

SUBMISSION



NEW ZEALAND
INSTITUTE OF
CHARTERED
ACCOUNTANTS

SUBMISSION ON:

**Consultation Paper – A Framework
for Audit Quality**

15 May 2013

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Dear James

Submission on Consultation Paper: A Framework for Audit Quality ('the Framework')

The New Zealand Institute of Chartered Accountants (NZICA) welcomes the opportunity to comment on the Framework and commends the International Auditing and Assurance Standards Board (IAASB) for taking the initiative on this important topic. NZICA has over 33,000 members who work across New Zealand and the world. Our members operate throughout the economy, participating in and advising all types of businesses, entities and individuals. In considering this topic, NZICA balances the interest of its members who are the supply-side of qualified auditor services with the public's interest in being able to access information from the financial reporting system.

NZICA performs an active role in the regulation of the audit market in New Zealand. Under the Auditor Regulation Act 2011, NZICA is an Accredited Body and issues licenses to auditors and registers audit firms where it believes applicants meet Prescribed Minimum Standards set by the Financial Markets Authority (FMA). NZICA undertakes audit firm inspections under the direction of FMA.

Outlined below are the main areas that NZICA encourages IAASB to consider further as it proceeds to establish a conceptual framework for audit quality. *Appendix A* contains NZICA's response to the specific questions raised in the Consultation Paper.

The Framework is likely to have its genesis in the Global Financial Crisis (GFC) events and therefore seeks change. However, minimal commentary is provided on the degree of change sought to the concept of audit. In absence of details, such as the degree of change sought and the process in which users of audit gain confidence in the financial statements, the Framework is not envisaged to be used to affect transformational change. If transformational change were to have a central role within the framework, NZICA would anticipate the contextual factors positioned earlier on in the analysis of the Framework and an undertaking of greater analysis on these factors. The Framework therefore appears grounded in the current settings of what audit means and how it is designed to meet the needs of financial information users. NZICA encourages greater exploration of transformational change aspirations that challenge the appropriateness of the audit 'product' akin to discussion undertaken with Financial Reporting using Integrated Reporting as a platform.

NZICA notes that, whilst a definition of audit quality (that may be considered a 'macro' term or 'empty signifier' in the academic assurance literature) is not detailed, the Framework does define what attributes are present when a high quality audit has been achieved (ie a 'micro' approach). These attributes are concerned with the audit evidence and the engagement team that obtained it. Against this background, the Framework seeks to describe the factors that influence the outcome of a high quality audit in terms of the inputs, outputs, contextual factors and interactions that comprise the audit. Having undertaken this process, the IAASB outline how the Framework can be used and detail further considerations for exploration to determine actions to improve audit quality.

NZICA acknowledges the above attributes and recommends consideration be given to a tiered approach as follows:

1. The extent to which market users have confidence in financial statements on an overall basis (ie the role and strength of the audit profession).
2. The extent to which the audit work and report meet the needs of financial statement users (ie the 'design' of the 'product' the profession has in place to undertake its role).
3. The 'quality' to which the audit has been performed (ie the work undertaken).

NZICA agrees with the IAASB's view that a high quality audit is one for which the audit report can be relied upon (level 3 above). In extending this view, NZICA notes that a discussion on audit quality should be considered on the three levels to raise pertinent questions that rely upon contextual relevance provided by a tier approach.

Internationally, regulators continue to observe a significant level of non-compliance with ISAs. Firms have designed their audit software packages around the clarified ISA requirements to ensure compliance. The largest of these firms expend significant resources undertaking their own audit inspections and quality control procedures. Despite this attention, improvements in audit quality are still called for by regulation around the world. NZICA considers that an important contextual factor of audit quality that is not reflected in the Framework is the way the audit market operates with regard to information and *how* it reacts to differentiation in audit quality. Such an understanding serves as a pre-requisite for transformational change.

If you have any questions regarding this submission, please contact Dr Michael Fraser CA (Director – Technical Services) on +64 4 917 4594 or michael.fraser@nzica.com.

