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Dear Arnold

**RE: Invitation to Comment on Enhancing Audit Quality in the Public Interest**

The Investment Association welcomes the opportunity to respond to the IAASB's Invitation to Comment on Enhancing Audit Quality in the Public Interest. The Association represents the UK's investment management industry and has over 200 members that manage more than £5.5 trillion for clients internationally, helping them to achieve their financial goals. Our aim is to make investment better for clients, companies and the economy so that everyone prospers.

In managing assets for clients, our members are major investors in companies whose securities are traded on regulated markets. The annual report and accounts of those companies are an important source of information for them in facilitating their understanding of the business and its drivers, and acting as a foundation for investment decisions. The requirements governing the audit of these accounts and the auditor's report to them are particularly important to them as users.

We support the IAASB's continuing commitment to enhancing audit quality and thus increasing the value and relevance of the audit for users, and welcome it issuing this Invitation to Comment (ITC). Whilst the ITC itself is challenging, being 100 pages long, overall it presents a good discussion that is both informative and educational. Nevertheless we have certain concerns about the issues raised. We set out below our key comments and in the attached our answers to the questions in the overview.

***Timing and content of the ITC.*** The ITC is soliciting comments before proposals on the three projects are drafted. On the basis of our understanding that projects tend to be developed by working parties largely made up of auditors, we support wider stakeholders being given the opportunity to provide input in advance. However, the text and questions in the ITC are quite technical and run the risk of only attracting feedback from the main auditing firms, and may deter other stakeholders. This could limit the benefits of consulting early. We also consider the IAASB should involve a wider group of stakeholders in the standard setting process to facilitate the timely completion of these important projects.

***Professional scepticism.*** Misstatements not only arise from error or fraud, as set out in the ISAs, but also from management seeking to present more favourable results when making estimates and judgements. It is important that the auditor addresses this natural bias and proactively challenges management when exercising scepticism. This should be addressed in the standards. The standards should also explain the risks to scepticism being applied and the safeguards necessary to address those risks. For example, auditors need to manage situations where their scepticism could be impaired.

Moreover, it is vital that any issues identified when management is challenged are followed through until either there is sufficient evidence to allay any concerns or the issues are addressed. This necessitates an audit team that has the time, seniority and skills to probe issues and, as these issues may not have been envisaged when the audit plan was set, an audit fee that allows for this. In this context, as part of the new Extended Form Auditor Report, investors would appreciate more transparency on the changes in audit scope not only from year to year, but also between the initial audit plan and the audit's completion.

***Other factors that impact audit quality.*** We continue to have concerns that the incentive structures within audit firms can tend to focus on the generation of revenues, particularly from non-audit services, rather than audit quality. Thus whilst in recent years there have been pressures on the main players in the capital markets to adopt long term incentive structures, the main auditing firms still operate under a partnership structure that does not impose such constraints. An audit firm's governance and leadership has a vital role in promoting a culture that emphasises the public interest role of the audit and the importance of audit quality. For example, a firms' processes for performance evaluation, compensation and promotion should emphasise the importance of audit quality and that it overrides commercial factors such as generating revenues.

It is also important that audit teams have the appropriate structure and sufficient middle ranking personnel. It requires people of a certain level of seniority to bring together the two ends of the audit (the detailed verification and numbers at one end with the high level judgements at the other) and to exercise scepticism by "kicking the tyres" and probing those in the business to clearly understand whether the numbers genuinely reflect what is happening in practice. This also has implications for the quality of the senior ranks of the audit profession in the future.

We consider that there is too little emphasis on these matters in the ITC.

***Quality control and group audits.*** Current standards do not establish any requirements for quality control at the network level, and yet many of the main audit firms rely on the work of firms within their network when auditing multinational groups. Thus we consider the Quality Management Approach should be applied to an audit firm and its network. In the event this is not possible, then at a minimum the Quality Management Approach should be pursued at the engagement level so that group audits are addressed.

It is also helpful to investors when audit reports provide information about the nature and extent of the involvement of other auditors in group audits. Notwithstanding, it is important that the group engagement partner continues to assume overall responsibility for the audit.

In this context, quality control in group audits needs to be managed more proactively at the group level. This should ensure that the direction, supervision and review of other auditors involved in the audit respond to the risks to audit quality. Such an approach would ensure that the standards address the changing business environment.

