

16 May 2016

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International Auditing and Assurance Standards Board  
International Federation of Accountants  
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Submitted via web link at:

<http://www.ifac.org/publications-resources/submit-comment?exposure-draft=45282>

Dear Madam,

The Auditing Standards Committee of the Auditing Section of the American Accounting Association is pleased to provide a response to the International Auditing and Assurance Standards Board (IAASB) *Invitation to Comment: Enhancing Audit Quality in the Public Interest* (hereafter referred to as the ITC).

The views expressed in this letter are those of the members of the Auditing Standards Committee and do not reflect an official position of the American Accounting Association. In addition the comments reflect the overall consensus view of the Committee, not necessarily the views of every individual member.

We hope that our attached comments and suggestions are helpful and will assist the IAASB in its efforts related to the issues of professional skepticism, quality control, and group audits. As an academic organization, we have limited our response to addressing ITC General Question number G3: “Are you aware of any published, planned or ongoing academic research that may be relevant to the three topics discussed in this consultation? If so, please provide us with relevant details.” We have reviewed the relevant academic research in each topic area and have provided insights to questions posed in the ITC where appropriate.

Please feel free to contact the subcommittee chair should members of the IAASB have any questions regarding our comments and suggestions.

Respectfully submitted,

Auditing Standards Committee  
Auditing Section – American Accounting Association

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## **General Comment**

The Committee commends the IAASB for its work relating to the three topic areas covered in the ITC. The questions raised in the ITC are very comprehensive and cover a wide range of relevant issues. We provide our responses broken out by topic area and then by question (as provided on pp. 87-95 of the ITC). At the end of this document we provide a bibliography of cited articles, also categorized into sections by topic area, for ease of reference for each topic working group.

### **Topic 1: Professional Skepticism**

General note: The Committee is aware that the IAASB recently commissioned an academic synthesis of the skepticism literature that was completed in December 2015 (Brazel and Shaefer 2015), referenced in the “Activities” section in paragraph 36 and in footnote 21. Therefore, our goal in this comment letter is not to recreate that comprehensive synthesis, since the academic literature on this topic is voluminous and dates back many years, and current research builds upon previous research. Instead we provide insights related to specific questions raised in the ITC from the standpoint of new and emerging academic research.

*PS1: Is your interpretation of the concept of professional skepticism consistent with how it is defined and referred to in the ISAs? If not, how could the concept be better described?*

The definition given in ISA 200 paragraph 13(1) and in the IAASB’s Glossary of Terms describes professional skepticism as: “An attitude that includes questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of evidence.” This definition and the related definitions from PCAOB and AICPA standards have been used extensively in the academic literature (Hurtt, Brown-Liburd, Earley and Krishnamoorthy 2013). Some academic papers, however, argue that the definition is still not well understood and imply that guidance in standards regarding professional skepticism and its application to audit engagements should be expanded to include other considerations. For example, Glover and Prawitt (2014) note that although skepticism is indeed “an attitude that includes a questioning mind,” the level of skepticism applied is context-specific. Therefore skepticism should be thought of as a level of evidence questioning ranging on a continuum from complete trust in the veracity of the evidence to complete doubt, depending on the circumstances (mainly tied to complexity and risk associated with the audit). This notion seems consistent with the section of the definition cautioning auditors “to be alert to conditions which may indicate possible misstatement due to error or fraud.”

The relationship between skepticism and the presence of management bias (as discussed in paragraph 39 of the ITC) also merits attention. ISA 540, paragraph 21, specifically notes that “auditors should review the judgments and decisions made by management in the making of accounting estimates to identify whether indicators of possible management bias exist.” This implies that the presence of bias in management’s estimates would increase the risk of material misstatement related to those estimates (and therefore auditors should be more skeptical of evidence provided by management when bias exists). Perhaps this is captured in the notion of increased risk on the continuum proposed by Glover and Prawitt; however, it seems that it would

be useful to link the assessment of management bias in estimates in ISA 540 to increased professional skepticism in ISA 200.

Interestingly, the link between management bias and skepticism is rarely made explicitly elsewhere in the academic literature, although Hurtt et al. (2013) note that researchers have linked auditors' own biases and their resulting lack of skepticism. Nolder and Kadous (2015) note that the auditors' own beliefs can impact their skepticism, and propose a definition of professional skepticism focusing more on the attitude component of the current definition in ISA 200. They believe that the auditor's feelings (or affect) should be explicitly taken into account in the definition of professional skepticism. Nolder and Kadous (2015) define skepticism in their paper as "an unobservable, latent attitude construct reflected in auditors' (1) evaluative beliefs about management's assertions, including the risk of material misstatement and what constitutes appropriate and sufficient evidence to support the opinion, (2) feelings in response to the risks associated with potential misstatement in management's assertions and potential evidence inappropriateness or insufficiency, and (3) intentions and behaviors associated with the nature, extent, and timing of additional audit procedures performed which determines the ultimate persuasiveness of the evidence supporting the audit opinion." It is noteworthy that the main areas of focus in the definition are the auditors' beliefs, feelings, and intentions and behaviors, which Nolder and Kadous (2015) argue are often ignored in academic studies of auditors' professional skepticism (the possible exception to this is measuring auditors beliefs about risks). This may be because affect is hard to capture in experimental settings, but making auditors aware of how their own feelings or biases can impact their skeptical judgments may be helpful and forms the basis for judgment frameworks as discussed below.