Yours sincerely



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Addendum A – Responses to Specific Questions

Q1. Does the Framework cover all of the areas of audit quality that you would expect? If not, what else should be included?

NZICA responses and comments

NZICA commends the IAASB for facilitating discussion on a comprehensive Framework and strongly encourages greater consideration to the following areas:

- *Market drivers to reward audit quality.* Frequently, audit recipients do not see value beyond a compliance exercise and as such are unwilling to pay for quality. In many industries or professions it is the competitive facet that facilitates quality. In contrast, the competitive nature of the audit market often sees low-balling that results in some audit firms winning work with an unsustainable fee base and decreasing audit quality over the longer term. A market that prices the audit based on the effort involved and not directly on the quality of the outcome is an important contextual element. General recognition of audit quality at a market level will significantly improve audit quality over the longer term.
- *Quality recognised as an integral element of audit firms sustainable business models.* Audits are increasingly driven by a compliance focus (to the ISAs) and this may, to some degree, be inhibiting quality. NZICA believes audit firms that embed quality as a central objective of their business model will be significantly advantaged when viewed at a systems level. Shifts in organisational behaviour (ie in particular, the motivation to achieve audit quality) would be very powerful in achieving audit quality. NZICA notes that IAASB does not frame audit quality as simply meeting the requirements of the auditing standards. Firms that strictly apply ISAs in lieu of important contextual factors are unlikely to foster organisational behaviours that support audit quality.
- *A focus on the user of the financial statements.* Paragraph 18 implies that a quality audit has been achieved when the auditor's opinion on the financial statements can be relied upon. If this assertion was referenced to the stated purpose of the audit (paragraph 1), it may instead reflect that a quality audit has been achieved when the degree of confidence of intended users has been enhanced. NZICA notes there is a contextual factor absent that relates to *how* the intended user seeks out confidence on the financial information and what provides that same user with enhanced confidence (ie audit expectation gap issue).
- *The size of the entity together with the capital market it operates in.* In NZICA's experience, smaller audit firms face unique challenges in achieving quality audits. Whilst NZICA agrees with IAASB's view that an 'audit is an audit', greater consideration is required for the 'smaller-end of the market'. Part of addressing the issue may be advocating continued policy reform around the requirement for audit of entities that are neither public interest entities or economically significant. NZICA believes further work should be undertaken to understand how users of small entity financial statements may derive enhanced confidence in them as the result of an engagement with an assurance practitioner. A focus on the user, coupled with an innovative solution to the issue, provides the ingredients to achieve a new 'catalyst for confidence' beyond traditional thinking. A critical mass of clients supported by focused regulation and involvement of audit committees will lead to audit quality. It should be noted that these factors have a significantly different impact on the completion of smaller audits.

- The Framework appears to limit itself unnecessarily to the national level. For example, as a member of IFAC, NZICA is obligated to use best endeavours to ensure the ethical requirements promulgated by IFAC are also required to be followed by its membership. Therefore, NZICA would be interested in the Framework extending to an international level.
- NZICA notes that the role of other internal and external stakeholders in enhancing the confidence of users in financial statements is understated in the Framework and could be explored as a contextual factor further in order to understand the impact on the assurance practitioner. For example, NZICA views the role of the Audit Committee as vital in the discussion of audit quality. In particular, NZICA views the following factors as important: the composition of the Audit Committee, what information the Audit Committee provides to users in respect to the external audit, how the Audit Committee assesses the quality of the external audit function and the appointment of the external auditor and its role in this.
- NZICA also views the quality of education supporting those entering the audit profession as an important contextual factor.
- Perception of audit quality is an important consideration in a discussion on audit quality. The recent GFC gave rise to a significant number of corporate failures with anecdotal evidence suggesting that the public perception is that corporate failure equates to audit failure. While corporate failure may be an indicator that an audit has not been performed to the requisite standard, it is not automatically the case. Additionally, regulators are increasingly influencing the public's perception of the performance of the audit profession. In this context, it is important that the process by which regulators assess and cumulate findings is aligned with how users may undertake audit quality assessments.

