



CANADIAN PUBLIC ACCOUNTABILITY BOARD
CONSEIL CANADIEN SUR LA REDDITION DE COMPTES

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Mr. James Gunn
Technical Director
International Auditing and Assurance Standards Board
545 Fifth Avenue
New York, NY 10017

Dear Mr. Gunn:

A Framework for Audit Quality – Consultation Paper

The Canadian Public Accountability Board (CPAB) is pleased to comment on the IAASB's Consultation Paper, *A Framework for Audit Quality*. We commend the IAASB for undertaking this important project in the area of audit quality.

CPAB is Canada's independent audit regulator and is responsible for overseeing firms that audit Canadian reporting issuers. Our mandate is to promote high quality independent auditing that contributes to public confidence in the integrity of reporting issuers' financial reporting. We accomplish our mandate by inspecting audit firms and audit working paper files which provides us with insights into how audit quality might be improved. We believe our role provides a valuable perspective in the area of audit quality.

Importance of audit quality

Auditing is becoming more complex and global in its nature and increasingly stakeholders are questioning the value and relevance of the audit. The effective operation of our capital markets depends upon public confidence in the integrity of financial reporting, which has its basis in high-quality financial audits. Auditors need to consistently exert their independence, objectivity and an appropriate level of skepticism; characteristics shareholders expect in high-quality audits.

A strong financial reporting environment requires auditors, audit committees and management to perform effectively in their roles within a culture of integrity, respect and transparency. The IAASB's attempt to take a holistic view of the factors that affect audit quality provides a useful starting point for engaging with key stakeholders on matters effecting audit quality.

CPAB supports the need for change and improvement in the audit process. The work of the IAASB in attempting to define a framework for audit quality (the "Framework") is an important first step in furthering the dialogue on audit quality.

International Co-ordination

As we operate in an increasingly global environment, we encourage the IAASB to co-ordinate its efforts to advance audit quality with other global parties, such as the PCAOB in the United States and the Financial Reporting Council in the United Kingdom, that are also considering this issue.

Practical use of the framework

In order to ensure effective use of the Framework to improve audit quality, we encourage the IAASB to be more ambitious and make it easier to apply in practice. As drafted, the Framework includes significant detail on a large number of components affecting audit quality and could be more useful if there was a prioritization of key items that have a greater impact on audit quality. This will assist in highlighting the areas of importance that have the most potential to create sustainable change.

We also encourage the IAASB to investigate ways to develop indicators to evaluate audit quality that can be used as a means to monitor progress. The development of such measures could also be useful to audit firms in determining actions they can take to improve audit quality as well as to stakeholders such as audit committees as they exercise their oversight of the external audit process.

Role of the audit committee

CPAB believes the Audit Committee is an important and, by and large, powerful force contributing to audit quality. We believe the Framework could be improved by adding additional discussion of the role of the audit committee, including consideration of how audit committees can effectively contribute to a quality audit. We believe enhancing the effectiveness of the audit committee's oversight of the external auditor is an important component of audit quality and we support measures to increase the accountability of the auditor to the audit committee.

Audit committees can improve audit quality by creating a climate of transparency and setting an appropriate "tone at the top". CPAB believes there is room for improvement in the effectiveness of audit committees. Consideration should be given to developing a set of guidelines for audit committees, or an "audit committee code" to strengthen audit quality and global consistency in this area.

Interaction with assurance standards

In considering the Framework, it is important to more clearly define how it is intended to interact with the IAASB's assurance standards. For key areas that impact audit quality, we encourage the IAASB to ensure that there is consistency in the requirements included in each ISA with the Framework.

Areas to explore

The consultation paper identifies several areas to explore. We have highlighted the areas that we believe would have the most benefit of further consideration.

Consistency of audit execution

We believe that audit firms need to build quality into the execution of the audit and commit to continuous improvement at all levels of their organizations in a manner which ensures improved audit quality is sustainable. Additional consideration is needed in determining how audit firms can build quality into their audits at an earlier stage. This could include enhanced monitoring of audit risks, monitoring of workloads of partners and other professionals and enhanced support for in process audits. Audit quality needs to be built in throughout the process.

Accountability and firm culture

We believe that shared accountabilities enhance audit quality. As audits become more complex, it is not realistic to hold one or two individuals accountable when many factors affecting quality, such as access to resources, may be beyond their control. Audit quality is a team effort.

To influence accountability and culture in a sustainable manner, audit partners, managers and staff need to know that audit quality is valued by the audit firm. One way in which audit quality can be emphasized is through making audit quality an important aspect of the evaluation, compensation and promotion of individuals within the audit practice. We encourage additional work in this area of accountability and firm culture and in the area of developing evaluation and compensation systems that reward audit quality.