Based on the Committee's review of the academic literature, it appears that the current definition of professional skepticism in the ISA's is adequate and captures the necessary characteristics of professional skepticism. Additional guidance might be needed about the appropriate level of skepticism to apply under specific circumstances, however (Glover and Prawitt 2014). This guidance would aid both auditors in their application of professional skepticism and regulators who evaluate the adequacy of audit procedures performed. It would also help to alleviate situations in which there is a mismatch between the amount of skepticism deemed adequate by regulators versus auditors (Glover and Prawitt 2014). In addition, the guidance should caution auditors to be aware of how their own feelings, beliefs, or biases may impact their application of professional skepticism. This self-awareness is a major component of the frameworks for professional skepticism developed by several professional services firms, as discussed in Glover and Prawitt (2014) and in the response to PS2 below.

*PS2. What do you believe are the drivers for, and impediments to, the appropriate application of professional skepticism?*

Drivers for and impediments to skepticism are covered extensively in the models proposed by Nelson (2009) and Hurtt et al. (2013) and are not covered in detail here. These include, characteristics of auditors themselves, their ability to exercise skeptical judgments, and characteristics of evidence or of the environment that promote or inhibit skepticism. Environmental factors include incentives provided by auditing firms to encourage skeptical

behavior, or pressures to complete audits in a timely manner, both of which can inhibit the collection of additional audit evidence. In addition to the academic studies cited in Nelson (2009) and Hurtt et al. (2013), more recent studies have provided insights into the drivers for and impediments to professional skepticism as noted below.

Since 2013, there has been an increased research emphasis on examining the drivers for and impediments to professional skepticism. Often they are two sides of the same coin; for example, increased time pressure may impede skepticism, while increasing time available in the budget may be a driver of skepticism. Westermann, Cohen and Trompeter (2014) conducted a survey and interviews with audit partners and noted that increased accountability for the quality of audit work (whether to regulators or to the firm) increased the application of professional skepticism, while pressures on engagements (such as budgetary or time pressures) inhibit the application of professional skepticism. Mocado (2016) notes that time pressure felt by auditors at the senior associate level negatively impacts the level of audit quality, with auditors reducing the amount of necessary procedures performed when under time pressure.

Kadous and Zhou (2016) find that skepticism is increased when auditors' intrinsic motivation to perform well is made salient to them. This suggests that a high level of internal accountability (as opposed to external sources of accountability noted in Westermann et al. 2014) can be highly effective in driving professional skepticism. Therefore reminding auditors of why they should take pride in their work, and why their role in protecting the public interest is important, should cause them to exercise more professional skepticism (as noted in bullet 4 of paragraph 37 of the ITC). Alternatively, auditors can become demotivated if they feel that their superiors discourage the exercise of professional skepticism. Brazel, Jackson, Rech and Stewart (forthcoming) find that when auditors exhibit skepticism and perform additional follow up procedures, but do not find misstatements, the auditors are viewed negatively by superiors. Brazel et al. (forthcoming) note that this focus on the outcome of the additional procedures (which they call the "outcome effect"), can discourage auditors from exercising professional skepticism, even when the additional effort is warranted. There are two possible solutions to reducing the outcome effect. One is to improve the "tone at the top" on audit engagements by encouraging greater skepticism, even when accounts are ultimately found to be fairly stated (this is related to firms' quality control efforts and discussed more in the section below). Another solution is for auditing standards to promote the application of professional skepticism when management bias is present by requiring auditors to document the impact of management bias on auditing judgments and procedures performed. This requirement would ensure that procedures are linked to the consideration of bias, not to whether or not the account is ultimately misstated.

Two studies, Bennett and Hatfield (2016) and Zimmerman (2016), examine how the medium through which auditors communicate affects their professional skepticism. Bennett and Hatfield find skepticism is enhanced in face-to-face versus computer-mediated (e-mail) settings. A greater number of follow up questions indicating greater skepticism was noted in the face-to-face condition, particularly when the client exhibited nonverbal cues designed to increase skepticism on the part of the auditor. Zimmerman (2016) only studied an e-mail communication setting, but varied the confidence expressed by management as well as the timing of e-mail response, and found that auditors were most skeptical when management exhibited low confidence and was slow to respond to requests.

*What role should we take to enhance those drivers and address those impediments?*

The academic research cited above suggests that addressing firm-level impediments to and drivers of professional skepticism, such as accountability for high quality work, motivation to perform well, encouragement of skeptical action without regard to outcome, planning audits appropriately to reduce time pressure, and encouraging face-to-face communication are promising avenues to promote the application of professional skepticism. All of these fall under the umbrella of firm quality control, and we encourage the continued development of activities related to enhancing standards of quality control that are described as the second topic of the ITC (and addressed by the Committee below).

*How should we prioritize the areas discussed in paragraph 37?*

As noted above, the bullet listed items relating to firm culture and quality control represent very promising areas of focus for standard-setting. Of the items presented in paragraph 37, these are represented by the first bullet (firm culture), second bullet (firm training) and sixth bullet (role of engagement and EQCR partners, audit committees, and external parties that oversee audits). These three areas should be a top priority for standard setting efforts.