I trust that the above and the attached is self-explanatory but please do contact me if you require any clarification of the points in this letter or would like to discuss any issues further.

Yours sincerely

Liz Murrall
Director, Stewardship & Reporting

## THE INVESTMENT ASSOCIATION'S ANSWERS TO THE SPECIFIC QUESTIONS RAISED

The Investment Association's answers to the questions in the overview are set out below.

***G1. Table 1 describes what we believe are the most relevant public interest issues that should be addressed in the context of our projects on professional scepticism, quality control, and group audits. In that context:***
***(a) Are these public interest issues relevant to our work on these topics?***
***(b) Are there other public interest issues relevant to these topics? If so, please describe them and how, in your view, they relate to the specific issues identified.***
***(c) Are there actions you think others need to take, in addition to those by the IAASB, to address the public interest issues identified in your previous answers? If so, what are they and please identify who you think should act.***

The Investment Association agrees that the IAASB has broadly identified the most relevant public interest issues in the context of the projects on professional scepticism, quality control, and group audits. In particular, with IFRS there has been an increase in the number of estimates in accounts and it is vital that auditors exercise scepticism and have processes to ensure quality is managed across the firm when management's assumptions and judgments are assessed. For example, we were surprised by the variations in the numbers reported by different financial institutions in relation to the same instruments, held for the same purpose and valued in accordance with the same accounting policies, even when the institutions concerned had the same auditors. Similarly, we understand from the UK's Audit Quality Review Team that there were situations where conflicting judgments were accepted by the same firm for different clients in the same or similar industries (question G1(a)).

Each issue in Table 1 is important, but we consider there should be one additional public interest issue "enhancing the quality and value of the audit for investors as the primary users" (G1(b)).

The ITC is soliciting comments before proposals on the three projects are drafted. On the basis of our understanding that projects are developed by working parties largely made up of auditors, we agree it is important that wider stakeholders are given the opportunity to provide input in advance. That said, the current process for the development of standards is long and the ITC lengthens it further such that the projects in the ITC may well not be complete before 2018. Moreover, the text and questions in the ITC are quite technical and run the risk of only attracting feedback from the main accounting firms, and may deter other stakeholders. This could limit the benefits of consulting early. We consider the IAASB should involve a wider group of stakeholders in the standard setting process to facilitate the timely completion of these important projects (G1(c)).

***G2. To assist with the development of future work plans, are there other issues and actions (not specific to the topics of professional scepticism, quality control, and group audits) that you believe should be taken into account? If yes, what are they and how should they be prioritized?***

Other than the topics of professional scepticism, quality control and group audits, we consider there are issues around audit firms' remuneration structures and independence that need to be addressed. In particular, we continue to have concerns that the incentive structures that operate within firms tend to be more focused on the generation of revenues rather than audit quality. In recent years there have been pressures on the main players in the capital markets to adopt long term incentive structures and yet the main auditing firms still operate under a partnership structure that does not impose such constraints. There is also a perception that non-audit services can impair audit quality in that the significant revenues generated and the nature of the services can affect auditors' independence and lead them to identify themselves with the interests of management rather than those of investors. We consider that there is too little emphasis on these matters in the ITC.

***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.***

This question is outside the remit of the Investment Association.

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

The ISA definition of professional scepticism is "an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence[1]".

The Investment Association considers that this does not go far enough. In particular, misstatements not only arise from error or fraud, but also from management seeking to present more favourable results when making estimates and judgements. It is important that the auditor addresses this natural bias and proactively challenges management as opposed to simply adopting a questioning mind.

It is vital that any issues identified from this challenge are followed through until either there is sufficient evidence to allay any concerns or the issues are addressed. The audit team needs to have the time, seniority and skills to probe issues and, as these issues may not have been envisaged when the audit plan was set, an audit fee that allows for this. In this context, as part of the new Extended Form Auditor Report, investors would appreciate more transparency on the changes in audit scope not only from year to year, but also between the initial audit plan and the audit's completion.