Professional scepticism

A healthy degree of professional scepticism is fundamental to—and the foundation of—an effective, quality audit. It is not good enough to simply accept management's views without challenge. Effective auditors weigh what management tells them against what they know of the reporting issuer's business, together with their knowledge of the broader business environment.

By so doing they can evaluate management's views in the context of available internal and external evidence and derive an independent position, which may conflict with or confirm that of management.

We believe the IAASB should extend its Framework to discuss key drivers of professional scepticism and develop recommendations for how they could be enhanced.

Balance of professionalism and commercialism

A key to achieving audit quality is resolving the inherent conflict between professionalism and commercialism. If audit committees and other stakeholders do not recognize the value of an audit—seeing it as a controllable cost rather than an important value-added service where quality is a differentiator—it risks becoming a commodity based solely on price. If firms are accepting lower fees in the face of higher risk, then they are implicitly accepting lower margins and lower profitability. We are concerned that audit firms may try to inappropriately maintain profitability at the expense of audit quality. We encourage additional effort by all stakeholders to investigate this issue further which should include a broader debate about enhancing the value and relevance of the audit.

Relevance of the audit

We support the IAASB's attempt to take a more holistic review of audit quality in an increasingly global, 24/7 interconnected world demanding more real time information. In our view, in addition to the development of the Framework for Audit Quality, the debate on the value and relevance of the audit should be part of a more comprehensive initiative to reform the corporate reporting framework which will require the active involvement of all stakeholders, including policy makers, investors, regulators, standard setters, corporate directors, company management and auditors.

In addition to our comments above, we have responded to the questions posed in the Consultation Paper. These responses are included in the Appendix to this letter. We appreciate the opportunity to respond to the Consultation Paper, and would be pleased to discuss any of the above comments with you at your request.

Yours very truly,



Brian Hunt, FCPA, FCA
Chief Executive Officer

Appendix – Response to questions in the consultation paper

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

The Framework provides a comprehensive listing of all of the areas of audit quality that we would expect. The separation of components into input factors, output factors and key interactions is a logical organization of the factors affecting audit quality.

The Framework includes significant detail on a large number of components affecting audit quality. The Framework could be more useful if there was a prioritization of key items that have a greater impact on audit quality to assist in highlighting the areas of most importance that have the most potential to create sustainable change.

Our observations from inspections of audit files show that all audits are not performed at a consistently high level of quality. We have also noted instances where appropriate professional scepticism was not applied in performing key audit procedures. We believe that actions taken and work performed at the engagement level has a significant impact on audit quality. We encourage the IAASB to expand on the discussion of areas that audit quality can be improved at the engagement team level. This could include additional emphasis on the importance of the engagement quality control reviewer, the importance of mentoring and coaching in the field by managers and partners of the audit teams and the impact of effective supervision and review.

2. 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?

In the area of interactions there is discussion of the role of those charged with governance, specifically the audit committee. We believe the discussion of the role of those charged with governance could be enhanced, specifically the role of the audit committee in overseeing the auditor.

In our roundtable discussions with audit committees in Canada, many audit committee members have commented on the need for more dialogue with auditors on higher risk areas of the audit and for less time in audit committee meetings to be spent on more compliance oriented aspects of the audit. We believe it is important to further explore how communication between auditors and audit committees can be more forthright and transparent, particularly with respect to reporting of significant audit risks and related judgements. Audit committees also have a responsibility to

assess whether the auditor has exhibited professional scepticism in their audit with specific focus on significant estimates such as fair values developed by management.

In 2012, CPAB, in collaboration with the Canadian Institute of Chartered Accountants, launched the Enhancing Audit Quality Initiative (EAQ) and formed working groups to explore ways in which audit quality can be enhanced in three key areas:

- (i) Auditor Independence
- (ii) The Role of the Audit Committee
- (iii) Auditor Reporting

The key recommendation of both the Auditor Independence and Audit Committee working groups to address the threat of institutional independence and enhance auditor professional scepticism is for the Audit Committee to enhance its oversight of the work of the external auditor and perform a robust annual assessment and periodic Mandatory Comprehensive Review of the audit firm. The Group noted that the audit committee must clearly state its expectation that the auditor conduct their work with an appropriate degree of professional scepticism. The audit committee should monitor the work of the auditor to ensure the auditor is exercising professional scepticism appropriately.

We encourage the IAASB to include additional discussion in the Framework on the audit committee's oversight of the work of the external auditor including exploring the concept of a mandatory comprehensive review. Additional information can be found in the EAQ Auditor Independence and Audit Committee discussion papers issued by the working groups at:

<http://www.cica.ca/enhancing-audit-quality-canadian-perspective/item68293.pdf>
<http://www.cica.ca/enhancing-audit-quality-canadian-perspective/item71922.pdf>

The conclusions and recommendations from the Enhancing Audit Quality initiative can be found at: <http://www.cica.ca/enhancing-audit-quality-canadian-perspective/item74564.pdf>

We believe that audit committees need the right tools to perform their role and to effectively oversee the work of the external auditor. We believe these tools should be developed to support the important role of the audit committee.