The next priority should be the last item (bullet number 8). The item asks whether the standards should incorporate a framework for professional skepticism. We highly recommend the development and use of a framework for several reasons. First, a major reason for the difficulty encountered by standard setters in defining and measuring professional skepticism is likely due to its inseparable link to the fundamental ethical principles of integrity, objectivity and auditor independence. A professional skepticism framework would be useful to identify inputs to and outputs from the audit process that enhance the auditor's ability to remain independent, act with integrity and objectivity, and maintain an attitude of professional skepticism. Second, relying on the model introduced by Nelson (2009) and extended by Hurtt et al. (2013), the framework should be based on the recognition of the difference between skeptical judgment and skeptical action. Professional skepticism is an attribute of auditor performance because it is a product of auditor judgment revealed by skeptical behavior (Nelson 2009). As described in Nelson (2009) and Hurtt et al. (2013), auditor knowledge, traits and incentives drive professional skepticism's role in judgmental decision making throughout the audit. Similarly, the model should also depict how the interaction of auditor judgment with knowledge, traits and incentives produces action or inaction. A framework that structures a distinction between judgment and action underscores to the auditor that documentation of both professional judgments and actions are necessary to provide supporting evidence that professional skepticism was applied appropriately.

The next priority should be the impact of local norms and culture (bullet item 7), which is discussed in Hurtt et al. (2013). As noted in that paper, there is little academic research on the interaction of culture and professional skepticism specifically, but there is research regarding the impact of cultural differences on audit judgment and decision making, suggesting that skepticism could be impacted by differences in: perceived power distance; communication and documentation of issues; tolerance for ambiguity; and acceptability of questioning behavior, to name a few factors. It seems that even if firms put policies and procedures in place to promote

skepticism through quality control efforts, cultural differences could derail consistent application of such efforts at a global level if they are not addressed in the development of those policies and procedures.

Bullet item 5 (technology) is evolving and should take priority for the IAASB as part of the Data and Analytics project; however, this item, as written, implies that auditors would rely on technology or checklists in making their judgments. Although technology provides benefits in helping auditors make sense of the growing complexities of audits, there are drawbacks to technology, such as overreliance on tools without a deep understanding of the underlying issues. This may result in reduced skepticism. Note from studies discussed above (Bennett and Hatfield 2016; Zimmerman 2016) that even the use of a simple technology such as e-mail can impact the application of professional skepticism. See Westermann, Bedard, and Earley (2015) for a discussion of the benefits versus the drawbacks of technology in promoting knowledge acquisition in auditing.

Bullets 3 and 4 relate to individual characteristics of auditors (including both their traits and the internalization of their public interest role). Significant research has examined auditor characteristics (see Brazel and Shaefer 2015; Hurtt et al. 2013; Nelson 2009), but such characteristics are difficult to incorporate into standard setting, and these should therefore be lower priority efforts, except as they might be incorporated into an overall framework, as noted above (i.e., highlighting the need for auditor self-awareness of their own biases). The Committee recommends that an emphasis on firm quality control represents a more promising direction for enhancing professional skepticism on audit engagements.

## **Topic 2: Quality Control**

*QC1. We support a broader revision of ISQC 1 to include the use of a [Quality Management Approach] (QMA) as described in paragraphs 45–67.*

The Committee believes the use of QMAs can improve audit quality and reduce the number of audit engagement deficiencies. In a similar way to how performance and control systems help company managements to minimize significant risks and to achieve important organizational objectives, properly-functioning QMAs can help audit firm managements to minimize their quality-related risks and meet their professional responsibilities to stakeholders. Systems helping to build consensus around organizational objectives and performance evaluation measures lead to increased performance on achieving strategic objectives (e.g., Ho, Wu and Wu 2014). Building systems to support high-quality professional audit judgments and decisions, and explicitly linking audit quality to firm and professional performance evaluation, should lead to increased quality throughout the organization (Grafton, Lillis and Widener 2010; Peecher, Solomon and Trotman 2013).

The International Forum of Independent Audit Regulators' 2015 survey describes an initiative recently undertaken by the six largest audit networks to achieve a measureable reduction in findings of audit deficiencies, worldwide, by 2019 through the use of root-cause analysis (IFIAR 2016). For this to succeed across the entire network, managements will presumably use an approach similar to that outlined for a QMA.

Use of a QMA should enable firms to tailor their quality management systems and quality control to the needs of their clients for quality audit and assurance services. As this would be a relatively new formal requirement from the Board, firms will likely need significant guidance on how to implement such a tailored system, while still meeting the Board's standards. Considering that certain jurisdictions include firms' systems of quality control in their inspections (*e.g.*, the PCAOB's inspections in the U.S.), it is important for firm managements to understand how to incorporate required features in the system, while keeping the needed flexibility for their firms to adapt to changes in their risk profiles over time. This may be especially challenging for SMPs, which have limited resources to dedicate to formal quality control efforts compared to larger firms and networks.

Boards continue to identify systemic audit quality issues in their inspections (IFIAR 2016). In addition, one study found that firm offices with low-quality audits (measured by number of restatements) tend to have other lower quality audits as well, for up to five years, also suggestive of systemic issues (Francis and Michas 2013). At an engagement level, teams tend to allocate more resources to riskier audit engagements (*e.g.*, Elder and Allen 2003). Firms should take a similar approach across their entire audit practices to identify and mitigate key quality risks. Therefore, if the Board does not formally require a QMA, ISQC 1 should include additional guidance on implementing systems of quality control, focusing especially in the areas of:

- scalability of quality control systems for SMPs, for the reason cited above; and
- firm-wide monitoring of the quality system to ensure systemic issues are identified and remediated in a timely fashion.

