to identify the key drivers of audit quality and to assess

particularly in developing countries or emerging economies, or in jurisdictions where there has been little or no debate on AQ.

- A framework would enable stakeholders to not only better understand how auditing standards fit into the AQ equation, but also recognize other elements of AQ that may deserve priority attention to enhance audit effectiveness. For example, a framework could prompt participants in the financial reporting process, such as regulators and other standard setters, to take further action to ensure that audits are performed to a consistently high quality. Additionally, a framework could be used to better inform those charged with governance about AQ[3] and encourage them to think about the right questions to ask in the context of the audit.

(b) *In relation to IFAC's Standard-Setting Public Interest Activity Committees (PIACs)*

- Given that standard setting is an evolving process, a framework could act as input to each of the standard-setting PIACs' ongoing assessment of whether it has the appropriate set of standards. For example, it could facilitate IAASB consideration of whether there are areas within ISQC 1[4] and ISA 220[5] that may require attention. More generally, a framework could assist the IAASB, IESBA and IAESB in thinking through the implications of new standard-setting proposals.

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whether any measures should be taken to address any threats to these drivers of audit quality. The discussion paper can be accessed at: http://www.treasury.gov.au/documents/1745/PDF/Audit_Quality_in_Australia.pdf.

- In its October 2008 report, the Advisory Committee on the Auditing Profession set up by the U.S. Department of the Treasury called on the U.S. Public Company Accounting Oversight Board (PCAOB) to consider the feasibility of developing and disclosing AQ indicators so that more information on AQ can be developed and communicated. A summary of the report's recommendations can be accessed at: http://www.treasury.gov/press-center/press-releases/Pages/hp1158.aspx.

[3] 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; and

[4] ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

[5] ISA 220, *Quality Control for an Audit of Financial Statements*

(c) *In relation to firms and professional bodies*

- A framework could help firms when reflecting on how to enhance the consistent application of auditing standards or internally-developed guidance within the firms or across their networks. It could also help facilitate the communication of information about AQ by firms and professional bodies.

(d) *In relation to academics*

- A framework may help to stimulate relevant academic research on the topic.

16. The Task Force is firmly of the view that the key objective and output of the project are the establishment of the framework itself. What is needed in the public interest is a universal platform − hitherto absent – from which stakeholders can work to further examine AQ, discuss and share insights about it, and take appropriate actions to maintain and enhance it.

17. The Task Force therefore proposes that the objective of the project be articulated as follows:

> To establish an international framework that describes AQ holistically including the influences of input, output and context factors. This framework will be used to illustrate:
>
> (a) Stakeholders' varying perspectives on AQ; and
>
> (b) The important 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 AQ.

18. For consultation purposes, the inter-relationships between the ISAs and ISQC 1 and the elements of AQ will be described in order to elicit input as to whether there are areas for further enhancement within IAASB standards. A preliminary outline of the proposed consultation paper is set out in Appendix 2.

19. With regard to the SMP Committee comments, a number of the issues raised therein may be addressed by other projects. For example, the ISA Implementation Monitoring project is focusing on the application of ISAs for SME audits. That said, the Task Force acknowledges that liaison with the SMP Committee will be important to ascertain whether the input, output and context factors for SME audits are different from those for larger audits.

Matter for CAG Consideration

1. Do the Representatives support an IAASB project to develop an AQ framework and, if so, the objective of the project as articulated above?

PROPOSED PLAN FOR THE WAY FORWARD

20. Given IAASB agreement on the need for a collaborative approach to the project, the Task Force has identified on a preliminary basis the following stakeholders, apart from the IAASB CAG, with whom to engage before a consultation paper is issued:

- IESBA
- IAESB
- SMP Committee
- IFIAR
- Investors
- International Organization of Securities Commissions (IOSCO)
- National auditing standard setters (NSS)
- Forum of Firms
- ICGN
- International Organization of Supreme Audit Institutions (INTOSAI)

Other stakeholders, of whom there may be many, will have the opportunity to respond to the consultation paper once it is issued. Depending on the responses received, the Task Force or IAASB may decide to actively engage with some of those other stakeholders to discuss their comments.

21. Subject to IAASB approval of the objective of the project, a possible timeline for discussion with these stakeholders is set out below, together with an indication of the timing for the various stages of development of the consultation paper. This timeline anticipates IAASB approval of the consultation paper in Q1 2012. Comments to be received in late 2012 on the consultation paper could then provide input to Phase 2 of the ISA Implementation Monitoring project.

Timing	Discussion/ Outreach with Stakeholder Representatives	Activity
2011		
April 28–29	NSS	• Discuss thought piece

Timing	Discussion/ Outreach with Stakeholder Representatives	Activity
		• Confirm support for consultation phase, including objective
April/May	• Forum of Firms • IFIAR • IESBA and IAESB • INTOSAI • ICGN	• Discuss thought piece • Confirm support for consultation phase, including objective
June IAASB Meeting • Update on discussions/outreach and other TF activities[6] • First discussion of consultation paper		
July	• IFIAR Standards Coordination Working Group • Investors	Discuss key aspects of draft consultation paper
September IAASB CAG Meeting Discuss key aspects of draft consultation paper		
September IAASB Meeting Status report to IAASB		
September	• IFIAR • IESBA and IAESB • SMP Committee	Discuss key aspects of draft consultation paper
October	• Forum of Firms • IOSCO	Discuss key aspects of draft consultation paper
December IAASB Meeting Second discussion of consultation paper		
2012		
March IAASB Meeting Approval of consultation paper		

[6] This will include, as appropriate, consideration of Terms of Reference for the initiative.