3. 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?

As an audit regulator we are interested in factors impacting audit quality and developing sustainable solutions to improve audit quality and in taking a more holistic approach to this area including the roles of all parties in the financial reporting process.

The audit quality framework should assist in identifying areas where changes can be made to improve the consistency of audit execution and overall audit quality. We support the need to evaluate the roles of all stakeholders and take a wide-ranging review of the drivers of audit quality.

In evaluating the factors that impact audit quality, we think it would be useful to consider developing indicators that can assist in measuring audit quality. Measuring factors that could impact audit quality can be an important motivator in driving improvements in audit quality. We support efforts being taken by standard setters such as the PCAOB in evaluating audit quality indicators that can be used to measure audit quality and we encourage the IAASB to work with these other parties to develop a consistent approach.

In Canada, the Enhancing Audit Quality initiative has recommended the audit committee complete a comprehensive review of the audit firm on a periodic basis as part of its role of overseeing the auditor. This framework and potential audit quality indicators that are developed can be used in informing audit committee members about audit quality and can be used in the evaluation of the auditor.

4. 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?

We believe there are a number of key areas that should be explored further including:

IAASB suggested areas to explore

Establishing global guidance against which audit firms can assess their governance arrangements

Audits have increasingly become global. Affiliates of the global firms are essential to the satisfactory completion of many audits. We believe it is important to establish global guidance and methods to govern the audit firms at a global level.

As an audit regulator we have been working with other audit regulators within the International Forum of Independent Audit Regulators (IFIAR) to further this initiative. IFIAR has an ongoing dialogue with the international audit networks that are members of the Global Public Policy Committee (GPPC). Discussions have included meetings with the chief executives and senior representatives of individual firms and with representatives of the GPPC firms collectively. The focus has been on understanding the role of global networks in audit quality and the response to audit issues arising from the economic downturn. The plenary meetings have included sessions devoted to meeting with the international network firms. Each of the networks has agreed to meet periodically with the working group to provide an update on their progress in addressing issues and to discuss policy matters.

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

This is an important area of study in determining how professionals are evaluated, promoted and remunerated and how audit quality can be impacted. We believe that compensation structures and promotion can be used to emphasize and recognize the importance of audit quality and influence behaviour.

In order to be a focus, audit partners, managers and staff need to know and believe that audit quality is valued by the audit firm. One way in which audit quality can be emphasized is through making audit quality an important aspect of the evaluation, compensation and promotion of individuals within the audit practice. In this way audit quality can become part of the culture of the firm.

In our inspections, CPAB often finds it difficult to understand the weighting placed on audit quality in performance measurement and compensation of partners and other professionals. We have observed that many firms continue to investigate the best way to maintain the importance of audit quality in the evaluation and compensation of their people. We encourage the use of a framework for audit quality to assist in the development and use of non-financial metrics to evaluate an individual's contribution to audit quality. We believe it is important to align incentives and reward systems to audit quality to drive and sustain the right behaviours.

Considering whether audit inspection activities can do more to improve audit quality and to make audit quality more transparent to users

Independent audit regulators can contribute to sustainable improvement in the overall audit process, involving a broader range of stakeholders. Feedback to CPAB indicates there is room

for external inspectors to enhance information we provide to stakeholders such as audit committees, to support their role in audit quality.

We are supportive of increased transparency of inspection findings with the objective to improve audit quality. Such reporting should be balanced to ensure that the information provided to the public and audit committees enhances audit quality while also preserving the effectiveness of the regulatory approach.

In Canada we are working to develop a framework for the sharing of our audit inspection results with audit committees.

We also believe there is an opportunity for audit firms to improve the effectiveness of their quality monitoring programs. A firm's internal audit quality reviews can be an important tool to measure changes in audit quality and to identify areas where improvement is required. We believe that audit firms can improve their processes in the internal quality monitoring programs to support the goal of improving audit quality on a continuous basis.

Considering “root causes” and best practices by regulators, audit firms, and the wider audit profession in order to learn from past audit deficiencies and to identify and address systemic issues

We believe that a disciplined root cause analysis is essential in driving tangible improvement in audit quality.

We have found that firms that have been successful in improving audit quality have performed a comprehensive root cause analysis to understand the reasons for significant audit deficiencies and took appropriate action to prioritize their areas of focus. Several firms have created quality control committees that now meet regularly to discuss quality related issues on a real time basis, including analyzing the background and root cause of audit quality issues identified from internal and external inspections and taking appropriate action to respond.

