

May 7, 2013

Via website posting: <http://www.iaasb.org/>

Re: IAASB Consultation Paper: **A Framework for Audit Quality**

Dear Sir/Madam:

The Certified General Accountants Association of Canada (CGA-Canada) welcomes the opportunity to comment on the IAASB Consultation Paper: **A Framework for Audit Quality**. We have also provided additional comments on certain related matters.

## General Comment

It is recognized that it is intrinsically challenging to define audit quality, and further acknowledge that the debate should be guided by a doctrine of public interest. This naturally requires a balance between the costs and benefits to those concerned. We look forward to the results of the IAASB's consultation and the corresponding reflections that it will stimulate amongst the various stakeholder groups.

## Question 1

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

## Answer

We believe that the Framework is sufficiently comprehensive to encapsulate all the major drivers of audit quality. However, the expanse of the Framework can be enhanced by the insights gained from relevant research in this area.

We note that the term audit quality is not explicitly defined by the IAASB. As a good approximation, we like the definition provided in one study as “the market-assessed joint probability that a given auditor will both (a) discover a breach in the client’s accounting system, and (b) report the breach”<sup>1</sup> As per this definition, higher quality auditing involves a higher probability of detection and reporting of unadjusted misstatements.

Currently, there is little consensus about how to define audit quality, and the various frameworks and disclosures that exist are, for the most part, incomplete. The range of definitions is quite broad because they focus on different attributes of the audit, such as outcomes, process, and

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<sup>1</sup> DeAngelo, L., (1981) “Auditor size and auditor quality”, Journal of Accounting and Economics, December, pp.183-199.

judgments. As a result, stakeholders cannot observe audit quality in its entirety, just the attributes that manifest through the various phases of the audit itself. While regulators demand that audits be conducted in accordance with GAAS, investors and audit committee members may simply demand that audits discover frauds. Therefore, to consider what matters the most for improving audit quality, it is important to keep in mind the attributes of the audit itself: incentives, uncertainty, uniqueness, process, and judgment.

Research has shown that incentives related to auditor tenure, non-audit services, internal firm pressures, and partner compensation can influence auditor decisions in a positive or negative manner. Studies of audit outcomes have shown that uncertainty can manifest in potentially negative ways; i.e., levels of accruals, restatements and the nature of audit reports.

Further, the degree of uniqueness has been shown to manifest with variations in risks, controls, audit procedures and evidence. The audit process attempts to compensate for the uncertainty and uniqueness an auditor faces, but has also been shown to influence audit quality in unforeseen ways. Finally, audit quality is ultimately dependent on the judgment of a team of auditors. A great deal of research has pointed to some of the potential causes of auditor errors, as well as providing insight into compensating factors and techniques for mitigating such errors. Nevertheless, virtually every so-called “audit failure” can be traced to an error in judgment made by the audit team during the course of an engagement, whether made intentionally or otherwise.

In summary, one might conclude that a “high quality” audit is one where there is execution of a well-designed audit process by properly motivated and trained auditors who understand the inherent uncertainty of the audit and appropriately adjust to the unique conditions of the client. In short, all five attributes must be considered when considering whether an audit is high or low quality. It is important to bear in mind that audit quality is a perceived, rather than directly observed, trait since we can only learn about cases when audit quality is compromised (e.g., through the revelation of fraud).

In order to facilitate stakeholder perceptions about audit quality, we believe that a useful strategy is to develop a “balanced scorecard” that captures the key attributes of auditing. The elements of a scorecard could be populated with the drivers of audit quality, as narrated in this IAASB Consultation Paper, as well as relevant research. For example, various studies have documented that some of the factors affecting the perception of audit quality include knowledge of a client, industry experience, audit committee oversight, compliance with auditing standards, audit firm ethics, economic independence of the auditor, rotation of audit partners, and audit inspection.