#### *QC2. Engagement Partner Roles and Responsibilities including Paragraphs 69-86*

The Committee would like to draw the Board's attention to two specific issues related to partners' management of engagement quality. First, audit engagements are usually performed under tight deadlines, and auditors report deadline constraints as a top impediment to audit quality (Persellin, Schmidt and Wilkins 2014). Experimental and survey research indicates that workload pressures lead to dysfunctional behaviors and lower audit quality among individual auditors (*e.g.*, Alderman and Dietrick 1982; DeZoort 1998; Glover, Hansen, and Seidel 2015). Second, audit partners should select and assign professionals to engagements and areas of risk with full and careful consideration of the professionals' competencies. Partners can over-estimate their subordinates' abilities to find audit-related errors, especially those that are more complex (Messier, Owhoso, and Rakovski 2008). Note that although these studies explicitly mention the impact of various firm-specific factors on audit quality, it is likely that the audit quality impacts relate to the misapplication of professional skepticism and that these items can be considered as additional impediments to skepticism in response to ITC Question PS2.

#### *QC3. Others Involved in the Audit- Paragraphs 87-104*

The Committee believes that the Board should provide guidance to engagement partners for proper direction, supervision, and review of other auditors in firm engagements. In addition, the Board should consider expanded reporting on the use of other auditors on engagements, while

recognizing that such reports may have unintended consequences, if audit quality is viewed as lower when others are involved. For example, Dee, Lulseged and Zhang (2015) show that audits with other participants have, on average, lower quality, and the market reacts consistently with this when the participation of others is disclosed in the audit report.

*QC5–QC10 address the more significant issues relating to quality control specific matters*

*QC5. Governance of the Firm, Including Leadership Responsibilities for Quality*

The Committee believes that formal support by and accountability of top management are important drivers of success in achieving quality control. An important firm-level quality control mechanism is tone at the top established by firm leadership. Prior research (*e.g.*, Schaubroeck *et al.* 2012; Pickerd, Summers and Wood 2015; Pyzoha, Taylor, and Wu 2016) provides evidence of the importance of a strong “tone at the top” in ensuring operational, internal control, financial reporting effectiveness, and auditors’ engagement-level judgments when auditing complex areas (*e.g.*, complex estimates). For example, the quality control climate related to identifying and communicating audit errors internally impacts reporting of the errors (Gold, Gronewald and Salterio 2014). Also, the perceived leadership style of the firm’s reviewers influences audit quality related decisions by engagement team members (Otley and Pierce 1995). Moreover, a tone at the top message that is balanced in equally emphasizing firm-level audit quality and firm performance goals reduces auditors’ tendency to over rely on management’s assumptions when auditing complex estimates susceptible to management biases. However, a tone at the top message focused solely on audit quality may be needed to reduce auditors’ tendency to over rely on audit evidence prepared by management’s specialists (Pzyoha *et al.* 2016). Tone should be set by the firm leadership across the entire practice, and at the engagement partner level for specific audits.

From a governance perspective, responsibility for quality control should be vested in the firm’s managing board of partners. The board of partners, as the analog of the board of directors for companies, oversees management of the firm and manages the firm’s important risks. Research supports the notion that strong boards help to mitigate and remediate risks and control-related issues (*e.g.*, Goh 2009; Hoitash, Hoitash and Bedard 2009).

*QC6. Engagement Quality Control Reviews and Engagement Quality Control Reviewers, Paragraphs 136–146*

The Committee views engagement quality reviews (EQRs), both internal and external, as a critical part of quality control for audit firms. Internally, EQRs involve firm partners working together in a professional, non-adversarial process toward finding solutions to complex problems (Emby and Favere-Marchesi 2010).

Research shows that engagement quality reviews (EQRs) improve audit risk assessment judgments (Ayers and Kaplan, 2003; Matsumura, Subramanyam, and Tucker 1997), induce engagement partners to plan higher levels of audit testing (Matsumura and Tucker 1995), and

reduce the tendency to focus more on confirmatory evidence (Tan 1995). External reviews, such as peer reviews and formal inspections, provide important information about audit firm quality useful to both audit firms and stakeholders (Casterella, Jensen and Knechel 2009).

Firms should select knowledgeable EQR partners similarly to how they assign lead partners to engagements. Partners in close geographic proximity to the office reviewed, and partners with expertise in the industries for engagements they review, tend to provide more thorough reviews than those where partners are farther away and less knowledgeable (Anantharaman 2012).

#### *QC7. Monitoring and Remediation, Paragraphs 147–159*

The Committee notes that the initiative cited in our response to QC1 by the six largest networks uses root cause analysis to identify underlying reasons for identified inspection findings and reduce their incidence (IFIAR 2016). This approach appears to be consistent with the Board’s monitoring and remediation objectives. Their efforts, if successful, may provide a model for other networks and firms to follow.

In general, research supports formal performance measurement and feedback mechanisms as integral components of organizational performance measurement systems. When key performance measures are identified and communicated to facilitate organizational decision-making and evaluation, management uses the information for feedback and remediation purposes (*e.g.*, Grafton, Lillis and Widener 2010, Hall 2008). For example, research has shown that firms remediating material weaknesses in internal control issue higher quality subsequent financial reports (*e.g.*, Bedard *et al.* 2012).

We expect audit firms, as business organizations focused on providing quality audits, to respond similarly to quality-related issues. Academic research provides evidence consistent with this expectation. For example, Gul, Sami, and Zhou (2009) find that audit firms in China tended to render higher quality audits after policies implemented by China’s government to increase independence. In the U.S., audit firms failing to remediate their significant quality-related issues risk losing their abilities to attract and retain clients in jurisdictions in which low quality audits are observed (*e.g.*, Abbott, Gunny, and Zhang, 2008; Boone, Khurana, and Raman 2014; Swanquist and Whited 2015).

While SMPs may have more difficulty in implementing full-scale QMA systems, evidence indicates that, in the U.S., triennially inspected (smaller) firms can make adjustments to their audit judgments based on quality review findings (Gramling, Krishnan, and Zhang, 2011).