Moreover, as scepticism is a set of behaviours and is more about how it is applied, it may be helpful to give guidance and examples in the standards as to what types of behaviours and actions constitute appropriate professional scepticism. The standards should also explain the risks to scepticism being applied and the safeguards necessary to address those risks. For example, auditors need to manage situations where their scepticism could be impaired. (In this context, we are aware that certain of our members wrote to the UK's Financial Reporting Council relation to EY's position as auditor of both Shell and BG Group. EY has long been auditor of BG Group and following a tender in May 2015, Shell announced the appointment EY as auditor for 2016. Shell acquired BG Group in early 2016 and these members' concerns are whether EY's objectivity and scepticism may be compromised if, for example, during the course of 2016 a material error in BG's 2014 and 2015 accounts comes to light.)

***PS2. What do you believe are the drivers for, and impediments to, the appropriate application of professional scepticism? What role should we take to enhance those drivers and address those impediments? How should we prioritize the areas discussed in paragraph 37?***

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[1] ISA 200, paragraph 13(l)

For auditors to challenge management and exercise scepticism, we consider it vital that they are independent of management and are objective in undertaking their work. Whilst the areas discussed in paragraph 37 are important to professional scepticism, the ITC gives insufficient attention to the issues of auditor independence and governance. The significant fees from non-audit services and, although it is now being addressed with increased tendering, the long terms auditors can hold office can impair auditor independence and objectivity. It is thus important that an audit firm's leadership and "tone at the top" promotes a culture that reinforces the importance of audit quality. For example, a firms' processes for performance evaluation, compensation and promotion should emphasise the importance of audit quality and that it should override commercial incentives such as generating revenues.

***PS3. What actions should others take to address the factors that inhibit the application of professional scepticism and the actions needed to mitigate them (e.g., the International Accounting Education Standards Board, the International Ethics Board for Accountants, other international or national standards setters, those charged with governance (including audit committee members), firms, or professional accountancy organizations)?***

The Investment Association supports a joint working group being established between the IAASB, IESBA and IAESB. The International Education Standards and IESBA Code each address matters that impact professional scepticism, such as technical competence, professional skills, integrity, objectivity and independence, and it is important that these are considered as a whole. However, we are unclear whether the supervision and enforcement procedures for the IAASB's, IESBA's and IAESB's requirements are harmonised internationally. If not, then this needs to be addressed.

Investors would also welcome audit firms being more transparent as to how they are applying scepticism. The FRC introduced a more discursive audit report, the Extended Form Audit Report, for accounting periods starting on or after 1 October 2012 for companies that are required to apply the FRC's Corporate Governance Code - Premium Listed companies. This required the auditor to disclose certain information on audit scope; audit materiality and risk of misstatement. We are currently in the third reporting cycle under these requirements and are encouraged by the progress. Initially there were quite mixed results but since then there has been more convergence in the matters reported and it is still evolving. In particular, in 2015 certain of the firms went further than the requirements and reported what they found when addressing the risks of material misstatement when their work had resulted in management changing the estimates in the accounts. In addition as noted under PS1 above, investors would appreciate more transparency on the changes in audit scope between the initial audit plan and the audit's completion. These disclosures clearly demonstrate that the auditor challenged management and exercised scepticism. It would be helpful if such reporting were to be promulgated internationally.

***QC1. We support a broader revision of ISQC 1 to include the use of a quality management approach (QMA) as described in paragraphs 51–66.***

***(a) Would use of a QMA help to improve audit quality? If so why, and if not, why? What challenges might there be in restructuring ISQC 1 to facilitate this approach?***
***(b) If ISQC 1 is restructured to require the firm's use of a QMA, in light of the objective of a QMA and the possible elements described in paragraph 65, are there other elements that should be included? If so, what are they?***
***(c) In your view, how might a change to restructure ISQC 1 impact the ISAs, including those addressing quality control at the engagement level?***

***(d) If ISQC 1 is not restructured to require the firm's use of a QMA, how can we address the call for improvements to the standard to deal with differences in the size and nature of a firm or the services it provides?***

The Investment Association supports the Quality Management Approach which identifies and monitors the risks to audit quality. The ITC identifies the critical factors that can impact audit quality that have not necessarily been addressed to date, for example, offshoring, remuneration, governance, business model and transparency. This is very welcome, however, certain of the factors, for example, the remuneration structures and/or governance model of firms are at the end of the section and dealt with relatively briefly. As noted elsewhere in this response, we consider that there needs to be more emphasis on these factors.