We also believe that the Framework for audit quality should not be viewed as a static concept but a dynamic road map which should continuously evolve in response to changing business, economic and regulatory environments. It should also continuously improve by an iterative process in light of feedback received from all the stakeholders.

Looking more specifically to the contents of the Consultation Paper, we also suggest that a definition of “smaller entities” be included, making it clear to the reader to whom the classification applies. It would perhaps be appropriate to include the definition as described in the IAASB Handbook. Furthermore, the definition of the audit process included in section 5.2 needs expansion beyond basic acceptance that the audits of these entities are relatively simple and employ audit methodology that tends to not be overly complex. Such simplification may lead to the impression that there is bifurcation within the audit profession between those that perform smaller audits, and those that service listed entities.

## Question 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?*

### Answer

We believe that, although all stakeholders can contribute meaningfully to the promotion of audit quality, it is primarily the responsibility of the auditor to maintain the appropriate level of quality subject to the limitations of the contextual factors and interactions with other stakeholders. We also appreciate that performing audits in today's environment is increasingly challenging because:

- Reporting deadlines are shorter;
- Accounting and auditing standards are more complex and ever-changing;
- Business models and technology are continuously shifting;
- Global business environment remains uncertain; and,
- Experienced human resources are scarce.

We believe that quality begins with setting the proper tone at the top of the organization, and that timely and transparent communication amongst all stakeholders is a necessity. However, these alone are not sufficient conditions for a high quality audit outcome.

We believe that the Framework does an adequate job of narrating the factors contributing and limiting audit quality, as well as reflecting an appropriate balance among the stakeholders in the responsibility for audit quality.

Our overriding concern with the exploration of audit quality is that a balance of the pressures between regulators, standard-setters and the profession be maintained such that the conduct of an audit remains focused on the skill-set required of the auditor, and not contemplate additional clerical components within a working paper file (which only serve to distract the auditors' focus from concentrating on risk in favour of the completion of checklists in order to satisfy inspectors).

## Question 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?*

### Answer

Founded in 1908, the Certified General Accountants Association of Canada (CGA-Canada) is a self-regulating, professional association of 75,000 Certified General Accountants (CGAs) and students in Canada and nearly 100 countries.

As a major Association of professional accountants, CGA-Canada aligns its professional standards with relevant international pronouncements and also pronounces its own professional standards including:

- Code of Ethical Principles and Rules of Conduct
- Independence Standard
- Public Practice Entrance and Continuance Standard
- Public Practice Review Standard
- Continuing Professional Development Standard
- Compliance Standard

CGA-Canada will continue to monitor the development of the Framework for audit quality and introduce best principles and practices in its above-mentioned professional standards as appropriate.

#### **Question 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?*

#### **Answer**

In the following paragraphs, we offer our brief comments on the suggested Areas to Explore, as detailed within Appendix 1 of the Consultation Paper.

- *Establishing global guidance against which audit firms can assess their governance arrangements (refer to page 26).*

Such guidance should not be prescriptive but based on principles so as to accommodate diversity across jurisdictions.

- *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 (refer to page 27).*

It would be efficient to leverage work done by the IAESB for this purpose so that the competencies imparted by the training programs of the professional accounting bodies and competencies evaluated by the recruiting professional accounting firms are aligned.

- *Improving information sharing between audit firms when one firm decides to resign from, or is not reappointed to, an audit engagement (refer to page 30).*

This is an important Input Factor in enhancing audit quality and does require further refinement.

- *Considering whether audit inspection activities can do more to improve audit quality and to make audit quality more transparent to users (refer to page 43).*

We believe that the audit inspection process can, and does, play a very positive role in the improvement of audit quality.

- *Exploring whether there would be value in national authorities responsible for determining sanctions on auditors exchanging information with a view to evaluating the relative effectiveness of their different arrangements (refer to page 43).*

We do see value in exchange of this kind of information among national authorities. In fact, such exchange should be extended to cover other types of regulating activities as well.

- *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 (refer to page 43).*

We support such a proactive approach for enhancing the credibility of the auditing profession.

