

May 27, 2013

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by electronic submission

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Dear James,

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

We would like to thank you for the opportunity to provide the International Auditing and Assurance Standards Board (IAASB) with our comments on the Consultation Paper “A Framework for Audit Quality” (hereinafter referred to as “the framework”).

We commend the IAASB for having undertaken the very difficult task of addressing the issue of audit quality by developing the framework. Without some understanding of the meaning of audit quality in all of its many facets, it is very difficult for standards setters who provide some of the inputs into audit quality (whether education, ethics or auditing standards setting) to place their activity into an appropriate context. This context is also a prerequisite for the appropriate focus of legislative and regulatory activities of legislators and regulators in relation to auditing and of financial reporting. On the whole, we are very pleased with the framework. Consequently, even though our comments hereafter dwell on those matters with which we take issue, this should not be misunderstood as a lack of support on our part, but rather a reflection of our desire to provide the IAASB with constructive suggestions to further improve an already very good framework.

**page 2/16** to the comment letter to the IAASB dated May 27, 2013

We address in the body of this letter a number of more important or pervasive issues that we have identified. Our responses to the questions posed in the Request of Comments are included in Appendix 1 to this letter. Our detailed comments by paragraph are included in Appendix 2 to this letter.

### **Value of Audits vs. Audit Quality**

Reference to the word “value” or “valuable” in relation to audits is made a number of times in the framework. We believe that the framework needs to clearly distinguish between audit quality and the value of audits. While there are many input factors, interactions, and contextual factors that affect audit quality, the value of audits of financial statements is closely linked to the value of the information contained in financial statements due to the requirements of the applicable financial reporting framework. To use an extreme example to make our point, if the information required to be included in the financial statements by the applicable financial reporting framework were valueless to users, it would still be possible for auditors to perform a high quality audit, but such an audit would have no value to users – even if auditor reporting were to be improved in this respect. There are therefore considerations with respect to the quality of financial reporting standards and hence financial reporting independent of an audit that have an impact on the value of an audit beyond those auditability (measurability) considerations that do have a direct impact on audit quality. On the other hand, it is possible to have reliable financial statements that include information of great value to users, but yet have a poor quality audit of no real (as opposed to perceived) value to users. This demonstrates that the value of audits and audit quality are related, but fundamentally different.

In concept, the quality of the financial reporting framework depends upon both the relevance and understandability of the information it requires to be included in the financial statements, and upon the measurability (auditability) of that information. The latter has a direct impact on audit quality, but the former only has an impact on the quality of financial reporting and hence the value of such financial reporting, which in turn affects the value of having that financial reporting audited, but not the quality of an audit. It may be helpful for the paper to refer to principal-agent theory, which forms the basis for the notion that audits should have value and must therefore be of sufficient quality to yield that value.

page 3/16 to the comment letter to the IAASB dated May 27, 2013

### **Definition of Audit Quality**

We recognize that it is difficult to define audit quality. However, we do believe that it would be helpful to describe what the objective of audit quality ought to be to provide some indication of what audit quality is for and to help delineate the boundaries of the inputs and outputs of audit quality. In this context, it may be helpful to distinguish audit quality in relation to the current objective of audits under ISA 200, as opposed to audit quality issues that may involve a broader scope than an ISA audit as currently defined in ISA 200. It may also be useful to differentiate between objective notions of quality based upon accepted benchmarks vs. subjective notions of audit quality that vary among different stakeholders. We also note that the depiction of audit quality in the framework tends to be static rather than dynamic. It may be useful to convey the dynamic nature of audit quality - that is, notions of audit quality change over time. In particular, there is an interaction over time between the expectations of users of audits and standards or laws governing audits that causes perceptions of audit quality to change over time.

### **Costs and Benefits**

We note that the framework addresses the issue of costs on a number of occasions in passing, but we believe that the issue of costs (including the potential cost of litigation) and benefits is central to a discussion of audit quality, and therefore requires greater emphasis up front. All other things being equal, greater quality generally implies greater cost. Of course, recognition can be given to audit process improvements that may mitigate this relationship somewhat. However, society needs to make decisions about the proportion of its resources devoted to audits (and its inputs) as opposed to other activities based upon the net benefits (i.e., the value after considering opportunity costs) it expects from audits. Without considering costs and benefits of audits and the central role of these in audit quality, the discussion in the framework about audit quality takes place in an economic vacuum.