Increasing the informational value of auditor's reports and improving perceptions of the value of the audit

We recognize the need for change and improvement with respect to auditor reporting. Auditors can demonstrate greater value by better informing financial statement users of audit related matters. Change needs to be responsive to the needs of users, and should be implemented in a thoughtful, responsible way such that audit quality is enhanced and in no way diminished.

In our view, auditors need to share more information related to the audit process and the key audit risks and related findings with users of the financial statements. We believe, in performing the audit, the auditor gains an in-depth understanding of the business and related systems and processes, which could be better utilized to bring greater value to the users of the financial statements.

In our inspection of audit files, we see examples where the audit approach taken in high risk areas does not clearly demonstrate how the risks were mitigated. We believe that if an auditor had to disclose the significant risks identified and the approach taken to address those risks it would reduce those inconsistencies and improve audit quality.

We believe that the concept of an Auditor Commentary outlined in the IAASB's "Invitation to Comment – Improving the Auditor's Report" is an appropriate response to the call for auditors to provide more information to users through the auditor's report. The increased transparency into the audit process will improve audit quality and ultimately lead to improved disclosures in publicly available financial information. It will also help contribute to the users' appreciation of the relevance of the audit. To be effective the Auditor Commentary should be targeted at the key risk areas of most importance to the users' understanding of the audit.

Striving for greater international harmonization in the role of audit committees with regard to the evaluation of the quality of the external audit

CPAB believes that the Audit Committee is an important and powerful force in directing audit firms towards satisfying the interests of shareholders.

The audit committee's oversight of the auditor is an important role in the delivery of high quality audits. The audit committee should assess the quality of the audit as part of its oversight activities. This assessment should be done on an annual basis and evaluate the performance of the auditor over the past year, including efforts taken to improve audit quality. The EAQ working group focused on the role of audit committees also favoured performing a comprehensive review of the firm on a periodic basis. This review would be more in-depth than the annual assessment and would include an assessment of actions taken by the audit firm to perform high quality audits.

To safeguard the auditor against institutional familiarity threats at the audit firm level the audit committee should perform a comprehensive review of the issuer's relationship with the auditor on a periodic basis. This review would include, among other items, evaluation of audit quality including the auditor's level of professional skepticism, the quality of the engagement team, and the length of tenure of the firm and key engagement team members, and consideration of audit regulator inspection findings. This review would require the audit committee to carefully

consider the quality and value of their current auditor and would be combined with reporting to shareholders of the results and conclusion of this review. As a consequence, mandatory comprehensive review may lead to tendering or a change in auditor. The mandatory comprehensive review would require both the audit committee and auditor to focus significant attention on indicators of audit quality and the exercise of professional scepticism and challenge to management, which mandatory rotation and tendering do not. This should drive behavioural and cultural change in the interaction between audit firms, audit committees and management.

We believe the strengthening of the audit committee's role should be supported through the development of guidance and tools and greater resources to assist audit committee members in performing the duties required to fulfill their obligations to oversee auditors and contribute to enhanced audit effectiveness.

Additional areas to explore

In addition to the areas to explore identified in the consultation paper, there are a few additional areas that we believe would benefit from additional attention. These areas were noted in our covering letter as follows:

Accountability and firm culture

We believe that shared accountabilities enhance audit quality. As audits become more complex, it is not realistic to hold one or two individuals accountable, when many factors affecting quality, such as access to resources, may be beyond their control. Audit quality is a team effort.

To influence accountability and culture, audit partners, managers and staff need to know that audit quality is valued by the audit firm. One way in which audit quality can be emphasized is through making audit quality an important aspect of the evaluation, compensation and promotion of individuals within the audit practice. We encourage additional work in this area of accountability and firm culture and in the area of developing evaluation and compensation systems that reward audit quality.

Balance of professionalism and commercialism

A key to achieving audit quality is resolving the inherent conflict between professionalism and commercialism. If audit committees and other stakeholders do not recognize the value of an audit—seeing it as a controllable cost rather than an important value-added service where quality is a differentiator—it risks becoming a commodity based solely on price. If firms are accepting lower fees in the face of higher risk, then they are implicitly accepting lower margins and lower profitability. We are concerned that audit firms may try to inappropriately maintain profitability

at the expense of audit quality. We encourage additional effort by all stakeholders to investigate this issue further which should include a broader debate about enhancing the value and relevance of the audit.

Relevance of the audit

We support the IAASB's attempt to take a more holistic review of audit quality in an increasingly global, 24/7 interconnected world demanding more real time information. In our view, in addition to the development of the Framework for Audit Quality, the debate on the value and relevance of the audit should be part of a more comprehensive initiative to reform the corporate reporting framework which will require the active involvement of all stakeholders, including policy makers, investors, regulators, standard setters, corporate directors, company management and auditors.