- *Increasing the informational value of auditor’s reports and improving perceptions of the value of the audit (refer to page 45).*

We agree with the need to increase the informational value of auditor’s reports, but at the same time “maximum information” should not be misconstrued as “optimum information”. Please refer to our response to the IAASB ITC: *Improving The Auditor’s Report*.

- *Achieving improved two-way communication between auditors and financial and prudential regulators, particularly in the financial services sector (refer to page 51).*

We believe that improved communication among the stakeholders leads to better audit quality and, accordingly, we consider this to be an area worth exploring.

- *Striving for greater international harmonization in the role of audit committees with regard to the evaluation of the quality of the external audit (refer to page 57).*

We expect such differences to persist despite efforts for international harmonization because of inherent legal, business, economic and cultural diversity across jurisdictions.

- *Encouraging audit committees to provide more information to users of the financial statements on the work they have undertaken, the main issues they have addressed, and the reasons for their conclusions (refer to page 58).*

We believe that detailed research and consultation is required before initiating any such undertaking.

We likewise would propose that the following additional matters be deliberated:

- Examine how alternate financial reporting frameworks impact the quality of audits within the small-and-medium entity environment; and,
- Undertake a study of how the rigour of complementary professional standards (such as national accounting standards, codes of ethics and rules of professional conduct, and auditor education) impacts audit quality.

We also encourage the IAASB to explore how the Framework for Audit Quality can be adopted by SMPs and SMEs effectively and efficiently in view of their limited resources. We ask the IAASB to consider if the input, output and contextual factors are different with respect to SMPs. The IAASB might likewise consider how the interaction among the stakeholders will be impacted in the SMP/SME environment. We believe that the IAASB should focus on the special circumstances of SMPs to avoid fragmentation of the auditing profession.

## Additional Comments

We believe that the risks of misstatements in the financial statements arise not from what the stakeholders do not know because information is being concealed, but from what they do not know that should be well understood. The best safeguards against such risks are auditor independence and (re)enforced auditing procedures. Hence, we suggest continuous and evidence-based innovation for improving the auditing standards. We believe that the IAASB efforts to improve and refine the *audit-risk standards* will increase audit quality as a result of better risk assessments through a more detailed understanding of the entity and its environment, including its internal control, and improved design and performance of audit procedures to respond to assessed risks of material misstatements. The improved linkage of audit procedures and assessed risks can be expected to result in a greater concentration of audit effort on areas where there is a greater risk of material misstatement.

With respect to the auditors' report, we believe that it is essential to reduce both the actual and perceived information gap as well as the expectation gap. It is important to appreciate that the audit process does not take place in a vacuum. There are various external influences that can impact the ability of auditors to fully and effectively discharge their responsibilities. We note that there is an increasing use of fair value measurement in accounting standards such as IFRS, and therefore increased use of judgement (both by preparers and auditors) in the preparation and audit of financial statements.

This is likely to have a longer term and more significant impact on audit quality because the degree of measurement uncertainty implicit in fair value valuations increases the risk that misstatements in financial statements will occur, whether innocently or as a result of deliberate manipulation by management. It is inevitable that auditors will be expected to detect such misstatements. The ability of the profession to do so will depend on the experience of the members of the engagement team involved in making audit judgements, the level of involvement of the lead audit partner, and the information and techniques they rely upon.

Overall, we commend the efforts of the IAASB to enhance audit quality and taking the first step by releasing this Consultation Paper.

Should you wish to discuss the contents of this comment paper or require further elaboration on any of the items presented herein, please do not hesitate to contact Kamallesh Gosalia at [kgosalia@cga-canada.org](mailto:kgosalia@cga-canada.org) or alternatively the undersigned at [rlefebvre@cga-canada.org](mailto:rlefebvre@cga-canada.org).

Sincerely,



Rock Lefebvre, MBA, CFE, FCIS, FCGA  
Vice-President, Research & Standards