### **Scope of the Framework**

Upon reading the framework, there appears to be an underlying assumption that it applies primarily to audits of complete sets of general purpose financial statements – as opposed to audits of special purpose financial statements or audits of single financial statements or elements of these. We believe that the framework needs to be clear about its scope near the beginning. We also note

**page 4/16** to the comment letter to the IAASB dated May 27, 2013

that the framework is not consistent in its use of “in accordance with the financial reporting framework”, “fair presentation in accordance with the financial reporting framework”, and “fair presentation”. While it is true that the majority of audits of complete sets of general purpose financial statements relate to financial statements prepared using fair presentation frameworks, this is often not the case. Furthermore, with the possible exception of the U.K., “fair presentation” or “true and fair view” is never used (and not in the ISAs) without reference to the applicable financial reporting framework. We therefore suggest that either the scope of the framework be clarified that it applies only to fair presentation frameworks, or that references to “fair presentation” be removed. If the former is preferred, then “fair presentation” should not be used without reference to the applicable financial reporting framework.

### **Audit Quality Outputs Other than Reporting**

In paragraphs 163 and 158, the framework addresses some aspects of audit quality outputs other than audit reporting. We believe that improvements in financial reporting and internal control over financial reporting are the outputs of greatest audit quality impact. We believe that not enough emphasis has been placed on the auditor’s role in assisting management, as part of the audit process, in improving financial reporting and internal control over financial reporting, and some of the other byproducts. These improvements include:

- Improved internal control over financial reporting
- Reduced incidence of misstatements in the financial statements after audits
- Improvements in the choice and application of accounting policies
- Improvements in accounting estimates within their reasonable range, and in their disclosure
- Improvements in the quality of disclosures in the financial statements
- Improvements in other information containing the financial statements due to the correction of material inconsistencies and material misstatements of fact
- Improved management accounting in relation to, and internal control over, business processes
- Improved oversight by those charged with governance over financial reporting and management decision-making

**page 5/16** to the comment letter to the IAASB dated May 27, 2013

The study undertaken by the University of Duisburg-Essen on behalf of the European Commission in 2009 showed that audits have a positive impact in these areas.

**Neutrality with Respect to Governance Structures**

Some of the assertions made in the framework related to those charged with governance, or audit committees, tend to be associated with single-board systems of governance, rather than the two-tier system prevalent in a number of central European countries, including Germany. We note these instances in our comments by paragraph.

We hope you find our comments useful and would be very pleased to have the opportunity to discuss our comments with you and to provide any additional clarifications about our views to you.

Yours truly,



Klaus-Peter Feld  
Executive Director

Wolfgang P. Böhm  
Director Assurance Standards,  
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page 6/16 to the comment letter to the IAASB dated May 27, 2013

## **APPENDIX 1: Responses to the Questions Posed In the Framework**

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

We believe that the framework covers all areas of audit quality, but it should emphasize the unseen outputs more (see our letter on audit quality outputs other than reporting). Additional issues related to audit quality (value of audits, costs and benefits) should also be addressed.

**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?**

Overall, we believe that the appropriate balance in responsibility has been achieved.

**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?**

We may refer to the framework when considering the quality aspects in the development of auditing and assurance standards. The changes that we propose to the content and form in our letter and our comments by paragraph would increase the value of the framework to us.

**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 that on the whole the suggested areas to explore are a useful pointer to areas that need further attention internationally.

**page 7/16** to the comment letter to the IAASB dated May 27, 2013

In terms of additional areas to explore, we believe that the interactions between those charged with governance and regulators are a matter that ought to be subject to further exploration. In addition, we also believe that interactions between those charged with governance and financial statement users is a matter that ought to be subject to further exploration. We also believe that in the further exploration of the role of those charged with governance, priority should be given to considering having those charged with governance (and in one-tier board systems, the non-executive directors) responsible for engaging auditors. It may also be useful to explore the difference between the value of an audit and audit quality, as well as the impact of financial reporting standards on both.