#### *QC8. Engagement Partner Performance and Rewards Systems- Paragraphs 160–170*

While the Committee understands that the Board cannot/should not dictate the compensation terms of audit firm partners and professionals, the Committee believes that the Board can and should strongly recommend structuring engagement partner compensation to reward maintenance and enhancement of audit quality as a best practice. Compensation contracts provide firm partners incentives to perform both optimal and sub-optimal behaviors (Trompeter 1994; Burrows and Black 1998; Liu and Simunic 2005). Compensation tied to increasing audit

quality can provide incentives for partners to work together and monitor each other to ensure consistent quality (Pizzini 2010) and to decrease audit errors (Knechel, Niemi, and Zerni 2013). Providing direct rewards for making difficult, but quality-enhancing decisions, such as resigning from a client over a material disagreement about the quality of reported information, should encourage auditors to take those actions (Peecher, Trotman, and Solomon 2013).

From a client portfolio perspective, engagement partners typically face more threats to their independence and objectivity if their compensation is linked to their personal client portfolios or to office-level clientele (Francis 2011). Compensation linked to firm-wide performance leads to the audit firm taking on a higher-risk portfolio (Hay *et al.* 2007), but provides incentives to partners to provide high quality audits for these client firms. This is consistent with the model of Liu and Simunic (2005), which shows that directly linking partners' compensation to their cooperation on complex audits leads to firms that successfully specialize in higher-risk engagements.

#### *QC9. Human Resources and Engagement Partner Competency- Paragraphs 171–187*

The Committee believes that the standard should address audit firms' abilities to both recruit well qualified engagement professionals and commit to providing the means to keep these professionals' knowledge, skills, and abilities current. It is well documented that education, experience, industry specialization, qualification, continued education and training all positively affect audit quality (*e.g.*, Gul *et al.* 2013; Chen, Liu, and Chien 2009; Aldhizer *et al.* 1995.) Libby and Frederick (1990) find evidence of experience leading to improved auditor knowledge, specifically knowledge relating to financial statement errors and error occurrence rates. Specialized experience appears to be most beneficial. Some studies have found general auditing experience can improve auditor decisions (Messier 1983), whereas others report no effects on audit quality from general experience (Ashton and Brown 1980).

The Committee believes that succession planning, especially in light of firm or partner rotation requirements, is important to ensure continuous audit quality. Because audit quality can vary across audit partners in the same audit firm based on the partners' specializations (Chi and Chin 2011), audit firms should ensure their engagement partners, like their professionals, are matched to engagements based on the partners' knowledge of and experience with firms and industries. Van Buuren and Causholli (2015) find strong evidence that partner industry specialization is associated with: a greater likelihood of detecting misstatements; higher likelihood of discovering misstatements that are subjective in nature; and higher likelihood to issue modified opinions. Also, Gul *et al.* (2013) find that industry specialization partially mitigates lower earnings quality of firms with shorter-tenured auditors.

As to the necessity of audit firm and auditor rotation itself, research findings continue to be mixed. Some studies find no increase in audit quality under rotation programs (*e.g.*, Chi *et al.* 2009; Ruiz-Barbadillo *et al.* 2009; Cameran *et al.* 2015). Others find differences in adjustment proposals and outcomes in the years surrounding or after rotation to an independent firm or partner (*e.g.*, Lennox, Wu, and Zhang 2014; Chen, Su, and Wu 2009; Wang and Tuttle 2009).

#### *QC10. Transparency Reporting- Paragraphs 188–190*

The Committee notes that the 8<sup>th</sup> European Union Company Law Directive, Article 40 requires audit firms to provide annual transparency reports. In the U.S., the Advisory Committee on the Auditing Profession (U.S. Department of the Treasury 2008) recommended that the PCAOB study quality and quality control indicators and consider requiring audit firms to produce annual transparency reports. Research on the relationship between disclosures in transparency reports and audit quality is limited to date; one study does not find strong evidence of a positive relationship (Deumes *et al.* 2012). We therefore encourage support of additional research on the effectiveness and information content of transparency reports.

### **Topic 3: Group Audits**

#### *GA3. Communications between the Group Engagement Team and Component Auditors*

*(a) Paragraphs 218–225 set out matters relating to communications between the group engagement team and component auditors.*

*(i) Which of the possible actions outlined in paragraph 224 would be most meaningful in addressing issues relating to communication between the group engagement team and the component auditor?*

Academic research from auditing, management, and information systems provides evidence that communication challenges in distributed work arrangements, such as group audits, hinder knowledge sharing, formation of mutual knowledge, and coordination between the group engagement team and component auditors (e.g., Downey and Bedard 2015; Hanes 2013; Barrett et al. 2005; Cramton 2001). Therefore, we agree with the Board’s focus on improving two-way communications between group engagement team and component auditors beyond formal written communications in the audit documentation. The extant academic research provides relevant insights regarding some of the possible actions the Board outlined in paragraph 224 to address challenges associated with communication when conducting group audits.