In particular, we consider it important that requirements around audit firm governance are strengthened. This has a vital role in promoting a culture that emphasises the public interest role of the audit and the importance of audit quality. The UK has had an Audit Firm Governance Code since 2010 which provides a formal benchmark of good governance practice against which firms that audit listed companies can report for the benefit of investors. Our members invest internationally and want to know how consistency in audit quality is ensured and auditing standards applied globally. Given the importance of the global networks, we would like to see an Audit Firm Governance Code promulgated internationally and applied at the network level.

***QC2. We are also thinking about revising our quality control standards to respond to specific issues about audit quality (see paragraphs 67–83).***
***(a) Would the actions described in paragraphs 68–83 improve audit quality at the firm and engagement level? If not, why?***
***(b) Should we take other actions in the public interest to address the issues in paragraphs 67–83?***
***(c) Should we take action now to tackle other issues? If yes, please describe the actions, why they need priority attention, and the action we should take.***

Whilst we agree that paragraphs 67 to 83 identify the issues that are relevant to ensuring audit quality, we are concerned that current standards do not establish any requirements at the network level, nor do they explain how or to what extent a firm can rely on a network's policies and procedures[2]. Many of the main audit firms rely on the work of firms within their network when auditing multinational groups. To ensure that such groups are subject to a quality audit, we consider that the Quality Management Approach should be applied to the network. In the event this is not possible - as the ITC states this would be likely to be challenging due to the networks' varied structures and policies - then at a minimum the Quality Management Approach should be pursued at the engagement level so that group audits are addressed. We are disappointed this is not covered in the ITC.

In the UK we welcomed the transparency reports that the UK firms publish and the insight they give into the firms' systems of quality control and would welcome these being required internationally. In particular, the main UK audit firms have co-ordinated their approaches to publishing Key Performance Indicators on matters such as the results of their own quality control reviews and those of the FRC's Audit Quality Review Team. These disclosures are helpful and investors would like to see them promulgated internationally.

[2] Paragraph 70.

It is also important that audit teams have the appropriate structure and sufficient middle ranking personnel. It requires people of a certain level of seniority to bring together the two ends of the audit (the detailed verification and numbers at one end with the high level judgements at the other) and to exercise scepticism by "kicking the tyres" and probing those in the business to gain a clear understanding of whether the numbers genuinely reflect what is happening in practice. This also has implications for the quality of the senior ranks of the audit profession in the future.

***GA1. We plan to revise ISA 600 (and other standards as appropriate) to respond to issues with group audits.***
***(a) Should we increase the emphasis in ISA 600 on the need to apply all relevant ISAs in an audit of group financial statements? Will doing so help to achieve the flexibility that is needed to allow for ISA 600 to be more broadly applied and in a wide range of circumstances (see paragraphs 84–97)? If not, please explain why. What else could we do to address the issues set out in this consultation?***
***(b) Would the actions we are exploring in relation to ISA 600 improve the quality of group audits? If not, why?***
***(c) Should we further explore making reference to another auditor in an auditor's report? If yes, how does this impact the auditor's work effort?***
***(d) What else could the IAASB do to address the issues highlighted or other issues of which you are aware? Why do these actions need priority attention?***

The Investment Association supports the introduction of guidance that will increase the emphasis in ISA 600 of the importance of applying all relevant ISAs in a group audit. In this context, mandatory firm rotation is being introduced in Europe with the implementation of the Audit Regulation and Directive. However, Member States are not necessarily implementing the same time periods for rotation and there is an increasing likelihood that group audits will involve firms from outside the group auditor's network. We, therefore, consider it important that the IAASB not only addresses when and how a network firm can be relied on but also firms from outside the network where stronger quality control procedures may be necessary.

It is helpful to investors when audit reports provide information about the nature and extent of the involvement of other auditors in group audits. Notwithstanding, it is important that the group engagement partner continues to assume overall responsibility for the audit.
In summary, we believe that quality control in group audits needs to be managed more proactively at the group engagement level to ensure that the direction, supervision and review of other auditors involved in the audit respond to the risks to audit quality. Such an approach would ensure that the standards address the changing business environment.