These matters require attention by auditing standards setters, regulators, legislators, audit firms, and preparers.

#### **Other Questions Posed on the Request for Comments**

- A. In particular, the IAASB is seeking views on whether the Framework is clear, comprehensive and useful.**

With the exception of the matters noted in our letter and in our comments by paragraph, we believe that the framework is clear, comprehensive and useful. However, it may be helpful to have the framework include an executive summary at the beginning for readers who prefer not to wade through the entire document.

- B. The IAASB welcomes views on whether international collaboration in these areas [Areas to Explore] would be fruitful and whether there are other areas that need to be explored internationally to improve audit quality.**

We do believe that international cooperation on areas to explore would be useful. We note some additional areas to explore in our response to Question 4.

page 8/16 to the comment letter to the IAASB dated May 27, 2013

## APPENDIX 2: Comments by Paragraph

### Forward from the IAASB Chair

The second last bullet point of the third paragraph refers to “valuable reports”. As we point out in our general comments and our response to Question 1, the framework needs to clearly distinguish “value” from “quality”. On this basis, we are not convinced that the reference to “valuable” is appropriate.

This issue of value vs. quality becomes important when considering the role of the framework in the bullet points of the second last paragraph. The framework should also serve to clarify the difference between quality and value and thereby indicate the impact of the quality of financial reporting standards on financial reporting quality and hence on the value of financial reporting, which in turn has an impact on the value of audits. Consequently, the bullet point list needs to be augmented with a reference to the framework serving to prompt a discussion on the relationship between high quality financial reporting standards and the value of audits.

### The Framework for Audit Quality

1. In line with our comments in the letter on the scope of the framework, we note that the use of the word “usually” at the beginning of the first sentence to be too strong – we suggest replacing it with “often”. In addition, the following words need to be added to the end of this sentence: “in accordance with the applicable financial reporting framework”.
4. In line with usage in most places in the framework the word “appropriate” prior to “judgment” should be replaced with “reasonable” because judgments can be reasonable or unreasonable, but by their nature there may be a lack of suitable criteria to determine appropriateness. We note that the qualities of perseverance and robustness do not appear to be directly addressed elsewhere in the framework: perhaps the concepts need further treatment, or they are covered by other concepts, which then implies the need to make this paragraph consistent with the rest of the framework.

**page 9/16** to the comment letter to the IAASB dated May 27, 2013

8. The reference to the failure to identify material misstatements as a result of the overall audit model could be misinterpreted to mean that the current audit model is deficient and needs changing. We suggest that reference be made to the inherent limitations of audits instead.
10. The words “could be” in the last sentence need to be replaced with “are” because one is dealing with the “risks that the financial statements … are materially misstated”, not that they “could be”, which doubles up on the risk threshold.
11. While we agree with the assertions made in this paragraph, the relationship between this paragraph and paragraph 10 is unclear and the information in paragraph 11 does not appear to relate to the heading for these two paragraphs. Either the link between the two paragraphs needs improving, or paragraph 11 needs to be in a separate section.
21. The word “by” should be inserted after the word “and” in the first sentence because the framework does not apply to audits “of all audit firms”.
30. In the table, attribute 1.2.3 refers to “Financial considerations do not drive actions and decisions that may have a negative impact on audit quality”. We believe this statement to be misleading because audits are conceived within the context of the value of the information that they provide, which means that the costs of audits and the timing of audit reporting is a prime consideration – auditors therefore do not – and should not – have unlimited time or resources to perform audits. By definition, accepting potentially lower audit quality is inherent to the performance of an audit without unlimited time or resources. The attribute should therefore be phrased as follows: “Financial considerations do not drive actions and decisions that may reduce audit quality to an unacceptable level.”

In relation to the attributes in 1.6, we note that having education requirements that are clearly defined and that training is adequately resourced as posited in 1.6.2 is a necessary – but not sufficient condition – in relation to the quality of auditor education. It is also important that the educational system actually delivers the requirements defined with the resources put at its disposal. We therefore suggest the addition of the following additional attribute thereafter: “The education system achieves the educational requirements defined.”