Regarding the Board’s recommendation to strengthening requirements related to more timely two-way communication in group audits, the academic literature notes several important factors that we believe the Board should take into account as they may influence effectiveness of communication and coordination between the group engagement team and component auditors. The type of technology-mediated communication (e.g., emails, instant messaging, web conference), communication response time (e.g., immediate or delayed), spatial boundaries (e.g., different cities), and temporal boundaries (e.g., different work hours) have been shown in prior research to impact the effectiveness of communication and in turn coordination between geographically distributed team members (see Hanes 2013; Cummings et al. 2009; Kankanhalli et al. 2006). For instance, extant literature suggests that asynchronous communication technologies (e.g., emails) can be disruptive and in large volumes can lead to information overload. These potential negative consequences of asynchronous communication in spatially and temporally separated teams can result in lower coordination among team members and increase task conflicts (i.e., differences in views among members of the team regarding the task at hand) (e.g., see Hanes 2013; Cummings et al. 2009; Kankanhalli et al. 2006). In contrast, prior research demonstrates that

use of synchronous communication technologies, such as instant messaging and web conferencing, reduced coordination delays for globally distributed teams, but only when members are separated by spatial boundaries and not by temporal boundaries (Cummings et al. 2009).

Although the extant research suggests that synchronous communications facilitate more timely two-way interactions by improving response and feedback times when team members have overlapping work hours (see Hanes 2013; Cummings et al. 2009), recent research cautions against over-relying on technology to mitigate challenges associated with group audits (Downey and Bedard 2015). In fact, Downey and Bedard (2015) find that in some instances, greater availability and reliance on technology for communication between teams exacerbates challenges associated with language and cultural barriers.

*(ii) Why do you believe these actions are necessary?*

Academic research in auditing and management suggests that geographically distributed teams often encounter difficulties establishing norms and mutual understanding, thus leading to greater conflicts and poorer performance (see Hanes 2013; Downey and Bedard 2015). Consequently, as noted in our response to (i) above, the Committee concurs with the Board's initiatives to encourage more timely two-way interactions between the group engagement team and component auditors. However, as we note in our responses to parts (iii and iv) below, strengthening standards by emphasizing timely two-way communication may not be sufficient to improve coordination, and in turn improve performance of group audits.

*(iii) Are there other relevant issues that we should consider, or actions that would be more effective than those described?*

Strengthening standards to emphasize the need for two-way communication with component auditors should increase more timely communication and interaction between the group audit team and component auditors. Extant academic literature in auditing and management, however, suggests that increased communication alone may not improve coordination in geographically distributed teams given cultural, language, and work environment differences that are challenging barriers to overcome in group audits (Hanes 2013; Downey and Bedard 2015). That is, without establishing shared norms, mutual understanding, and appreciation of the perspectives of other team members, increased communication may not necessarily mitigate coordination issues since variations in team members' interpretations and expectations of audit requirements will likely continue to persist (e.g., Hanes 2013; Downey and Bedard 2015; Joe et al. 2016). Therefore, the Committee would encourage the Board to consider alternative interventions investigated in recent audit research shown to enhance communication and in turn mitigate coordination issues between cross-functional and geographically separated teams (see Downey and Bedard 2015; Joe et al. 2016). For instance, results of Downey and Bedard's (2015) study suggest that strategies focusing on establishing common grounds between team members are more likely to improve auditors' ability to anticipate the actions of geographically disbursed team members. Relatedly, results of Joe et al.'s (2016) study suggest that perspective taking of other team members (i.e., the ability to consider the psychological perspectives of others) can enhance collaboration, coordination, and social interactions between cross-functional teams (e.g., core audit team members and their firm's

specialists).

*(iv) Please also describe any potential consequences of possible actions that you believe we need to consider further.*

While technology-mediated communication can facilitate two-way communication between geographically dispersed teams, the Committee recommends that the Board take into account additional auditing research that investigates the positive and potential negative impacts of technology-mediated communications on auditors' performance and judgments (e.g., see Hanes 2013; Downey and Bedard 2015; Agoglia et al. 2009; Lynch et al. 2009; Brazel et al. 2004). Thus, while technology can be employed to promote two-way communication and interactions between the group audit engagement team and the component auditor, research warns that in some instances increased use of technology may not reap the intended benefits (e.g., Downey and Bedard 2015). Also see our response to (i) above.

#### *GA5. Identifying and Assessing the Risks of Material Misstatement in a Group Audit*

*(a) Paragraphs 243–253 set out matters relating to identifying and assessing significant risks in a group audit:*

*(iii) Are there other relevant issues that we should consider, or actions that would be more effective than those described? If you would not support a particular action, please explain why.*

Academic research, though limited with respect to assessing risks of material misstatement in group audit settings, provides some insights into factors that pose misstatement risks to the group auditor. The Committee agrees with the stakeholder sentiments the Board outlines in paragraph 244 suggesting that more clarity is needed about understanding “the group, and its environment” in order for the group engagement team to be able to appropriately identify material misstatement risks on a group audit. Whereas the Board outlines stakeholder sentiments related to diverse markets and differing cultures, complexity of group structures, and the evolving nature of group structures, the Committee encourages the Board to consider other factors that academic research finds are related to risks of material misstatement in group audit settings. Academic research finds that factors related to the group's internal control environment, the reporting requirements of components within the group, and the group engagement team's proximity to group components can affect the risk of misstatement on a group audit (e.g., Allen et al. 1998; Hegazy and Nahass 2012; Choi et al. 2012).

Auditing Standard No. 5 (AS 5, PCAOB 2007) suggests that internal controls over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial statements. In addition, academic research considers internal controls to be the first line of defense against financial statement misstatement (e.g., Hoitash et al. 2008; Lin et al. 2011). In a group audit environment, internal control procedures may not be uniformly implemented across components and may vary significantly (Allen et al. 1998). Such disparity in internal control frameworks across components can pose differential misstatement risks to financial reliability at the component level. Further, even if there is relative uniformity in the implementation of internal control procedures across components, relative compliance will likely

differ (Allen et al. 1998; Hegazy and Nehass 2012), and as such, would still pose a significant misstatement risk. While ISA 600 considers aspects of internal controls on the group audit, there is limited guidance on how group auditors should interpret and assimilate the variant effects of internal control deficiencies at the component level on the risk of material misstatement in a group audit setting. Therefore, the Committee encourages the Board to consider the differential implications of internal control implementations and applications to the risk of material misstatement on the group audit.