Timing	Discussion/ Outreach with Stakeholder Representatives	Activity
April	NSS	• Publish consultation paper • Discuss with NSS

Matter for CAG Consideration

2. The Representatives are asked for their views on the proposed approach to, and timing of, the AQ project.

Material Presented –IAASB CAG PAPER

Agenda Item F.1 Audit Quality Thought Piece, *Audit Quality: An IAASB Perspective*

Appendix 1

Project History

Project: Audit Quality

Summary

	CAG Meeting	IAASB Meeting
Project commencement	September 2010	December 2009 June 2010 December 2010 March 2011

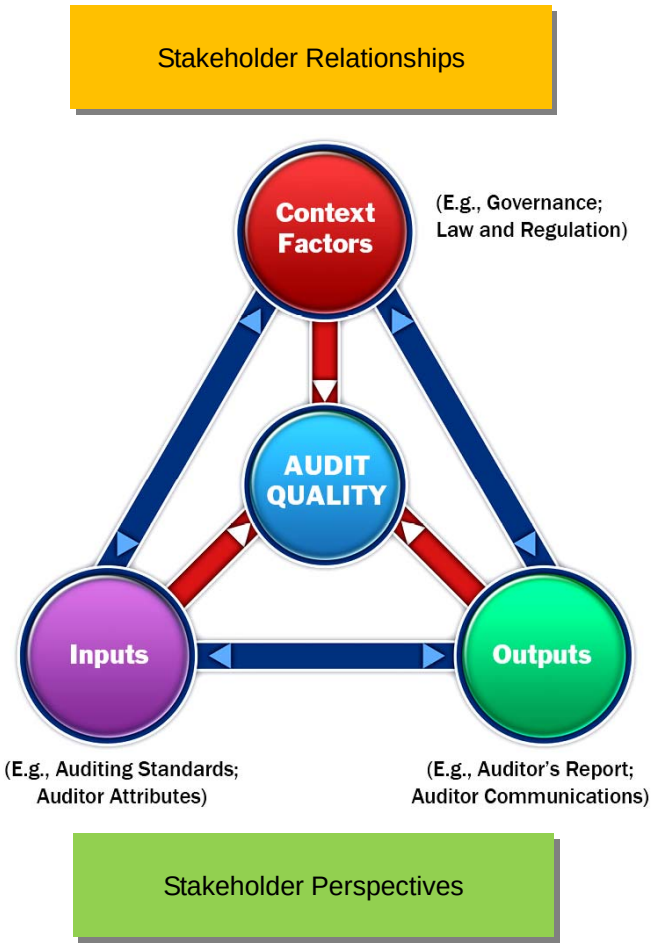
CAG Discussions: Detailed References

Project Commencement	September 2010 See IAASB CAG meeting material: http://www.ifac.org/IAASB/Meeting-FileDL.php?FID=5665 See draft September 2010 CAG meeting minutes at Agenda Item D. See report back on September 2010 CAG meeting in paragraph 7 of this paper.

Appendix 2

Outline of Proposed Consultation Paper

1. Introduction
   - Background
     - Recap main ideas from AQ thought piece
     - Leverage schematic below to highlight:
       - Relevance of inter-dependencies between different elements of financial reporting supply chain to AQ
       - Stakeholder perspectives on AQ



     - Summary of recent IAASB discussions
     - Relevant external developments

- Overview and purpose of consultation paper
  - Objective—to develop an international AQ framework that will be of value to IAASB and stakeholders
  - Builds on work done by UK FRC and others on AQ
  - Rationale for an international AQ framework and how it can help achieve, maintain and enhance AQ
- Guide for respondents

2. The financial reporting supply chain and audit quality
   - Key participants in the supply chain
   - Inter-dependencies between different elements of the supply chain from perspective of AQ
3. Input factors
   - The culture within an audit firm
   - The skills and personal qualities of audit partners and staff
   - The quality of the audit process
4. Output factors
   - The reliability and usefulness of audit reporting to users of audited financial statements
   - The reliability and usefulness of audit reporting to management and those charged with governance
5. Relationship between ISAs/ISQC 1 and input/output factors
   - Discussion of specific provisions in ISAs and ISQC 1 that address the input/output factors
6. Context factors
   - National business practices, including the legal framework
   - National culture
   - The culture within the entity's business
   - The educational environment and resource capacity
   - The applicable financial reporting framework (e.g. degree of complexity)
   - The client's reporting timetable
   - The regulatory environment relating to auditors

7. Perceptions of audit quality and external expectations
   - Perceptions of audit quality
   - External expectations