In line with our comments in our letter on audit quality outputs other than reporting, item 2 on outputs, and in particular 2.1.5 could be emphasized further and expanded.

**page 10/16** to the comment letter to the IAASB dated May 27, 2013

31. Our analysis of this section suggests that the framework does not clarify the relationship between 1. values ethics and attitudes, 2. knowledge experience and time, and 3. audit process and quality control procedures. In particular we note that the items 2 and 3 are in fact rooted in values, ethics and attitudes. For example, the ethical requirement for professional competence forms the basis for the educational requirements (both IPD and CPD) relating to competence – both in terms of knowledge and experience. Likewise, the ethical requirement for due care forms the basis for the requirements in relation to audit process and quality control. On this basis, the requirement in relation to “time” actually relates to due care and belongs under audit process and quality control procedures, rather than being grouped together with knowledge and experience.
34. The second sentence does not logically follow the first because providing an appropriate degree of challenge is an issue related to professional skepticism, whereas the reference to the interest of stakeholders and the wider public interest in the first sentence only implies that the auditor needs to consider those interests in performing the audit, which may include, among other matters, maintaining an attitude of professional skepticism, but this is not supported by the argument posed.
36. Unless the IAASB is able to determine items in the financial statements that can be recognized and measured with absolute certainty, the word “few” in the second sentence should be changed to “no”. In any case, this sentence ought to make reference to recognition as well as measurement. We do not believe that auditors have a responsibility to reduce the risk of management making biased judgments or otherwise following inappropriate accounting practice unless these lead to material misstatements, which are covered in the first part of the sentence. For this reason, the final phrase beginning with “making” can be deleted.
38. We do not believe that independence relates to the ability to exercise professional judgment alone: it also relates to objectivity and integrity when no professional judgment needs to be exercised. For this reason, we suggest that the reference to professional judgment in the first sentence ought to be deleted. We also believe that auditors are capable of acting objectively and with integrity even when independence in fact is compromised. For this reason, the word “allowing” is not appropriate. Therefore, we believe that the words “allowing them to act with integrity and exercise” ought to be replaced with “fostering integrity and the exercise of”.

**page 11/16** to the comment letter to the IAASB dated May 27, 2013

41. Auditors do not respond to business risks: they respond to misstatement risks that result from business risks. Hence, the words “business risks” in the last sentence should be replaced with “risks of material misstatement”.
44. The closing phrase after “confidence” should read “whether an entity’s financial statements are fairly presented in accordance with the financial reporting framework”.
46. We believe there can be no difference between the long-term interests of the firms and the public interest. For this reason, in the last sentence we suggest inserting “and long term interests of the firm” after the words “public interest” and inserting the words “short term” prior to “commercial”.
47. In relation to the first bullet point, it is unclear to us how governance arrangements “establish independence”. In relation to the second bullet point, in line with our comments on paragraph 30 attribute 1.2.3, we believe this bullet point should read: “Financial considerations do not drive actions and decisions that may reduce audit quality to an unacceptable level.”
49. It is unclear to us how promoting other practice areas would be to the detriment of audit quality unless it involved reducing the resources available for the audit practice area. We suggest that the wording be changed to read “... by inappropriately reducing the resources available for the audit practice area to the benefit of other practice areas (such as tax....)....” .
52. We refer to our comments on attribute 1.2.3 for paragraph 30 and our comment on paragraph 47. We agree with the statements made in this paragraph, but believe that the paragraph is incomplete unless it closes with the following sentence: “However, the cost of additional assurance needs to be worth the benefit of that assurance obtained by the auditor.”
53. The reference to reductions in audit quality in each of the bullet points could be deleted and the phrase “at the expense of audit quality” added at the end after the bullet points.
68. In line with our comment on paragraph 31, it seems to us that the first three bullet points are ethical issues, whereas the fourth to seventh bullet points are audit process issues.
75. Auditors make a very large number of judgments on even small simple audits. The bullet point list therefore seems disproportionate for all of the judgments that auditors make. The bullet point list appears to be more

**page 12/16** to the comment letter to the IAASB dated May 27, 2013

appropriate for significant judgments in relation to significant matters (see ISA 230). For this reason, we suggest changing the introductory words to state “Making reasonable significant judgments in relation to significant matters involves...”.