Special reporting requirements of components in the group audit can affect the risk of misstatement of the group as a whole as well as on a component level (Allen et al. 1998). The audit reporting requirements of components within the group can vary considerably and may require certain components to submit audit reports to various local and statutory authorities (e.g., Allen et al. 1998). In so doing, the group auditor may be required to submit audit reports at the component level as well as at the consolidated level. Where this is the case, and the group auditor bears the risk and responsibility for the financial statement opinion rendered at both the component and group levels, the assessment of misstatement risk will likely differ across components, and may have implications for the group level misstatement risk as a whole (Allen et al. 1998). Therefore, considering the findings of academic research, the Committee recommends that the Board considers how individual components and the associated audit reporting requirements may affect the group auditor's evaluation of misstatement risk.

Academic research also suggests that the group auditor's geographic proximity to the components has implications for audit risk and the risk of misstatement (Choi et al. 2012). Findings from Choi et al. (2012) suggest there are informational advantages to auditors who are within closer proximities to audited components. Being within closer geographic proximities helps auditors to develop greater knowledge about client-specific characteristics used to evaluate misstatement risk factors e.g., management incentives and opportunities to manage earnings, effectiveness of internal controls. Similarly, Baik et al. (2010) and Peterson and Rajan (2002) find that local and institutional investors are able to reduce information asymmetry and garner superior information that allows them to better monitor firm performance compared with nonlocal or geographically separated investors. These findings suggest that the geographic dispersion of components relative to the group and component auditors will likely have deleterious effects on auditors' assessment of misstatement risk. That is, the more geographically separated the auditor is from the components, the lower the reliability of the information the auditor obtains and subsequently factors into the evaluation misstatement risk. From this perspective, the Committee encourages the Board to consider how geographic and location proximities of the group and component auditors variably affects the reliability of the information used to evaluate misstatement risk.

#### *GA6. Issues Relating to Component Materiality and Other Aspects of Materiality Relevant to Group Audits*

*(a) Paragraphs 254–261 set out issues relating to applying the concept of materiality in a group audit. Do you agree with the possible actions recommended in paragraph 261 to clarify the different aspects of materiality in a group audit?*

ISA 600 calls for the group engagement team to determine materiality at the group as well as component levels. While the standard provides this directive, there is limited guidance with regard to how auditors should go about determining these materiality amounts at the respective levels. Glover et al. (2008) reports that regulator inspections find varied and disparate approaches to assessing component materiality that are problematic. As such, the Committee agrees with the Board's consideration, as indicated in paragraph 261, of more specific guidance relating to component materiality and other aspects of materiality relevant to group audits. While there is limited academic research providing wide-ranging evidence of the factors that group auditors should consider in this regard, two studies offer keen insights that the Board can consider when evaluating potential amendments to ISA 600 i.e., Glover et al. (2008), and Stewart and Kinney (2013).

Glover et al. (2008) developed a probabilistic model that provides insights into an approach that group auditors can use to develop or evaluate component materiality. This model is designed to generate multiples that can be used to determine upper bounds for aggregate component materiality based on the overall group materiality and the number of components. The development of this multiple assumes that the group auditor uses professional judgment to evaluate and select the number of significant components within the group over which the "maximum aggregate component materiality" ([MACM], Glover et al. 2008, 44) will be allocated. To determine the aggregate component materiality using this model, the overall group materiality is multiplied by the appropriate benchmark multiple (as determined by the model). The model calls for the resulting aggregate component materiality to then be allocated across significant components using either proportional or weighted allocation methods. Using this approach, Glover et al. (2008) propose that their model provides a practical approach to effectively and efficiently allocate overall group materiality across components.

Stewart and Kinney (2013) suggest an alternate approach to allocating group materiality to components. They develop a model to determine component materiality amounts using inputs derived from auditing standards, the audit risk model, factors from prior academic research and Bayesian probability theory. This model is referred to as the "general unified assurance and materiality" model ([GUAM]). The model also incorporates factors related to the number of components, the probability distribution of potential misstatements, as well as group-wide controls. Stewart and Kinney (2013) contend that this approach is innovative as it incorporates elements from component assurance and aggregate group assurance into one unified Bayesian model that can be used in audit planning decision making as well as developing conclusions for group financial statement audits.

While the Committee does not endorse nor promote any specific model for determining group and/or component materiality, we discuss the state of current academic literature in this regard in an attempt to highlight approaches and factors the Board may consider as it deliberates revising ISA 600.