Q2. Does the Framework reflect the appropriate balance in the responsibility for audit quality between the auditor (engagement team and firm), the entity (management and those charged with governance), and other stakeholders? If not, which areas of the Framework should be revised and how?

NZICA responses and comments

NZICA's view is that the responsibility for the quality of the audit work that supports the audit opinion rests firmly with the auditor and the audit firm. However, NZICA acknowledges that other stakeholders influence this. In practice, the Audit Committee and management have the ability to 'drive' audit quality and therefore can have a significant influence, albeit indirect, on the quality of the audit.

While the audit engagement leader takes primary responsibility for the delivery of a firm's audit opinion, deficiencies in audit quality can also occur because of circumstances not necessarily under their control. These can include staffing and resource shortages, inadequate audit tools and training, and the lack of an appropriate emphasis on quality at higher levels. Therefore, ultimate responsibility for audit quality in any audit firm rests with the leadership of that firm and accountability needs to extend beyond the audit engagement leader to other leaders and management in the firm.

It is evident in the New Zealand market place that there is a limited understanding as to whether clients view themselves as purchasing a quality assurance product or not. The only tangible output (the auditor's report) should be the same regardless of the assurance practitioner carrying out the work; therefore the audit opinion is of limited value to the market in assessing audit quality. The Audit Committee has the ability to communicate to investors their interactions with auditors to enable investors to make an assessment of audit quality. This is considered in number 10 of the areas to explore and NZICA agrees this is an important consideration.

Management are a key participant in the financial reporting supply chain. They are responsible for the preparation of the financial statements and for ensuring they comply with the applicable financial reporting framework. The culture within the audited entity is vital to create an environment where all staff embrace a constructive relationship with the auditors, and have a high level of integrity. In the absence of quality financial reporting and cooperation, it is unlikely a quality audit can be achieved.

The Framework details audit quality in respect to the reliability of the audit opinion, rather than the stated purpose of the audit which is enhancing the degree of confidence of the intended users of the financial statements. By looking at the role of others in achieving this outcome, NZICA believes the Framework will be more informative to those parties advocating for positive change. This might be achieved by expanding the contextual factors and identifying levers for improving users' confidence in financial statements and will thereby improve the inputs and outputs of the external audit process.

Q3. How do you intend to use the Framework? Are there changes that need to be made to the form or content of the Framework to maximize its value to you?

NZICA responses and comments

In NZICA's view, the Framework is already in use and the real value lies in future-orientated activities that may be facilitated with greater development. In the future, the Framework may form a good source for various educational pieces. In particular, one of these could be to provide Audit Committees with a basis to assess the performance of the external audit process.

From the feedback NZICA has received from audit practitioners, it is unlikely these respondents would use it as there is a lot of repetition of the standards which are already incorporated into the audit firms system of quality control, and into their audit methodologies.

As detailed earlier in the submission, it would be useful to position the contextual factors at the beginning of the Framework. NZICA views these as being one of the most important aspects of the Framework, and believes that they should be analysed more fulsomely and positioned more prominently.

Q4. What are your views on the suggested Areas to Explore? Which, if any, should be given priority and by whom? Are there additional Areas to Explore?

NZICA responses and comments

Area 2: *“Establishing a common understanding of capabilities and how they are demonstrated and assessed, as they relate to audit quality for use by audit firms when recruiting, evaluating, promoting, and remunerating partners and staff”*. NZICA considers this area could be extended to research, whether such attributes are inherent within individuals, or the type of educational programmes that might be most effective for teaching such attributes.

Area 9: *“Striving for greater international harmonization in the role of audit committees with regard to the evaluation of the quality of the external audit”*. NZICA would encourage greater international harmonisation around which entities are required to have an Audit Committee and who can be on an Audit Committee, in terms of having the appropriate qualification/accreditation displaying financial literacy. It is apparent that some Audit Committees lack the required skills to hold the auditor accountable for audit quality. A client who gets the most out of an audit is one who has an empowered Audit Committee, which comes from possessing an appropriate combination of skills.