80. Since auditors respond to risks of material misstatement, we suggest that “business risks” be changed to “risks of material misstatement”. In relation to the last sentence, we believe that the provisions for the rotation of key audit partners by the IESBA Code is supposed to provide an adequate safeguard against other members of the engagement team not having adequate professional skepticism or independence of mind. We therefore suggest adding a sentence to this effect at the end of this paragraph.
82. Reference is made at the end of the second last sentence to reduced testing. However, cost pressure may not just lead to reduced testing: it may also cause the auditor to change the nature or timing of audit procedure to those that are less costly. We therefore suggest that reference also be made to these.
95. In line with our comments on paragraph 31 attribute 1.6, we suggest that an additional bullet point after the second be inserted that reads: “The education system achieves the educational requirements defined.”
96. The backslash should be changed to an “or” and the word “persons” to “individuals” since persons can also refer to organizations that are legal persons.
99. In line with footnote 1, the word “country” should be replaced with “jurisdiction”.
106. A bullet point should be added that refers to the acquisition of sufficient appropriate audit evidence.
107. In many jurisdictions, voluntary audits are not regulated, and the number of voluntary audits exceeds the number of statutory ones. For this reason, we suggest that the word “usually” in the first sentence be replaced with “often”.
118. Audit methodologies should not only evolve with changing professional standards, but also in reaction to changes in business processes and the environment. We suggest that the first sentence reflect this thought.
123. The words “of the” can be deleted. The reference to “offshore” has a U.K. ring to it: the word should be replaced with “elsewhere”.

**page 13/16** to the comment letter to the IAASB dated May 27, 2013

124. In line with footnote 1, the word “country” should be replaced with “jurisdiction”.
126. In line with our comment on paragraph 75, we suggest replacing the word “an” with “significant” and inserting the words “in relation to a significant matter” after the first use of the word “judgment”.
130. What is the difference between an external review and an inspection?
131. If systemic issues have been revealed by internal or external monitoring activities, there is no need for firms to identify them. We therefore suggest that the word “identify” be replaced with “take appropriate action” and that these words be deleted from the end of the sentence.
136. IFAC does NOT require adoption AND implementation. We suggest that the IAASB refer to the latest SMOs to determine what IFAC requires.
138. We believe that it is important that inspections focus on appropriate risk assessment and risk response by auditors, rather than focusing on formalities. Research suggests that focusing on formalities actually causes dysfunctional effects that reduce audit quality. This issue needs to be addressed in the paragraph.
140. The word “most” should be replaced with “more” to avoid exaggeration.
146. In Areas to Explore 6, we suggest that the word “best” be replaced with “good”, because the term “best practices” is widely misunderstood.
148. In relation to this paragraph and section 2.1.5, we refer to our comments in our letter on audit quality outputs other than reporting.
153. For the second sentence, we note that the value of the signal may also be affected by the reputation of the profession as a whole: we therefore suggest adding this thought to the second sentence.
155. We suggest that the words “or the terms of engagement” be added at the end of the first sentence, because assurance conclusions on other information can also be provided under the terms of engagement even when law or regulation do not provide for this.
184. By using the term “including the audit committee”, this paragraph presumes that all governance structures have an audit committee, which is not the case – particularly in jurisdictions with a two tier board. We suggest that this be taken into account.