*(b) Recognizing that significant changes to ISA 320 will not be contemplated until a review of ISA 320 has been performed in its entirety (potentially as part of a future project to address materiality more broadly), please describe any other relevant issues or additional actions that*

*you think may be appropriate relating to component materiality, component performance materiality or the clearly trivial threshold at the component level.*

Academic research provides insights into factors that affect materiality at the group and component levels. For example, Holstrum and Messier (1982), and Messier et al. (2005) provide reviews of the literature on materiality and related judgments. In a recent study, Eilifsen and Messier (2015) provide insights into materiality guidance utilized by major accounting firms. Eilifsen and Messier (2015) investigate six research questions that, in addition to other factors, inquire about the approach and benchmarks accounting firms employ to determine overall materiality, tolerable misstatement, clearly trivial misstatement as well as materiality determinations for group audits. They find commonality in the quantitative benchmarks firms use to determine overall materiality (e.g., income before taxes, total assets, and revenue) and consistency in the multiples firms use to determine tolerable misstatement as well as clearly trivial misstatement. Further, firms use approaches that are fairly consistent with the current standards when determining materiality on group audits. However, the authors found differences in firms' approaches to determining component materiality. In addition, through interviews with firm partners, the study finds factors that practitioners consider when making materiality judgments. These factors include the existence of significant estimates, related-party transactions, non-routine transactions, identified fraud risks, and significant prior period misstatements. The Committee recommends that as the Board considers component materiality, component performance materiality, and the clearly trivial threshold at the component level, it should contemplate the aforementioned factors that academic research finds relevant to these decisions.

*GA8. Review and Evaluation of the Work of Component Auditors by the Group Engagement Team*

There are no studies that directly address the questions raised by IAASB. However, several relevant studies can provide insights. For example, research finds that proximity between the component and group auditor can enhance the group auditor's evaluation and review of the component auditor's work. Agency theory predicts that proximity reduces information asymmetry and improves monitoring. Consistent with this reasoning, Choi et al. (2012) examine whether the geographic distance between auditors and clients improves audit quality for a sample of US companies. Geographic distance is measured as the difference between the major metro area for the client's headquarters/main business operations versus the major metro area of the auditor's engagement office (location for audit opinion). Audit quality is measured as the size of abnormal accruals in the audited financial statements. They find improved audit quality when auditors are closer to the client and the clients are less complex (fewer operating segments and geographic locations). However, the relationship between proximity and audit quality is weakened or even goes away when the client is diversified and has several reporting segments. For those who are concerned about the familiarity/economic between component auditors and the client component, this result offers a ray of hope and suggests that appointing local component auditors to perform the components of multinational clients can enhance audit quality because the local auditor can better monitor the segment office. Similarly, multinational CPA

firms with the resources to travel and conduct testing from more geographically dispersed regionals are a good fit for large diversified clients with reduced threat to audit quality.

Similar to the archival studies, recent research by Carrasco (2016) finds that the geographic separation between auditors and high ranking superiors can have a negative impact on audit quality. In an experimental setting Carrasco finds that junior ranking auditors perform better on review and preparation tasks when the superior auditor is in close proximity to the auditor compared to when the superior is geographically distant. Her findings suggest that efforts to reduce the geographic separation between group auditors and component auditors might increase the quality of the group auditor's review of the evidence prepared by the component auditor.

The IAASB expresses concerns about auditor's ability to review and incorporate findings from the component audit into the group audit conclusion. The literature on knowledge sharing can offer insights on how information gathered from component audits can be harnessed and incorporated to the group audit conclusions. Results from the literature are mixed. For example, Joe and Vandervelde (2007) examine how knowledge is transferred from nonaudit tasks to the financial statement audit. They find that firm affiliation (i.e., whether the same audit firm or a different audit firm performs a service) can improve knowledge transfer for fraud risk identification but not for client risk assessment. Joe and Vandervelde (2007) also find that having the same audit team perform nonaudit and audit tasks enhances knowledge transfer and the audit team's ability to identify risky areas in the audit engagement. Their findings suggest that having the same audit team complete group and component audits can be advantageous in assessing audit risks. Another study that examines auditor affiliation, Glover and Wood (2014) finds that audit quality is enhanced when the same audit firm performs the group audit and the subsidiary audit. They find that this relation is particularly driven by the cases where the parent CEO is not the subsidiary CEO. Glover and Wood argue that having different CEOs gives the auditors stronger negotiating power to insist on high quality financial reporting from the subsidiary. Thus, having the same audit firm appears to have both knowledge sharing and bargaining power advantages in the group audit setting.

Related to knowledge sharing, Vera-Munoz, Ho and Chow (2006) review related literature to identify some of the issues that can impede knowledge sharing in accounting settings. Their discussion suggests that cultural differences (such as willingness to ask direct questions or to challenge authority figures) can influence how audit teams from different parts of the world interact. One implication from their review is that cultural differences could impact the group auditor's willingness to query and challenge evidence provided from the component audit team from different cultures. They also note that advances in information technology can improve communication and knowledge sharing across teams. Thus, group auditors might find it easier to communicate and incorporate information from component auditors using technological interfaces.

*GAI0. Are there any other issues relating to group audits that we have not identified? If yes, please provide details. What actions should we take to address these issues?*

With respect to other issues related to group audits, the Committee points to research that suggests strengthening authoritative guidance, especially in complex and uncertain environments, is unlikely to account for all situations auditors may encounter, and hence audit firms are likely to supplement with the firm's own internally developed guidance when clear authoritative guidance is not available (e.g., Salterio 1996; Glover et al. 2016). Such internal guidance provided by the firm's national office and often based on precedents of similar previous situations have been shown in prior audit research to influence auditors' judgments (e.g., Salterio 1996; Salterio and Koonce 1997). This notion is consistent with the position held by the Board as noted in paragraph 200, "Entities that may appear to have similar structures will typically have unique characteristics. Component auditors will also have different competence and expertise. Therefore, ISA 600 cannot be too prescriptive... nor can ISA 600 be expected to address all the different approaches that might be appropriate." The Committee, therefore, encourages the Board to consider and support improved firm guidance and consultation processes as another alternative method to improve the effectiveness of group audits.

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