**page 14/16** to the comment letter to the IAASB dated May 27, 2013

186. Reference needs to be made to the auditor's duty of confidentiality and how this may affect the ability of the auditor to respond to questions posed by shareholders.
190. Since auditors do not "provide" assurance, we suggest that the word "conclusions" be inserted after the word "assurance" in the third sentence.
196. This paragraph appears to be confusing audit quality and financial reporting quality – the latter relates to the value of an audit, rather than audit quality. Please note our comments on this issue in the letter.
200. This paragraph only touts the advantages of interactions between management and financial statement users. However, we note that there may also be some disadvantages, e.g., management may use these interactions to place a positive spin on negative matters. The paragraph should be more balanced in this respect.
202. We believe that the interactions between those charged with governance and regulators is a matter that ought to be subject to further exploration.
204. We believe that interactions between those charged with governance and financial statement users is a matter that ought to be subject to further exploration. By using the term "including the audit committee", this paragraph presumes that all governance structures have an audit committee, which is not the case – particularly in jurisdictions with a two tier board. We suggest that this be taken into account. For this reason, we also suggest that the words "audit committee" be replaced with "those charged with governance" in the last sentence.
206. We would like to point out that entities that are not publicly listed obtain capital from the capital market – but not from offerings to the public. We suggest that the words "from capital markets" at the end of the first sentence be replaced with "from offering securities to the public".
207. Does the reference to "audit risk" actually relate to "the risk of material misstatement"?
214. Given the discussion of enforcement in paragraph 213, we suggest adding the phrase "unless compliance is rigorously enforced" at the end of the first sentence.
218. In this paragraph, the distinction between the audit quality and the value of audits may be helpful. In the final bullet point, the word "judgments" should be replaced with "treatments", since evidence is required not only for judgments.

**page 15/16** to the comment letter to the IAASB dated May 27, 2013

223. The word “typically” in the second sentence is not in line with the definition of an internal audit function under ISA 610 and should therefore be deleted. In countries with a two tier board system, the internal audit function rarely reports to those charged with governance or the audit committee. Therefore in the last sentence, the word “often” should be replaced with “may” and the term “audit committees” replaced with “those charged with governance”.
224. The assertions about audit committees do not apply to two tier board systems. We therefore suggest that the term “audit committee(s)” be replaced with “those charged with governance”.
225. The assertion about audit committees does not apply to two tier board systems. We therefore suggest that the term “audit committee” be replaced with “those charged with governance”. This also applies to the area to explore 9. In relation to the area to explore 9, we believe it would be worth exploring having those charged with governance (and in one-tier board systems, the non-executive directors) responsible for engaging the auditor.
228. The moment matters are disclosed in the financial statements, the systems providing that information within an entity become a part of the accounting system and therefore subject to internal control over financial reporting. For this reason, we suggest that the wording at the end of the second sentence be changed to read “...discrete activity or from systems that are not normally a part of the accounting system”.
229. In a two tier board system, internal audit provides assurance to management – not those charged with governance. Those charged with governance obtain assurance conclusions from external auditors. We suggest that this paragraph be rewritten to reflect this.
233. We believe that even if auditors are comfortable with financial results in preliminary announcements due to their involvement, the assertion in the last sentence still applies that management would be resistant to the adjustment of misstatements identified by the auditor after the preliminary results have been released – in fact, even more so because the auditor was involved with the preliminary release and was comfortable with it. For this reason, we are not convinced that the argument made in this paragraph is valid.

**page 16/16** to the comment letter to the IAASB dated May 27, 2013

- 240. The last sentence criticizes conservatism, but this is unbalanced without adding a criticism of risk-taking, which will have the same impact – only in the other direction.
- 253. The title “Considerations Specific to Audits of Smaller Entities” is misleading because there are small publicly listed enterprises or small complex enterprises. Likewise, some fairly large entities are fairly simple. For this reason we suggest referring to “small and medium-sized entities” and then drawing on the description of these from ISA 200.
- 264. We note our comment on the heading in paragraph 253 and therefore suggest that reference be made to entities other than small and medium-sized entities, rather than to “larger entities” as long as our suggestion is followed that the description of the former from ISA 200 is drawn upon.
- 265. We disagree with the assertion in the final sentence: it is not at all unusual for SMEs to provide annual, monthly or quarterly unaudited financial statements to banks and other providers of capital and that later the audit of the annual financial statements is completed.

## **Appendix 1**

- 6. We suggest that the term “best practices” be replaced with “good practice” because the term “best practices” is often misunderstood.
- 7. We note our comments in our letter on the need to differentiate between the value of an audit and audit quality.
- 9. The reference here should be to harmonizing the role of those charged with governance (rather than just the audit committee). We also believe that having those charged with governance responsible (and in one-tier board systems, the non-executive directors) for engaging the auditor ought to be explored.